



**International Federation of Accountants**

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## Agenda Item

# K

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** London

**Meeting Date:** September 20-21, 2007

### **ED-ISA 540 (Revised and Redrafted), “Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”**

#### **Objectives of Agenda Item**

To review a summary of significant comments on ED-ISA 540 (Revised and Redrafted), “Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures” and the Task Force’s recommendations.

The IAASB will consider the summary of significant comments and the Task Force’s recommendations, and the proposed ISA at its September meeting. **Approval of the final ISA is planned for the December IAASB meeting.**

#### **IAASB Task Force**

The IAASB Task Force members are: Philip Ashton (Chairman); Jon Grant; and Randy Noonan.

#### **Background**

The IAASB commenced this project in response to developments that indicated a need to revise extant ISA 540, “Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures.” Research undertaken by the United Kingdom’s Auditing Practices Board (UK APB) has highlighted that management may be motivated to choose accounting estimates that affect the carrying amount of assets or liabilities as a means of managing earnings. Such motivation may result in financial statements that lack neutrality, or freedom from bias. In light of this, the IAASB approved a project to revise extant ISA 540.

In December 2004, the IAASB issued an exposure draft of proposed ISA 540 (Revised). The IAASB gave due consideration to the comments received on the proposed ISA and also consulted further with the IAASB Consultative Advisory Group. The IAASB approved the close off version of ISA 540 (Revised) in September 2006. The IAASB asked that the task force redraft ISA 540 (Revised) in accordance with the clarity drafting conventions, together with the necessary revisions such that matters of continuing relevance in ISA 545, “Auditing Fair Value Measurements and Disclosures,” are incorporated in one combined ISA dealing with the audit of accounting estimates, including fair value accounting estimates.

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ED-ISA 540 was issued in December 2006. The comment date was April 30, 2007. Forty-four comment letters were received. (ED-ISA 540 and the comment letters are available at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0069>).

#### **Significant Comments**

A significant majority of respondents expressed support of the IAASB's decision to combine the close off document of ISA 540 (Revised) with extant ISA 545, "Auditing Fair Value Measurements and Disclosures." Respondents concurred that the principles for auditing estimates should be consistent regardless of the basis of measurement. Many respondents specifically commented that the requirements of the proposed ISA were applicable to both accounting estimates and fair value accounting estimates. Significant comments relating to matters identified for the Representatives' consideration are summarized below. The Task Force's recommendations follow each significant comment.

#### **COVERAGE OF FAIR VALUE AUDITING ISSUES, INCLUDING DISCLOSURES**

1. A few respondents were of the view that the proposed ISA does not sufficiently address the additional audit requirements that are necessary to audit fair value estimates and that the ISA should be expanded to cover more fair-value-specific topics. With the exception of one request for a new requirement, these respondents did not indicate that the requirements set forth in the ED were lacking, rather, they requested additional application and other explanatory material to expand upon matters which they believed were important.
2. These respondents suggested that the proposed ISA should provide more guidance on the auditing procedures for addressing relevant controls surrounding fair value estimates, such as independent model validation and price verification processes, as well as greater emphasis to be placed on auditing the valuation methods used to arrive at fair value estimates.
3. These respondents requested additional application material covering the auditor's consideration of models used for valuation of estimates. They were of the view that such material should cover whether these are models which are generally accepted by and frequently used in the respective industry, or whether these models are self-developed by the entity and particular / specific to it. If the models are self-developed, respondents suggested additional guidance could be included on the assessment of the adequacy of controls around such models.
4. It should be recognized, however, that the above views represent only a small segment of the population of respondents, and that the majority of respondents did not find the ISA to be lacking. Further, in contrast to the above, one respondent was of the view that the proposed ISA strikes an appropriate balance between setting out different procedures for the auditor to perform and allowing the auditor to determine the nature, timing and extent of those procedures after considering factors such as the nature of the estimate and the risk of material misstatement. Another respondent also noted that in the context of a standard on accounting estimates and fair value accounting estimates which is to be applicable globally in virtually all

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engagements, it should not be a priority of the IAASB to develop additional application guidance at this point to cover the needs of the banking and insurance industries.

5. At the June IAASB CAG Meeting, the Representatives from the Basel Committee on Banking Supervision shared their response to ED-ISA 540 with the Representatives as part of the IAASB Strategy discussion. It was the view of these Representatives that the IAASB should develop guidance on valuation models in the form of a practice statement or other publication outside of an ISA. The IAASB was encouraged to draw upon expertise of major market participants (banks, investment banks, and insurance), audit firms, regulators, academics, controls experts to see if there are other ways in which the guidance which summarizes for auditors the nature of the modeling process and how it translates into valuation can be created to enhance audit quality. Other Representatives were of the view that coordination with the IASB and FASB would be essential in order to minimize duplication between the various standard setters, with the caveat that any guidance created by the IAASB should be auditing specific.
6. To this point, respondents to the exposure draft had suggested that certain International Auditing Practice Statements, e.g., IAPS 1012, "Auditing Derivative Financial Instruments," are likely to require amendment.

#### *Task Force's Recommendation(s)*

7. The Task Force accepts the point that fair values based on non-observable data/modeling are complex and have high estimation uncertainty. Indeed, many such fair value accounting estimates may be assessed as significant risks for audit purposes. Accordingly, it is essential that the ISA ensures that its principles-based requirements have appropriate guidance to support application in the context of such fair value estimates.
8. However, the challenge is addressing this within the proposed ISA while keeping an appropriate balance between regular estimates and fair values, length and complexity and understandability, and presenting material appropriate for broad application as an international standard.
9. The Task Force has added new application material as requested, within the following parameters / to the extent that:
  - It is not industry specific (except perhaps as an example);
  - It is not model or framework specific;
  - It is not assets specific (e.g., financial instruments, except perhaps as an example);
  - It is not duplicative in principle with material already contained elsewhere;
  - It does not upset the overall balance / readability of the ISA; and
  - The ISA remains principles based after incorporating this new material.
10. **See paragraphs 14-19 of Agenda Item K.1 for a detailed discussion of the Task Force's recommendations. Note that this Agenda Item makes reference to Agenda Item 6-B of the**

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***September IAASB meeting material (Agenda Item K.2 of the September IAASB CAG meeting material) to illustrate the proposed changes to the ISA as a result of these recommendations.***

11. With regard to the request for a practice statement or other form of guidance outside of the ISA, the Task Force recommends that the IAASB consider the demand for such a revision in conjunction with its Strategy and Future Work Program for the period 2009-2011. The Task Force believes the IAASB should consider involving those most concerned in a project to develop further guidance, such as an IAPS (or possible revision to IAPS 1012), in order to address the concerns that the standard require more specificity.

#### **Matters for Consideration by the IAASB CAG:**

- 1. Do the Representatives agree with the basis for direction taken as set out in paragraphs 7-8 above?**
- 2. Do the Representatives agree that the changes proposed by the Task Force are considered adequately responsive to the comments of those respondents that felt more is needed with respect to fair values, while remaining true to the concept that an ISA should be applicable globally in virtually all engagements?**

#### OTHER SIGNIFICANT COMMENTS

12. ***See Agenda Item K.1 for other significant comments identified by the Task Force:***

- The use of an expert – paragraphs 24-32 of Agenda Item K.1
- The objective of the ISA and the auditor's responsibilities regarding disclosures – paragraphs 33-41 of Agenda Item K.1
- Responses to the assessed risks of material misstatement – paragraphs 42-46 of Agenda Item K.1
- Completeness and validity of accounting estimates – paragraphs 47-48 of Agenda Item K.1
- Estimation Uncertainty – paragraphs 49-50 of Agenda Item K.1
- Documentation – paragraphs 51-53 of Agenda Item K.1

#### **Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY**

Agenda Item K.1	Summary of Significant Comments on ED-ISA 540 (Revised and Redrafted) – <b><i>Agenda Item 6-A of the September IAASB meeting material</i></b>
Agenda Item K.2	Proposed ISA 540 (Revised and Redrafted) – MARK-UP – <b><i>Agenda Item 6-B of the September IAASB meeting material</i></b>

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### **Action Requested**

The IAASB CAG is asked to review the significant comments on ED-ISA 540 highlighted in this paper, and to comment on the Task Force's proposed recommendations.