

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item **B.1**

Committee: IAASB Consultative Advisory Group

Meeting Location: Basel

Meeting Date: March 3-4, 2008

Report Back—Accounting Estimates

Objectives of Agenda Item

1. The objective of this Agenda Item is:
 - (a) To provide a brief report back on the proposals of Representatives on the proposed final ISA 540 (Revised and Redrafted),¹ discussed at the September 20-21, 2007 CAG meeting; and
 - (b) To provide an update on significant decisions at the December 10-14, 2007 IAASB meeting.
2. The IAASB approved ISA 540 (Revised and Redrafted) as a final standard at the December 10-14, 2007 IAASB meeting. The Public Interest Oversight Board has confirmed that due process was followed in developing the standard; the final standard was published on the IAASB's website on February 13, 2008.
3. As a separate initiative, the IAASB and interested parties are exploring whether and, if so, how the IAASB should supplement the ISAs with implementation guidance on auditing fair value estimates. See Agenda Item I.

Report Back – September 20-21, 2007 CAG Proposals

4. Below are extracts from the minutes of the September 20-21, 2007 CAG meeting² related to the discussion of the proposed final ISA 540 (Revised and Redrafted), and an indication of how the IAASB Task Force or the IAASB responded to the Representatives' comments.

Representatives' Comments	IAASB Task Force response / IAASB response
ADDITIONAL APPLICATION MATERIAL	
Mr. Gutterman reported that, with the exception of one member, the IAASB CAG Working Group is	Representatives' comments were supportive in this area.

¹ ISA 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures."

² The minutes will be approved at the March 2008 IAASB CAG meeting.

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.1

Report Back—Accounting Estimates

Representatives' Comments	IAASB Task Force response / IAASB response
satisfied with the manner in which ISAs 540 and 545 have been brought together and with the additional application material. While the text may be a little repetitious in places, this is not a significant problem and it would not be practical to try to change the structure at this stage to address it. Mr. Krantz agreed that the additional application material appears appropriate. Mr. Damant observed that the application material was not unnecessarily onerous. The additions were very much in the right direction, and the resulting text appears to have the right balance.	
Mr. Morris noted that, as the dissenting member of the Working Group, he disagrees with combining ISAs 540 and 545 because fair value estimates are more complex than, and have a different set of issues from, more straightforward accounting estimates such as provisions for litigation claims and obsolescence. He believed that putting the two topics together makes the combined ISA more complex than it needs to be.	The majority of respondents to the exposure draft supported the combination of ISAs 540 and ISA 545, and the IAASB agreed. As such, this comment is noted but was not re-deliberated by the Task Force or the IAASB.
Ms. Blomme noted that there is a great deal of new material, which FEE has not yet reviewed in detail because of time constraints. Because of the diversity of views at FEE, she was not in a position to conclude on the appropriateness of the additional application material at this stage. Some people at FEE thought that the extent of material is too great for SME audits. Others, however, thought that, while modeling is a relevant issue, other issues such as credit risk and actuarial assumptions could also be addressed.	At the meeting, Mr. Ashton responded that the Task Force believes that the application material has gone as far as generic guidance can go and that it will work for a good range of situations, e.g., insurance, long-term construction contracts, and extractive industries.
Mr. Pickeur supported the additions to the paragraph dealing with matters that the auditor may consider in testing a model, which he noted were in line with the submission of the Basel Committee on Banking Supervision.	Representative's comments were supportive in this area.
Ms. Sucher supported the manner in which ISAs 540	Paragraphs 19 and 20 of ISA 540 (Revised and

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.1

Report Back—Accounting Estimates

Representatives' Comments	IAASB Task Force response / IAASB response
and 545 have been brought together and the criteria used by the Task Force for adding new application material; in particular she agreed with the criteria that industry specific material should not be added except when used as an example. She noted that fair value and other estimates are a key risk area that regulators deal with, and was pleased that the Task Force has taken on board the comments in the submission of the Basel Committee on Banking Supervision in a non-industry specific way. She also noted that commentators on the exposure draft generally supported combining ISAs 540 and 545 as the issues are largely the same. Ms. McEnally agreed with this comment. She questioned whether the application material could say more about auditing disclosures, which will become more important as the accounting framework develops and changes. Mr. Damant agreed with this point.	Redrafted) require the auditor to obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework, and, for accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in context of the applicable financial reporting framework. Paragraphs A120-A123 provide guidance for the application of these requirements, including examples of some of the disclosures required by IFRS 7. The Task Force was of the view that the restructuring of the ISA to include a separate section dealing with requirements (and application and other explanatory material) related to disclosures of accounting estimates adequately emphasizes the significance of disclosures especially in relation to fair values. Additionally, the IAASB believes this will ensure that auditors are mindful that the same audit considerations apply both to accounting estimates disclosed in the notes to the financial statements and those that are recorded in the financial statements.
Mr. Sekiguchi questioned whether the linkages between asset valuation and capital and risk were adequately covered in the ISA, and suggested that the ISA include the concept of risk management.	The guidance in paragraph A17 of the exposure draft has been expanded to note: <i>"In other cases, where management's process is more structured, for example, when management has a formal risk management function, the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary."</i> (See ISA 540 (Revised and Redrafted).)
WORKING GROUP TO DEVELOP FURTHER GUIDANCE	
Mr. Damant sought feedback on the suggestion that the IAASB consider forming a working group to	At the meeting, Mr. Kellas noted that demand for a working group had been expected given

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.1

Report Back—Accounting Estimates

Representatives' Comments	IAASB Task Force response / IAASB response
develop further guidance, such as an International Auditing Practice Statement (IAPS), if not a further ISA, in order to address concerns that the standard requires more specificity.	developments in the financial markets ... However, the IAASB can only deal with audit issues ... To this end, the IAASB will likely be able to “sponsor” a working group ... See response below.
Messrs. Gutterman, Hegarty, Krantz and Pickeur and Ms. McEnally and Ms. Singh explicitly supported the formation of a working group. Mr. Gutterman was of the view that it should not wait until 2009 because world financial conditions demand that it be given more immediate attention. Mr. Pickeur suggested that the working group be established by the end of this or early next year. Ms. McEnally noted the importance of establishing a diversified working group to support to the IAASB. Mr. Krantz offered the participation of an expert from the World Federation of Exchanges. Ms. Singh noted the willingness of the Institute of International Finance to help.	The IAASB agreed to form such a group at its December 2007 meeting. See Agenda Item I for a discussion of the meeting held on February 12, 2008 to solicit views from interested parties, and background material on the meeting, including the draft Terms of Reference for the working group.
Mr. Damant emphasized the strong support and offers of assistance from the Representatives, which he urged the IAASB to consider seriously. He noted that the operation of a group may not require a significant amount of IAASB time in 2008.	At the meeting, Mr. Sylph noted that the IAASB will need to consider two practical issues: Whether the IAASB alone should draft the terms of reference for a working group, and whether the formation of a working group would take staff time away from other priority projects.
Mr. Hegarty responded that perhaps a subgroup of the IAASB CAG could assist in drafting the terms of reference, and volunteered to contribute to such a group.	A draft Terms of Reference was circulated to those members of the IAASB CAG noted in this section who had expressed interest in the formation of the working group. Their comments were factored into the draft Terms of Reference that were discussed by the IAASB at its December 2007 meeting.
APPENDIX “FAIR VALUE MEASUREMENTS AND DISCLOSURES UNDER DIFFERENT FINANCIAL REPORTING FRAMEWORKS”	
Mr. Gutterman noted that the position of the IASB is changing, which will likely require significant revision to the appendix. He suggested that the	At the meeting, Mr. Ashton responded that the proposed working group will take time to consider the matter, and that it is desirable that the material in

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.1

Report Back—Accounting Estimates

Representatives' Comments	IAASB Task Force response / IAASB response
<p>appendix be replaced with a reference to relevant financial reporting frameworks (rather than being a summary). Alternatively, the IAASB could allow for future amendments without the need for due process. Ms. Blomme questioned whether the appendix, which deals with an accounting matter, should be in an auditing standard, particularly as the financial reporting framework is likely to be revised regularly. While she had no objection to the content of the appendix, she was of the view that it may be better placed somewhere other than in the ISA. Mr. Sekiguchi observed that the appendix is a good summary, but asked whether it may be appropriate for the proposed working group, if one is to be formed, to consider whether it should be included in the ISA. Mr. Pickeur supported retaining the material in the appendix.</p>	<p>the appendix is available to auditors in the interim.</p> <p>The IAASB agreed that the material that had been added to the appendix for discussion at the September meeting was too accounting-specific and should be deleted, but that the appendix in general provided some background and context that some auditors, in particular SMPs, may find useful. Relevant discussion of observable and unobservable inputs was added to the application and other explanatory material where necessary to respond to comments on the exposure draft that the auditor may have different approaches depending on the level of observability of the inputs.</p>
<p>Mr. Ratnayake noted the importance of estimates in the valuation of biological assets under International Accounting Standard (IAS) 41, "Agriculture," and asked whether they should be considered in the appendix.</p>	<p>The Task Force did not agree that a reference to a specific type of asset was necessary in the Appendix, in light of other comments received about the need for the Appendix to be framework-neutral.</p>
OTHER MATTERS	
<p>Mr. Gutterman questioned whether use of the term "specialist" is appropriate, or whether "expert" should be used.</p>	<p>At the meeting, Mr. Ashton responded that use of the term "specialist" is consistent with proposed ISA 620 (Revised and Redrafted), "Using the Work of an Auditor's Expert" because people with accounting or auditing expertise are excluded from the definition "expert." The intention of proposed ISA 540 (Revised and Redrafted) in this respect is to make it clear that the auditor may need to seek specialist advice, but that it will often be from an accountant, rather than from a member of another profession.</p> <p>At its September 2007 meeting, the IAASB debated the requirement for the auditor to determine whether to use an expert. It was determined that as drafted in the September agenda materials, the requirement did</p>

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.1

Report Back—Accounting Estimates

Representatives' Comments	IAASB Task Force response / IAASB response
	<p>not adequately address the procedures the auditor should perform and was duplicative of requirements in other ISAs.</p> <p>The Task Force was of the view that including emphasis for the auditor to consider whether additional personnel who do not meet the definition of an auditor's expert should be included in the engagement team is necessary and in fact reflects what most often occurs in practice with regard to accounting estimates.</p> <p>The IAASB confirmed this view at its December 2007 meeting, and agreed that the requirements in other ISAs³ supported this, requiring the auditor to ensure that the engagement team consists of the appropriate personnel, including experts.</p> <p>As a result, the requirement has been revised as follows in paragraph 14 of the ISA:</p> <p><i>In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence."</i></p> <p>The IAASB believes that the changes that were made to the requirement from what was included in the exposure draft respond to concerns that the ISA imposed an unwarranted obligation on the auditor, in particular when a need for an expert may not be needed for many regular accounting estimates. These changes make it clear that there is no formal determination required in every case. However, it retains the essential consideration of the need for an expert or other specialist thereby ensuring that auditors understand that there may be merit in making use of such skills. Further, the application and other</p>

³ See ISA 300 (Redrafted), "Planning an Audit of Financial Statements," paragraph 7(e), and proposed ISA 220 (Redrafted), "Quality Control for an Audit of Financial Statement," paragraph 13.

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.1

Report Back—Accounting Estimates

Representatives' Comments	IAASB Task Force response / IAASB response
	explanatory material makes it clear that there will be many cases – indeed, the majority – where no additional expertise is required. (See ISA 540 (Revised and Redrafted).)
Mr. Pickeur asked that the Task Force reconsider whether the requirement with respect to responding to the assessed risks of material misstatement (paragraph 13 of the proposed ISA) should be changed in line with the comments of the Basel Committee on Banking Supervision.	The Committee suggested making revisions to paragraphs 13(b) and 13(c) to incorporate the increased use of fair value models, particularly in industries where fair values are extensively used such as in banking and insurance institutions. The Task Force considered this comment, but in order for the requirement to remain applicable to both regular accounting estimates and fair value accounting estimates, (as agreed by the IAASB in deciding to combine extant ISA 540 and ISA 545), the Task Force and IAASB agreed that changing the requirement was not appropriate. However, changes were made to the application and other explanatory material where appropriate within paragraphs A52-A95 to provide additional guidance explaining the circumstances in which each of the responses in paragraph 13 may be appropriate, to particularly note the considerations for fair value accounting estimates. (See ISA 540 (Revised and Redrafted).)
Mr. Krantz asked about the possibility of aggregating ranges of values. Mr. Damant noted that for complex financial instruments, complex note disclosure of information such as ranges is needed.	At the meeting, Mr. Ashton responded that footnote disclosure of ranges is gaining favor in accounting circles, rather than aggregation of ranges of values.
Mr. Pickeur enquired whether the IAASB is considering re-exposure.	At the meeting, Mr. Ashton responded that, in the Task Force's view, re-exposure is not necessary because the exposure draft was changed mainly to add application material. The basic requirements were not changed. The IAASB affirmed the view of the Task Force at its December 2007 meeting.
Mr. Damant noted that, if future guidance is issued as practice statements rather than ISAs, it may not be	At the meeting, Mr. Kellas responded that, regardless of their legal status, if practice statements are

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.1

Report Back—Accounting Estimates

Representatives' Comments	IAASB Task Force response / IAASB response
recognized in all jurisdictions in which the auditing standards have legislative backing. Mr. Damant suggested that the proposed working group consider the form in which any additional guidance should be issued.	developed, the additional guidance should be welcomed by auditors.

Material Presented – IAASB CAG REFERENCE PAPERS ONLY

Available from
<http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0141&ViewCat=0896>

ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures” published in February 2008

Available from
http://web.ifac.org/download/Basis_for_Conclusions_ISA_540_Revised_and_Redrafted.pdf

Basis for Conclusions: ISA 540