Grant Thornton International

Barry Barber
Worldwide Director of Audit and Quality Control
399 Thornall Street
Edison, New Jersey 08837
732-516-5500
732-516-5550 Direct
732-516-5502 Fax
email barry.barber@gt.com

Grant Thornton

April 30, 2005

Mr. James Sylph
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017

Via email – Edcomments@ifac.org

Dear Mr. Sylph:

Grant Thornton International appreciates the opportunity to comment on the Proposed International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures)*, approved for publication by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

We support the IAASB's issuance of the proposed revised standard. However, we have a few concerns and certain recommendations that we believe will improve the quality, clarity, and effectiveness of the proposal. As such, we respectfully submit our comments and recommendations below and in Appendix A, which offers other substantive comments and/or suggestions relating to specific paragraphs. Appendix B offers additional editorial revisions.

Indicators of Possible Management Bias

The proposed revised standard requires the auditor to consider whether there are indicators of possible management bias in the making of accounting estimates. We agree that the auditor should be alert to management bias and should consider such when performing the risk assessment and other audit procedures. However, the proposed revised standard lacks guidance with regard to the:

- Types of indicators of possible management bias, as partially addressed in connection with performance measures in paragraph 38 of ISA 315, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*.
- Correlation of such indicators with the risk of fraud, as described in paragraphs 80 and 81 of ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*.

- Further audit procedures to address the indicators that the auditor has identified as being present, which would be performed in accordance with ISA 330, *The Auditor's Procedures in Response to Assessed Risks*.
- Auditor's communication of possible management bias to those charged with governance, which would be a matter warranting attention that would be communicated in accordance with ISA 260, *Communication of Audit Matters with Those Charged with Governance*.

In determining the risk of material misstatement, the auditor is concerned with indicators of possible management bias that is inappropriate or excessive and suggests a lack of neutrality, which causes the financial statements not to be in accordance with the applicable financial reporting framework or poses a risk of fraudulent financial reporting. Accordingly, the auditor is alert to indicators of possible management bias throughout the audit. The auditor then designs audit procedures to address the indicators that the auditor has identified as being present, while considering the requirements and guidance provided by ISA 315, ISA 330, and ISA 240.

Therefore, we suggest that the IAASB amend the proposed revised standard to (a) incorporate the notions above, (b) reference other applicable ISAs, and (c) require the auditor to communicate matters relating to the quality of an entity's financial reporting (e.g., possible management bias) to those charged with governance.

We further recommend that the IAASB provide a more comprehensive list of indicators of possible management bias. We believe that the current examples are insufficient and flawed. For instance,

- Management ordinarily presents the auditor with a point estimate. In addition, when a reasonable range may be developed, the auditor is ordinarily not aware of the range or the range is not rigorous enough to evaluate the indicators of possible management bias (see "Changing the Location of an Accounting Estimate within a Reasonable Range" below).
- The examples do not portray indicators that might be considered when the auditor performs the risk assessment procedures (see paragraph 38 of ISA 315).

If a comprehensive list of indicators cannot be developed, then the auditor should not be required to consider or document the indicators of possible management bias.

Changing the Location of an Accounting Estimate within a Reasonable Range

Paragraphs 72 and 73 provide guidance in the situation where there is a change in the relative location of the accounting estimate within management's reasonable range and link this change to a potential indicator of possible management bias. There is a presumption in the proposed revised standard that (a) management develops a rigorous reasonable range, and (b) the auditor is aware of such range. These factors impact the auditor's ability to consider whether there are indicators of possible management bias in the making of an individual accounting estimate.

In our experience, it is more common for management to present an annual point estimate to the auditor, rather than to provide the auditor with management's rigorous reasonable range. Accordingly, the auditor may not be able to determine whether management has changed the relative location of the accounting estimate within the range. In such circumstances, the auditor's reasonable range (if determined) should not be used to evaluate whether possible management bias or a misstatement of the financial statements exists, as management's accounting estimate is developed absent the auditor's assumptions. In addition, the auditor's reasonable range should not be used by management to develop the accounting estimate, as this may entail performing a management function (see our comments to paragraphs 41 and 54-57 in Appendix A).

Therefore, it should be noted that accounting estimates may need revision (as discussed in paragraph 6). When such estimates are revised, the auditor needs to understand the underlying reasons for the change and considers any indicators of potential management bias in determining whether the change is appropriate. The auditor, based on his or her judgment, may determine that either (a) the accounting estimate is in accordance with the applicable financial reporting framework, (b) the accounting estimate is inappropriate or excessive and causes the financial statements not to be in accordance with the applicable financial reporting framework, or (c) management's change poses a risk of fraudulent financial reporting. The auditor then performs any necessary procedures to reduce the risk of material misstatement to an acceptably low level, including proposing adjustments to the financial statements. The amount of such adjustments should be determined by the auditor's procedures and therefore, may not always equal the difference between the accounting estimate made by management from one period to another.

Evaluating the Effect of Management Bias on the Financial Statements

We refer the IAASB to our comments relating to the proposed ISA 320 (Revised), *Materiality in the Identification and Evaluation of Misstatements*, which discusses our concerns pertaining to (a) evaluating whether the financial statements as a whole are free from material misstatement by considering the uncorrected misstatements and the qualitative aspects of the entity's accounting practices, including possible management bias, and (b) communicating matters relating to the quality of an entity's financial reporting that come to the auditor's attention during the audit to those charged with governance.

As indicated in our comments to ISA 320 (Revised), a separate evaluation, as contemplated by the proposal, of the financial statements as a whole at the end of the engagement is not necessary. We believe that the procedures performed throughout the audit, including the quantitative and qualitative evaluation of uncorrected identified misstatements and the final analytical procedures, provide the auditor with reasonable assurance as to whether the financial statements are free from material misstatement, including whether such financial statements are free from bias. As indicated above, matters relating to the quality of an entity's financial reporting that come to the auditor's attention during the audit should be communicated to those charged with governance.

Evaluating the Disclosure of Estimation Uncertainty

Paragraph 79 states: "Where an accounting estimate falls within a reasonable range of outcomes that is greater than materiality, the auditor should determine whether the applicable financial reporting framework requires disclosure of the estimation uncertainty and, if so, evaluate the adequacy of such disclosure." Paragraph 81 goes on to state: "Where the applicable financial reporting framework does not prescribe disclosure of estimation uncertainty, the auditor nevertheless encourages management to describe, in the notes to the financial statements, the circumstances giving rise to a reasonable range that is wider than materiality." Although we believe such guidance is appropriate, we do not feel that the proposed revised standard adequately addresses the potential implications of such matters on the audit.

Prior to evaluating the disclosure of an accounting estimate that falls within a reasonable range of outcomes that is greater than materiality, the auditor needs to evaluate the magnitude of the range and the impact on his or her audit. Accordingly, due to the significance of such estimation uncertainties, we believe that the IAASB should enhance the proposed guidance by:

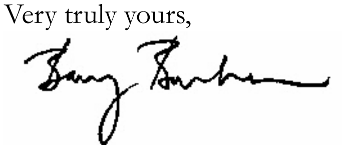
- Clarifying the "definition" of a reasonable range, in paragraphs 54-57, to stipulate that a reasonable range is ordinarily no greater than materiality. (Additional comments regarding the definition of a reasonable range are provided in Appendix A.)
- Linking the requirements and guidance provided by paragraphs 79-81 to paragraph 26, which discusses how an estimation uncertainty can be so high that a reasonable estimate cannot be made.

- Discussing the auditor's considerations of the magnitude of the reasonable range of outcomes, including when such magnitude could potentially impose a scope limitation on the audit.
- Providing additional guidance to evaluate the adequacy of the disclosure (e.g., evaluating whether disclosure is needed for other potential effects on the financial statements).
- Calling attention to the fact that the auditor should consider an emphasis of matter paragraph, including providing a reference to ISA 701, *Modifications to the Independent Auditor's Report*.

* * * *

We would be pleased to discuss this letter with you or another member of the IAASB staff. Please contact me at (732) 516-5550, if you have any questions.

Very truly yours,



Grant Thornton International
Barry Barber
Worldwide Director of Audit and Quality Control

Appendix A

The following describes additional concerns and offers other substantive comments and/or suggestions relating to specific paragraphs. It also includes our responses to the IAASB's questions with regard to small entities and translations. Suggested new language is shown in boldface; suggested deleted language is shown by strikethrough.

- **Paragraph 24** – This paragraph focuses on high estimation uncertainty, which may cause the auditor to determine that the accounting estimate poses a significant risk of material misstatement. We suggest that the proposed revised standard provide other circumstances that may pose significant risks in light of the guidance provided by paragraphs 108 through 112 of ISA 315. A cross-reference to such paragraphs is also recommended.

- **Paragraphs 38-40** – The auditor may respond to the risk of material misstatement by testing the operating effectiveness of controls over management's process for making the accounting estimate. This section should be enhanced to strengthen the point that testing the operating effectiveness of controls over management's process is ordinarily not sufficient, by itself, to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptable level; therefore, the auditor should perform appropriate substantive procedures (as indicated in paragraph 30). We further recommend that the IAASB include other controls that may exist in addition to "review and approval" controls.

- **Paragraph 41** – Sub-bullet No. 3 states that making an independent estimate would be an appropriate response when the entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented. We suggest that the IAASB express caution in such circumstances, as the underlying data may not be reliable. In other words, the auditor should avoid placing undue reliance on the underlying data when making the independent estimate. We further suggest that the IAASB caution the auditor with regard to performing management functions (i.e., an independent estimate is not appropriate when management has not made their own accounting estimate).

- **Paragraph 45** – In response to our comments concerning clarity below, we suggest referencing paragraphs 24 through 26 to clarify which estimates are significant risks that require special audit consideration. Further, the procedures pertaining to significant risks should also be clarified. For example, it is not clear that the section entitled "Responses to Risks of Material Misstatement" also applies to significant risks.

- **Paragraphs 54-57** – We suggest cautioning the auditor against performing management functions (as indicated in our comment to paragraph 41 above). It is management's responsibility to perform the necessary procedures to determine an accounting estimate that is in accordance with the applicable financial reporting framework. If management has not done so, the auditor should request that management perform additional procedures (e.g., sensitivity analysis or consider alternative outcomes), prior to requiring the auditor to consider whether it is practicable to develop a reasonable range of outcomes.

  In addition, as indicated in our letter, we believe that the "definition" of a reasonable range should be expanded to include the notion that the range is ordinarily no greater than materiality. If this is not the case, the auditor would need to question whether the applicable financial reporting framework's measurement criteria have been met and whether a scope limitation has been imposed. Further, it should be clarified that a reasonable range of outcomes is determined by (a) first reducing the standard deviation of the range so that the range is less than materiality (paragraph 56), and (b) then eliminating the high and low outcome values that are deemed to be remote and the outcome values within the range that are unlikely to occur (paragraph 55).

- **Paragraph 68 –** This paragraph states that misstatements involving subjective decisions arise from differences between management's and the auditor's judgments concerning the reasonableness of accounting estimates. We do not believe that misstatements arise from differences between management's and the auditor's judgments. As management is responsible for the financial statements, such misstatements arise from inappropriate management judgments that lead to unreasonable accounting estimates. As such, we recommend the following revision:

  "A misstatement involving subjective decisions arises from ~~differences between management's and the auditor's judgment concerning the reasonableness of accounting estimates~~ **management's judgments concerning an accounting estimate that the auditor considers unreasonable**, in the context of the applicable financial reporting framework. Such misstatements differ from misstatements of fact because the audit evidence is often less persuasive."

- **Paragraph 69 –** Our understanding of this paragraph is that (a) the auditor identifies a reasonable range, (b) he or she makes a probability assessment with regard to the outcomes within the range, (c) the outcome with the highest probability represents the auditor's point estimate, and (d) the difference between the auditor's point estimate and management's point estimate represents a known misstatement involving subjective decisions. However, we question whether our understanding is accurate due to the inconsistent use of the terms "reasonable range" and "point estimate." In addition, we note that it is fairly uncommon for the auditor to develop a reasonable range and a point estimate. Accordingly, we suggest that the IAASB clarify its intent as it relates to the requirements of this paragraph and therefore, we recommend replacing paragraphs 69 and 71 with the following:

  "**As discussed in paragraphs 54-57, where management has not applied a sensitivity analysis or considered alternative outcomes, the auditor may develop a reasonable range of outcomes with which to evaluate the reasonableness of management's point estimate.** If management's accounting estimate lies outside the auditor's reasonable range of outcomes, where each outcome is equally likely to occur, there is a known misstatement involving subjective decisions of, at least, the difference between management's accounting estimate and the nearest point of the reasonable range (paragraph 71). **When the auditor develops a point estimate (which represents his or her best estimate of the outcome with the highest probability), the known misstatement involving subjective decisions is the difference between management's point estimate and the auditor's point estimate**."

- **Paragraph 81 –** We suggest that the IAASB limit the discussion regarding the potential disclosures that may be recommended to the entity (e.g., encouraging management to describe the circumstances giving rise to a reasonable range that is wider than materiality), as disclosures are matters of accounting rather than auditing. See our comments with regard to "Promulgating Accounting Standards" below.

- **Paragraph 84** – We do not believe that it is necessary to repeat documentation requirements that already exist in other standards. Accordingly, the IAASB should consider revising this paragraph to simply reference the applicable standards, as the proposed revised standard should only include specific documentation requirements regarding estimates. In addition, the requirement to document the indicators of possible management bias should either be deleted or enhanced to document the auditor's procedures to address such indicators and the conclusions reached.

- **Clarity –** Consistent with the Proposed Policy Statement, *Clarifying Professional Requirements in International Standards Issued by the IAASB*, the use of the present tense should be eliminated. In addition, to more easily comprehend the proposed revised standard, we recommend including a summary paragraph in the introduction that briefly discusses the types of estimate risks addressed by the standard (e.g., those that pose a risk of material misstatement and those that are also deemed to be significant risks) and the responses to those risks (e.g., certain procedures are required for all estimates where there is a risk of material misstatement, but additional procedures are required for those that are deemed to be significant risks). It should be noted that certain estimates are less complex and more straightforward than others and therefore, the nature, timing, and extent of the auditor's procedures would be tailored accordingly. In addition, a flowchart may assist auditors in understanding their professional obligations.

- **Promulgating Accounting Standards** – We stress that the purpose of ISAs is not to promulgate accounting standards and that the IAASB should, when discussing matters of accounting, provide for circumstances in which the applicable financial reporting framework may differ. For example, financial reporting frameworks may apply the concept of conservatism rather than neutrality. In addition, the financial reporting frameworks may differ with respect to misstatements of prior period financial statements (paragraphs 21-22).

- **Small Entities** – We believe that the guidance in the proposed revised standard can be applied equally well to entities of all sizes, as a small entity is not precluded from having complex estimates that pose a significant risk of material misstatement. We note, however, that many small entities have few estimates that are less complex and more straightforward and therefore, it is important to convey the auditor's procedures in such circumstances, as indicated in our comments on "Clarity" above.

- **Translation** – As we have not attempted to translate this document, we are not aware of any significant translation issues. We do, however, recommend the IAASB consider whether it is necessary to clarify and refine complex concepts and/or sentence construction.

APPENDIX B

The following offers editorial suggestions relating to specific paragraphs. Suggested new language is shown in boldface; suggested deleted language is shown by strikethrough.

- **Paragraph 5** – In the first line, a comma should be added after "business activities."

- **Paragraph 9** – We suggest the following revision to clarify that (a) the risk assessment performed for estimates is an integral part of the overall risk assessment procedures, and (b) the auditor identifies and assesses the risk of material misstatement due to accounting estimates:

  "**As part of the auditor's risk assessment performed in accordance with ISA 315, *Understanding the Entity and its Environment and Assessing the Risk of Material Misstatement*, t**~~T~~he auditor should perform risk assessment procedures **sufficient** to identify **and assess the risks of material misstatement due to** accounting estimates~~ for which there is a risk of material misstatement~~, by:"

- **Paragraph 16 (last bullet)** – For consistency purposes (to structure all bullets as sentences), we recommend the following revision:

  "New conditions or events ~~that~~ **may** give rise to **new** accounting estimates."

- **Paragraph 17** – We believe that the entity's risk assessment procedures should identify transactions, events, and conditions that give rise to the need for accounting estimates. Accordingly, we recommend the following:

  "During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. If so, the auditor considers **why** ~~whether~~ the entity's risk assessment procedures **failed to identify** ~~should have identified~~ them~~. If they should have, the auditor considers why those procedures failed to do so. ~~ISA 315 provides guidance when the auditor identifies material weaknesses in the entity's risk assessment process."

- **Paragraph 18** – We suggest the following revisions to this paragraph:

  - Replacing the word "ensures" with the word "determines" in the fifth bullet.
  - Revising the sixth bullet to read as follows: "Whether management has performed a sensitivity analysis to determine the effect **of changes in the assumptions** on an accounting estimate~~ of changes in the assumptions~~."
  - Replacing the last bullet with the following: "**Internal controls over management's process for making the accounting estimate.**"

- **Paragraph 36** – For clarity and translation purposes, we recommend the following revision:

  "The auditor's consideration of management's assumptions can ~~only ~~be based **only** on information available to the auditor."

- **Paragraph 58** – Again, for clarity purposes, we suggest the following:

  "The auditor may obtain audit evidence ~~from performing the audit procedures to respond to significant risks, ~~that management's accounting estimates are reasonable in the context of the applicable financial reporting framework **from performing audit procedures to respond to significant risks**."

- **Paragraph 73 –** To clarify the term "location," we propose the following:

  "What constitutes a good reason for changing the **relative** location **of the accounting estimate within management's reasonable range** from one period to another is a matter of judgment."