Mr. J.M. Sylph  
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30 April 2005  

Dear Mr Sylph  

Response to IAASB Exposure Draft ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures  

We appreciate the opportunity to comment on Exposure Draft ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures). This response is made on behalf of the PricewaterhouseCoopers network of member firms.  

There are a number of significant matters in the proposed revision that we believe that IAASB should address before finalising the ISA, in particular:  

- Misstatements and indicators of management bias when there is a reasonable range of outcomes  
- The structure of the proposed ISA  
- Relevant guidance for audits of small and medium sized enterprises  

We elaborate on each of these points below. In the appendix to this letter, we also offer a number of suggestions on specific paragraphs for the IAASB’s consideration in finalising the wording of the revised ISA.  

Misstatements and indicators of management bias when there is a reasonable range of outcomes  

We do not agree with the guidance in paragraph 72 that an accounting estimate should always be considered to be misstated if, without good reason, management changes the relative location of the accounting estimate within management’s reasonable range from the prior period. Undoubtedly, such a change is an indicator of management bias that the auditor would take into account when forming an opinion on the fair presentation of the financial statements as a whole. Whether or not such a change is a “misstatement” on its own, however, depends on the requirements of the applicable financial reporting framework.  

The reasonableness of the accounting estimate needs to be evaluated in the context of the entity’s applicable financial reporting framework. When the financial reporting framework requires management to make a point estimate within the reasonable range of outcomes based on
management’s judgement of the most likely outcome of the uncertain future conditions, transactions or events (i.e. to make a “best estimate”), a change in the relative location within the reasonable range may indeed be indicative of a misstatement. In such circumstances, management would have to be able to defend how changes in the circumstances justify a change in management’s judgment of the best estimate. In many cases, such a change may be entirely appropriate as management becomes more optimistic or pessimistic about the most likely outcome within the reasonable range based on new information. If, however, management cannot provide adequate justification that the most likely outcome has changed, the change in the estimate would not be in accordance with the financial reporting framework and would represent a misstatement.

When the financial reporting framework does not require management to make a point estimate based on the most likely outcome and management’s estimate is within a range of equally possible outcomes – even if the relative location of the estimate in that range is different to the prior period – management’s estimate would still be in compliance with the applicable financial reporting framework. Thus, the accounting estimate could not, by definition, be unequivocally considered a misstatement as the estimate remains within a reasonable range and in accordance with the requirements of the financial reporting framework. As noted above, however, this does not remove the auditor’s responsibility to consider whether such movements in estimates are indicators of possible management bias that need to be taken into account when evaluating whether the financial statements as a whole are free from material misstatement (in accordance with paragraph 39 of the proposed revised ISA 320, ISA 240 Revised “The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements” and ISA 200 “The Objective and General Principles Governing an Audit of the Financial Statements”). In so doing, the auditor would still need to consider the appropriateness of management’s justification for making changes in its accounting estimates. Indeed, the auditor may conclude that the changes in management’s estimates are indicative of a lack of neutrality and, when taken into account with other indicators of possible bias and uncorrected misstatements identified in the course of the audit, could result in the financial statements not being fairly presented.

Nevertheless, we believe that the auditor must consider the requirements of the financial reporting framework when determining when a change of an estimate within a range of reasonable outcomes constitutes a misstatement, and when it is an indicator of management bias that should be taken into account when forming the opinion on the financial statements as a whole.

These comments apply equally to the discussion of management bias and the evaluation of misstatements in Exposure Draft of the proposed revised ISA 320 “Materiality in the Identification and Evaluation of Misstatement”, in particular to paragraph 40.

We strongly urge the IAASB to reconsider the proposed guidance in both proposed revised ISA 540 and ISA 320 on this matter.

Structure of the guidance

We have a number of comments on the structure of the proposed revised ISA 540, in particular, a general comment on the approach to drafting guidance on specific topics, and how the audit risk standards have been applied in this particular proposed ISA.

Approach to ISAs on specific topics

As a general comment, we are uncomfortable with the approach that has been adopted in drafting new ISAs on specific topics. The proposed ISA essentially parallels the entire audit process from planning to reporting, often repeating requirements from other ISAs (e.g., Planning (ISA 300), Audit Risk (ISAs 315 and 330)) but modifying them to demonstrate how the auditor considers this
particular topic in applying that requirement. We are concerned that this approach will result in unnecessary duplication, complexity and onerous documentation requirements.

In our view, the ISAs should be viewed as an integrated body of standards. ISAs that address specific topics, such as estimates or related parties, should include additional requirements needed to address those matters in the audit. It should not be necessary for each ISA to include principles that simply parallel each step in the audit process that is set out in other ISAs. For example, an ISA on the auditor’s responsibilities with regard to related parties should only need to focus on audit requirements surrounding the identification, measurement and disclosure of related parties. It should not be necessary for that ISA to repeat planning and risk assessment procedures that are already requirements in the Planning and Audit Risk ISAs respectively. If there are particular matters that need to be considered in planning or when performing the auditor’s risk assessments procedures, IAASB should carefully consider whether such guidance would best be a conforming amendment to the Planning and Audit Risk ISAs rather than repeat the requirements in the subject-matter specific ISAs.

To illustrate this point, we provide two examples below in the context to the proposed revised ISA 540.

The reason for emphasising this point is because unnecessary repetition of audit requirements results in duplication, and thereby introducing unnecessary complexity and possible confusion on how the various requirements are expected to fit together in an audit. It also represents a trend towards much more detailed, procedural-oriented audit procedures and raises questions regarding the documentation expected to demonstrate compliance with all of these detailed requirements. For the reasons we explained more fully in our response to the Clarity Exposure Draft, we are concerned that this approach could negatively affect audit quality because it may drive behaviour towards a preoccupation with compliance with the standards rather than focus auditor attention on the application of judgement to achieve the objective of the audit.

**Duplication in risk assessment procedures**

In relation to this Exposure Draft, we question whether the bold-lettered requirement in paragraph 9 is appropriately worded and, perhaps, even necessary. It requires the auditor to “perform risk assessment procedures to identify accounting estimates for which there is a risk of material misstatement” and sets out specific procedures the auditor needs to perform. Can we not presume that the auditor will identify relevant accounting estimates as an outcome of the auditor’s risk assessment procedures in ISA 315? ISA 315 describes a thorough and robust risk assessment process and, in our view, it is reasonable to presume that the auditor will identify accounting estimates for which there is a risk of material misstatement as a result of complying with ISA 315. In fact, there is a risk that, as drafted, the proposed wording in the Exposure Draft might be interpreted to imply that the auditor needs to carry out a parallel or separate risk assessment process focussed specifically on accounting estimates.

We believe that it would be appropriate for this ISA to explain that, as a result of the auditor’s risk assessment procedures, the auditor would be expected to have identified accounting estimates for which there is a risk of material misstatement and to provide guidance on the matters considered in doing so. We question, however, whether it is necessary to have a detailed bold-lettered requirement in ISA 540 that effectively replicates requirements in ISA 315. If there are specific risk assessment procedures that are exclusive to the audit of accounting estimates and would not be, ordinarily, carried out in complying with the requirements in other ISAs, then it is appropriate to establish additional requirements.

**Documentation**
We are also concerned that the bold lettered requirement in paragraph 84 of the proposed revised ISA repeats other documentation requirements included in other ISAs. As noted in our January 2005 response to the Clarity Exposure Drafts, a consistent approach is needed for documentation requirements to avoid the risk of duplication and confusion. For example, paragraph 84(a) suggests that the auditor should document “The results of the auditor’s risk assessment procedures”, yet this is already included as a requirement in paragraph 122(b) of ISA 315. We believe this ISA should include only documentation requirements that are in addition to requirements in other ISAs and specific to the audit of accounting estimates. For example, where the auditor has obtained an independent accounting estimate, it would be appropriate to document that information.

**Structure of the guidance**

We found the structure of the proposed ISA confusing, in particular how the requirements regarding responses to “significant risks” relate to the guidance on responses to risks of material misstatements that are not significant risks. Whilst we appreciate that the Task Force was trying to align the proposed revised ISA 540 with the audit risk standards, it is very difficult to follow the guidance as currently drafted and we question whether it is unduly complicated.

*Assessing the risk of material misstatements and identifying significant risks*

In the section on ‘Assessment of the Risks of Material Misstatement’, the bold lettered requirement in paragraph 23 of the proposed revised ISA 540 states that as part of the risk assessment the auditor should consider those risks that require special audit consideration, i.e. “significant risks”. The identification of significant risks is, of course, already a requirement in ISA 315, and, as a further example of our point regarding duplication, brings into question whether this separate bold lettered requirement is needed in this ISA. Furthermore, because there is no requirement in this section to identify and assess whether there are other risks of material misstatement for accounting estimates, the approach is confusing. Clearly, the auditor needs to identify all risks of material misstatement because the guidance that follows in the section, ‘Responses to the Risks of Material Misstatement’, requires the auditor to “design and perform audit procedures whose nature, timing, and extent respond to the assessed risks of material misstatement of accounting estimates at both the financial statement and assertion levels”, i.e. consider all risks of material misstatement. It is only later (paragraphs 45-63) that the guidance addressed the auditor’s consideration of specific responses to “significant risks”. Furthermore, some of the guidance regarding responses to significant risks in paragraphs 45-46 is considered as part of the inputs to the auditor’s risks assessments in ISA 315. Thus, this guidance seems to be introduced at the wrong stage of the audit process in this document.

We are concerned that this structure will confuse practitioners because it is unclear what requirements are necessary in which circumstances, and when, in the audit process, they should be performed.

*Responding to identified risks*

We also found the relationship between the requirements regarding how the auditor responds to risks of material misstatements in paragraphs 27-44 and to significant risks in paragraphs 45-63 confusing.

Whilst ISA 330 sets out specific considerations when designing procedures to respond to significant risks, ISA 330 does not separate the guidance on audit procedures in response to risks of material misstatement and audit procedures in response to significant risks. Yet, the proposed revised ISA 540 has not only uses separate headings, but includes specific requirements that must be followed in relation to significant risks in all circumstances.
As drafted, we found it unclear whether auditors must comply not only with the specific requirements in paragraphs 45-63 in relation to significant risks but also with the requirements in paragraphs 27-44. Furthermore, we are not convinced that the additional requirements specified for significant risks would be necessary in all circumstances and thought that some of the guidance in the section on significant risks could also be relevant in fulfilling the requirements in paragraph 30 in relation to other risks.

For example, if the auditor has made an independent estimate, we question whether it is necessary for the auditor to carry out the additional audit procedures proposed for significant risks. Particularly in situations in which the auditor uses an expert to make the independent estimate, the expert’s independent estimate is likely to provide robust evidence regarding the reasonableness of management’s accounting estimate. The process of making that independent estimate is likely to include a thorough evaluation of the data, an evaluation of the assumptions and independent tests of the calculations as an integral part of making that estimate. Thus, in our view, an independent estimate would in many, if not most, circumstances constitute sufficient appropriate audit evidence to evaluate the reasonableness of management’s accounting estimate.

Furthermore, much of the guidance on evaluating significant assumptions and evaluating whether and how management has considered alternative assumptions or outcomes would also seem relevant if choosing to respond to a risk of material misstatement by testing management’s process – whether or not the estimate is a significant risk.

Thus, we strongly recommend that IAASB reconsider the split in the proposed procedures between significant and other risks. It is important that the ISA emphasise that the auditor must design procedures specifically responsive to any significant risks and that any evidence obtained from testing the operating effectiveness of controls be obtained in the current period. But we are not convinced that the case has been made as to why it is necessary to mandate these specific proposed procedures for all significant risks and encourage IAASB to reconsider the structure of and approach to this section before finalising the ISA.

Relevant guidance for audits of small and medium enterprises (SMEs)

As noted in our January 2005 response to the Clarity and Documentation exposure drafts, the length and complexity of auditing standards pose particular challenges when applying them to audits of smaller, non-complex entities. The proposed revised ISA 540 is quite long and complex and documentation requirements potentially quite onerous. It is important for the IAASB to consider the impact of the new requirements on SMEs and challenge whether all of the requirements are necessary in all circumstances. For example:

- The majority of accounting estimates are unlikely to have the same level of measurement uncertainty that a practitioner would find in a public interest entity.

- It is quite conceivable that an SME will be able to rely on longer periods awarded in preparing the financial statements and hence the auditor should be able to determine, in most cases, that events occurring up to the date of the auditor’s report confirm or contradict the accounting estimate. In this situation, the majority of requirements that follow paragraphs 28 and 29 of the proposed revised ISA 540 will not be relevant to the SME.

- The process of preparing the financial statements in an SME environment might involve less formal internal control systems, more limited processes and procedures in developing accounting estimates.
Thus we encourage the IAASB to consider whether there are acceptable simplified approaches to fulfilling particular requirements in audits of smaller non-complex entities. For example, we recommend that IAASB explain, in the introduction to the proposed standard, that some requirements are unlikely to be relevant in the audit of SMEs because many of those entities will not have complex accounting estimates, and to identify those requirements that are most likely to be applicable in such audits and those that they may not relevant in their circumstances.

**Concluding remarks**

In conclusion, whilst we support IAASB revising ISA 540, we believe that there are some substantive issues in the proposed revised ISA and encourage the IAASB to consider the suggestions that we have outlined in this response before finalising the ISA.

Please contact either Roger Marshall, Chair of our Global Audit Policy Board (+41 1 625 3697) or Diana Hillier (+44 (0)20 7804 0472) if you would like to discuss any of these comments further.

Yours sincerely,

PricewaterhouseCoopers
Appendix

Detailed comments on paragraphs

Paragraph 1
Paragraph 1 describes an accounting estimate as an “approximation of a monetary amount in the absence of a precise means of measurement” and Paragraph 2 then suggests that an accounting estimate is that which “describes items recognized or disclosed in the financial statements”. Whilst we agree with both statements, we believe that it is confusing having the two descriptions of an accounting estimate in separate paragraphs. Furthermore, consideration should be given to editing paragraph 1 significantly so that it focuses on introducing the standard and the purpose of the standard, rather than the definitions. This would be a more consistent approach with other ISAs. For example:

“I. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on auditing accounting estimates and related disclosures, other than those involving fair value measurements and disclosures. An “accounting estimate” is an approximation of a monetary amount in the absence of a precise means of measurement. [Moved to paragraph 2] Making an accounting estimate frequently requires management to develop assumptions about the outcome of future conditions, transactions or events that are uncertain at the time of the estimation. “Estimation uncertainty” is the susceptibility of a financial statement item to a lack of precision in its measurement because the outcome of future events is not known. [Moved to precede paragraph 5]

2. The term “accounting estimate” is an approximation of a monetary amount in the absence of a precise means of measurement and used to describe items recognized or disclosed in the financial statements. For example, accounting estimates may be required for:

- Bad debts.
- Inventory obsolescence.
- Warranty obligations.
- Environmental remediation costs.

4a. Making an accounting estimate frequently requires management to develop assumptions about the outcome of future conditions, transactions or events that are uncertain at the time of the estimation. “Estimation uncertainty” is the susceptibility of a financial statement item to a lack of precision in its measurement because the outcome of future events is not known.”

Paragraph 4
The bold lettered paragraph introduces the term “reasonable estimates”. By virtue of its reference in the paragraph, the visibility of the term “reasonable” estimates to practitioners is heightened. Yet there is an absence of appropriate explanation of what is “reasonable” in the context of auditing accounting estimates. Later paragraphs (58-60) include additional guidance on “concluding on the reasonableness of the accounting estimate”, but we do not
believe that they adequately explain what a “reasonable estimate” is. We suggest that the IAASB expand on this term “reasonable estimate”, either by clarifying in the grey letter following paragraph 4, or by expanding on the definition of the term in paragraphs 58-60.

Paragraph 7 and Paragraph 76

Regarding the third sentence in Paragraph 7, “…When performing audit procedures, the auditor is therefore alert to indicators of possible management bias in the making of accounting estimates.”, and the first sentence in paragraph 76, “the auditor is alert for indicators of possible management bias”. As required by ISA 200, we agree that the auditor plans and performs an audit with an attitude of professional scepticism, recognising that circumstances may exist that cause the financial statements to be materially misstated. However, we are of the view that the practitioner would find difficulty interpreting the term “to remain alert”. Indeed, unless the auditor was aware of an indicator of management bias, carrying out this requirement would be very difficult, if not impossible, to evidence in documentation. Accordingly, we suggest the IAASB reconsider using the phrase to “remain alert” when finalising the ISA.

Paragraph 9(c)

This bold lettered paragraph requires the auditor to ‘obtain an understanding of the processes…’, yet paragraphs 18 – 19 discuss “Management’s Process for Making Accounting Estimates”. The IAASB should clarify if the processes as described in paragraph 9(c) are management’s processes or something other than management’s processes if that is the intention.

Paragraph 18

When management has monitored the outcome of the accounting estimates made in the prior period, as indicated in the eighth bullet of paragraph 18, and found weaknesses in that system, the auditor should consider whether management has adequately responded to those weaknesses. This is a consideration most practitioners would make, and indeed it is implied in paragraph 21 as follows: “Obtains information regarding the effectiveness of management’s prior period estimation process, from which the auditor can judge the likely effectiveness of management’s current period process”. However, we do not believe it is stated clearly enough in the standard. In fact if management were to ignore any weaknesses or exceptions in the process for making accounting estimates, year on year, it would be appropriate for the auditor to carry out further audit procedures in addition to reviewing management’s process. Accordingly, we suggest that paragraph 18 is expanded to clarify management’s role in this regard, for example:

18 …To obtain an understanding of management’s process for making accounting estimates, the auditor considers the following matters:…

- Whether management monitors the outcome of accounting estimates made in the prior period and if management has appropriately responded to the outcome of that monitoring procedure.

Paragraph 20

This paragraph makes reference to the requirements of paragraph 80(b) of ISA 240 (Revised), “The Auditor’s responsibility to consider Fraud in an Audit of Financial Statements”. Currently it is not clear why the “auditor’s review of the outcome…of accounting estimates…” is carried out in conjunction with the
requirements of… ISA 240”. Whilst it is not desirable to repeat paragraphs of cross-referenced ISA material, it is usually helpful to the practitioner to give some indication as to why the reference is included. We suggest that this could be easily resolved by changing the placement of paragraph 21 so that it precedes paragraph 20. Paragraph 21 is an appropriate introduction to the section heading “Reviewing the Outcome or Re-Estimation of Prior Period Accounting Estimates” and offers an appropriate lead to the reference to ISA 240.

Paragraph 21

We believe the first sentence of this paragraph is slightly confusing as it discusses the outcome of a circumstance (condition/event) “differing” from the outcome of an accounting estimate – they are different “subjects”. We therefore suggest that the sentence could be improved by the following amendments:

“21. The actual outcome of the condition, transaction or event that gave rise to an accounting estimate will often differ from the circumstances on which the accounting estimate was based—accounting estimate recognized in the prior period financial statements.”

Paragraph 30

Including comments on 28 and 29.

The logic underlying the proposed structure in this section is not entirely clear. We can appreciate that if there are confirming events prior to the date of the auditor’s report, this is likely to be the most efficient way to obtain robust evidence regarding the reasonableness of the estimate. Indeed, this may often be the case in the audits of small and medium enterprises, for example. But, as drafted, some readers misinterpreted the wording in paragraphs 28 and 30 as suggesting that the auditor can not decide if other procedures need to be performed until the auditor performs the auditor’s subsequent events review procedures.

An alternative approach would be to present the guidance in a manner similar to that adopted in extant ISA 540. The bold letter requirement in paragraph 30 regarding the types of procedures the auditor could perform in response to a risk of material misstatement could be more prominent in this section and follow paragraph 27. The option to obtain evidence through ‘events occurring up to the date of the auditor’s report’ could be included as part of the combination of approaches the auditor could perform in responding to the risks of material misstatement. For example:

28. 30. If confirming transactions or events are not expected to occur up to the date of the auditor’s report, In response to the assessed risk of material misstatement of accounting estimates, the auditor should perform one or more of the following procedures:

(a) Determine whether events occurring up to the date of the auditor’s report confirm, or contradict, the accounting estimate.

(b) Test management’s process used to make the accounting estimate.

(c) Test the operating effectiveness of the controls over management’s process for making the accounting estimate, together with appropriate substantive procedures.
(d) Make, or use an expert to make, an independent estimate for comparison with management’s accounting estimate.

The guidance following that requirement could explain when each of the options might be most appropriate and explain that if confirming transactions or events are expected before the date of the auditor’s report, this may be the most effective option.

Paragraph 32 We believe that the introduction to this paragraph is confusing as it does not state whether the auditor should carry out the requirements in 32(a) to (f) or whether the items in paragraphs (a) to (f) are examples of procedures the auditor might undertake when testing management’s process. Assuming that the IAASB intended paragraph 32 to be a list of steps that the auditor might undertake, we suggest the following amendment (extracted from paragraph 11 of extant ISA 540):

“32. The steps ordinarily involved in testing the process used by management include: Testing the process used to make the accounting estimate involves: …”

Paragraph 40 We believe that the first sentence of paragraph 40 is internally repetitive. It states that “When performing tests of the operating effectiveness of controls, the auditor obtains audit evidence that controls operate effectively.”, i.e. the last part of the sentence is repeating the point being made in the first part of the sentence in that we are “testing the operating effectiveness of controls”, and therefore, we are also, gaining evidence of the “operating effectiveness of controls”. We therefore suggest the following amendment:

“40. When performing tests of the operating effectiveness of controls, the auditor obtains audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. Guidance on testing controls is set out in paragraphs 28-47 of ISA 330.”

Paragraph 41 The guidance in this paragraph suggests that an independent estimate can be achieved, for example “…by using an auditor-developed model”. Whilst we recognise that this wording is used to describe a methodology the auditor will adopt, however complex or simple, it may also create an unrealistic expectation that the auditor is in a position to develop a sophisticated model in order to make an independent estimate in all cases. We therefore suggest that the guidance on “making an independent estimate” should be enhanced to explain that auditor developed models are ordinarily going to exist in more complex industries and circumstances, and examples should be included.

Paragraph 53 We do not believe it is appropriate to assume that in all cases the requirements of the applicable financial reporting framework will determine the scenario used to determine the point estimated as implied in paragraph 53. We suggest that paragraph 53 is edited to take account of the situations where the applicable financial reporting framework does not offer relevant guidance. For example:
“53. The scenario used to determine the point estimate recognized by management in the financial statements is, in most cases, determined by the requirements of the applicable financial reporting framework...”

Paragraph 54

We propose that this bold lettered paragraph is expanded to explain that the auditor should consider whether it is practicable to develop a reasonable range of outcomes, where it is reasonable to expect management to apply a sensitivity analysis or consider alternative outcomes. Currently the bold lettered paragraph implies that the practitioner should, in all cases where management has not applied a sensitivity analysis etc., develop a reasonable range. This would not be practicable, or necessary in all cases. We propose the following alternative wording:

“54. If management has not applied a sensitivity analysis or considered alternative outcomes, when it would be reasonable to expect management to do so, the auditor should consider whether it is practicable to develop a reasonable range of outcomes with which to evaluate the reasonableness of management’s point estimate”.

Paragraph 61

We believe this paragraph, as currently drafted, suggests that the auditor is making a decision on management’s judgement of whether to meet the requirements of the financial reporting framework. This paragraph should be revised to make it clear that management’s judgement as to “...whether or not to recognize the accounting estimate in the financial statements in accordance with the...applicable financial reporting framework” is a decision made within the boundaries developed by the recognition criteria of the applicable financial reporting framework. We suggest the following amendments:

“61. For accounting estimates that give rise to significant risks, the auditor should evaluate whether the audit evidence obtained is sufficient and appropriate to support management’s judgment as to whether or not to recognize the accounting estimate in the financial statements in accordance with the entity’s applicable financial reporting framework recognition criteria of the applicable financial reporting framework”.

Paragraph 64

We believe that this bold lettered paragraph should be consistent with the overlying objective relayed in paragraph 4 and suggest the following addition:

“64. The auditor should determine whether accounting estimates and related disclosures made by management are reasonable in the context of the entity’s applicable financial reporting framework.”

Paragraph 65

The reference to ISA 320 in paragraph 65 should refer to “uncorrected” misstatements in the last sentence rather than “all” misstatements – as this is the subject that paragraphs 35-38 of ISA 320 offer guidance.

Paragraph 66

As noted in our response to the Proposed Revised ISA 320 Materiality, we do not agree that a “Misstatement involving subjective decisions” can be a “known misstatement”. The misstatement can only be known for sure if it is a misstatement of fact – as indicated in 31(a)(i). If the misstatement has arisen because there is a difference between management’s judgement concerning an
estimate and the auditor’s judgement concerning an estimate, then the value of
the misstatement can not be known for a fact. This is because it is not known,
for a fact, which of the two estimates is the correct amount and hence what the
misstatement is. Furthermore, both management and auditor’s estimates could
be equally incorrect. Accordingly we have suggested alternative classifications
as shown below.

In addition, we believe it is preferable for the IAASB to use terms that are as
close to describing the actual guidance as possible. For example, the term
“likely misstatement” has been applied to a misstatement that might exist from
an extrapolation for audit evidence, i.e. a projected misstatement. We would
therefore suggest that in this instance the IAASB use the term ‘projected
misstatement’ rather than leave the practitioner to evaluate why the term
“likely” has been applied in this case and if it means anything other than a
‘projected misstatement’.

Extract from our response to Proposed Revised ISA 320 Materiality

31. When communicating details of misstatements the auditor distinguishes
between:

(a) Misstatements of fact
(b) Misstatements involving subjective decisions
(c) Projected misstatements

We also suggest that the revised classifications above, if adopted by the IAASB,
should replace the sub-titles in paragraphs 67 to 74.

Paragraph 67 It is not clear from paragraph 67(b): “Not followed the requirements of the
applicable financial reporting framework”, whether the IAASB has included
this as an example of where management have made a factual error in
interpreting the requirements of the applicable financial reporting framework.
Any “subjective” decision when interpreting the requirements of the financial
reporting framework has already been discussed in paragraphs 68-71.
Accordingly, we suggest that the description in paragraph 67(b) is amended to
clarify that there is a clear error of fact due to misunderstanding the
requirements of the applicable financial reporting framework. We suggest the
following alternative wording:

67…(b) Made mistakes in interpreting Not followed the requirements of the
applicable financial reporting framework; or…

Paragraph 73 We find this paragraph confusing. We agree with the first part of the paragraph
that suggests that it is a matter of judgement as to “what constitutes a good
reason for changing the location [of an accounting estimate within a reasonable
range of outcomes] from one period to another”. However, the paragraph then suggests that “even if the audit evidence supports management’s explanation, the auditor, nevertheless, considers whether the change is an indicator of possible management bias”. In other words, even when auditor generated evidence suggests that management has a good reason for the change in location of the estimate; the auditor disregards auditor evidence and considers possible management bias. Ultimately this paragraph suggests that any reasons given on a change of location, within the reasonable range of outcomes, is an indicator of possible management bias. We do not agree with this statement and suggest that the entire paragraph should be deleted.