

Accounting Estimates - Issues Paper

Introduction

- 1 The Task Force is tasked by the IAASB to make recommendations to it concerning possible revisions and improvements to ISA 540 'The Audit of Accounting Estimates'.
- 2 The Task Force presented an issues paper to the IAASB at its December 2002 meeting at which IAASB members expressed broad support for the following suggestions of the Task Force concerning the goals of the revision:
 - **To introduce greater rigor and skepticism into the audit of accounting estimates.** The extant ISA 540 adopts a largely procedural, as opposed to a risk based, approach. The revision would be an opportunity to conform the approach taken to the audit of estimates to the revised risk model recently developed by the IAASB
 - **To provide a framework for analyzing, and communicating to those charged with governance, not only misstatements and differences but also more subtle evidence of aggressive earnings management.**
- 3 IAASB members did not support the suggestion of the Task Force that ISA 540 should be developed as an overarching ISA dealing with measurement uncertainty and that ISA 545 should be converted into an International Auditing Practice Statement under the overarching ISA 540.

Preliminary Draft of a Revised ISA 540

- 4 Included with this issues paper is a preliminary draft of a revised ISA 540 (Draft ED). This Draft ED is presented to provide:
 - (a) A context for considering the issues raised in this paper.
 - (b) An overview of the totality of the ideas of the Task Force.

As the Draft ED is not presented with a view to being "read" by the IAASB the detail of the drafting need not be closely scrutinized by IAASB members.

Implementing the Objectives of the Revision

- 5 Implementing the ambitious objectives of the revision has challenged the Task Force. These challenges are addressed in the Draft ED in the following ways:

GREATER RIGOR AND SKEPTICISM

- Describing the implications for auditors of "measurement uncertainty" and aligning the Draft ED with concepts of measurement uncertainty expressed in Accounting Standards. Responding to this challenge led to the categorization of accounting estimates into three and using these categories as drivers of audit responses (see paragraphs 14 to 16¹). (Although the extant ISA 540 and 545 describe categories of estimate they are not used in those ISA's to determine audit procedures).

¹ These and all other references to paragraph numbers are to paragraphs in the draft ED (Agenda Paper N-B)

- Introducing rigor into the auditor’s process so that when auditing accounting estimates auditors are not able to regard an accounting estimate as being reasonable solely on the grounds that it is a “reasonably possible” outcome. Auditors are challenged to consider whether they have gathered sufficient appropriate audit evidence on which to conclude that the accounting estimate represents the “most likely” outcome. The challenge is two fold:
 - (a) Understanding the true extent of measurement uncertainty through evaluating either the range of likely outcomes or the implications of management’s choice of assumptions (see paragraphs 47 to 53).
 - (b) Where there is a range of possible outcomes, requiring auditors to seek additional evidence to reduce the range (see paragraphs 65 to 69).
- Defining what constitutes a “reasonable estimate” (See paragraphs 21 to 26). This is important because although Accounting Standards acknowledge the need for “reasonable estimates” they do not define “reasonable”. In the Draft ED management’s point estimate is regarded by the auditors as being reasonable if it falls within a narrow range of possible outcomes. A narrow range is defined, in turn, as a range that is less than the materiality of the financial statement item.
- Adopting a more risk based (and less procedural) approach in line with the revised risk model. This manifests itself in
 - Requiring the auditor, in gaining an understanding of the entity and its business risks, to understand the implications for accounting estimates (See paragraph 27). One purpose of the understanding is for the auditor to have a complete understanding of all the accounting estimates where there is a likelihood of material misstatement.
 - Requiring the auditor to assess the risk of material misstatement and determine overall responses to the assessed risk (See paragraph 30)
 - A greater focus on internal control (See paragraphs 37 and 40 to 41)
 - More possible substantive responses than are included in the extant ISA 540 (New substantive responses are, retrospective review of outturn of previous estimates, evaluating the reasonableness of assumptions, and considering the sensitivity of assumptions).
- Making an unambiguous linkage (at paragraph 36) between “accounting estimates that are subject to significant measurement uncertainty” and “significant risks that require special audit consideration”.
- Rigorous documentation requirements (Paragraphs 95 to 96).

FRAMEWORK FOR ANALYZING AND COMMUNICATING MISSTATEMENTS

- Providing detailed guidance on evaluating the results of audit procedures (See paragraphs 75 to 83).
- When the auditor finds evidence that management has misinterpreted or overlooked facts relevant to an accounting estimate this is recorded as a “known misstatement” (See paragraph 76).

- Guidance as to what constitutes a misstatement when the auditor only has sufficient appropriate evidence to support an interval estimate rather than a point estimate (See paragraphs 78 to 83).
- Developing a Summary of Unadjusted Misstatements Form (Appendix 3) for recording misstatements. This form is also used in the draft of ISA 320 which is the ISA where the results of the audit as a whole are pulled together and evaluated.
- A requirement for auditors to evaluate the disclosure of accounting estimates falling within a wide range of possible outcomes, in the financial statements (see paragraph 84). Guidance is provided to encourage directors to describe in the financial statements circumstances giving rise to uncertainties, the range of possible outcomes and the potential effects of the best and worst case scenarios (see paragraph 85).
- The auditor is required to consider whether management is biased when making accounting estimates (See paragraphs 92 to 94). Bias in relation to an accounting estimate is defined as a judgment that although reasonable is influenced by the subjectivity that arises when management has a pre-determined goal such as earnings management.
- Auditors keep track of their bias concerns on the “Summary of Other Findings Form” set out in Appendix 4. The disposition of the findings reported on this Form is dealt with in ISA 320. ISA 320 has a requirement that these findings be discussed with those charged with corporate governance.

Issues on Which the Task Force Seeks Further Guidance from the IAASB

- 6 As can be seen from the above, the proposed revisions to ISA 540 are ambitious. Inevitably this is reflected in the length of the proposed ED. The extant ISA 540 consists of 27 paragraphs whereas the Draft ED consists of 97 paragraphs and 4 appendices.
- 7 Before preparing a Draft ED suitable for a first read by the IAASB the Task Force seeks ratification from the IAASB concerning the general direction being taken by the Task Force, and in particular the following issues.

INTERRELATIONSHIP OF ISA 540 AND ISA 545

- 8 The IAASB at its December 2002 meeting did not support the suggestion of the Task Force that ISA 540 should be developed as an overarching ISA dealing with measurement uncertainty and that ISA 545 “Auditing Fair Value Measurements and Disclosures” should be converted into an International Auditing Practice Statement under the overarching ISA 540.
- 9 In developing the Draft ED the Task Force has taken account of the requirements of both:
 - (a) ISA 545; and
 - (b) the revised Risk Model.

The development of ISA 545 predated the recent revision to the risk model and consequently certain of the basic principles and essential procedures proposed in the Draft ED differ from the requirements of ISA 545.

- 10 Paragraph 7 of the Draft ED provides guidance to the effect that ISA 545 is used when auditing accounting estimates that involve fair value measurement and ISA 540 is used when auditing accounting estimates that do not involve fair value measurement.

- 11 Do members of the IAASB concur with the way in which the inter-relationship of ISA's 540 and 545 is dealt with?

CATEGORIZING ACCOUNTING ESTIMATES

- 12 The extant ISAs 540 and 545 categorize accounting estimates into two:

- (a) simple; and
- (b) complex.

The audit procedures performed under these ISAs, however, are not conditional upon an accounting estimate being in a particular category.

- 13 The Draft ED describes three categories of accounting estimate:

- (a) Accounting estimates that are not subject to significant measurement uncertainty;
- (b) Accounting estimates that are subject to significant measurement uncertainty; and
- (c) Accounting estimates where the degree of measurement uncertainty is so great that the recognition criteria of the financial reporting framework are not met.

Appendix 1 of the Draft ED provides, further description of each of these three categories, examples of each, and summarizes the sources of audit evidence that may be applicable to each category.

- 14 The distinction between the categories is not determined by either:

- (a) The complexity of the estimate; or
 - (b) The materiality of the item being estimated to the financial statements,
- but by the extent of “measurement uncertainty”.

- 15 Measurement uncertainty arises primarily when the accuracy of an accounting estimate is highly dependent upon management's judgment of the outcome of uncertain future conditions, transactions or events. The draft also notes that significant measurement uncertainty often leads to a complex measurement process (See paragraph 15).

- 16 The categorization acts as a driver of the auditor's response to an assessed risk of material misstatement. That is, certain sections of the ISA are intended to apply to accounting estimates falling within a particular category.

- 17 The Task Force considers that the principal focus of the ISA should be on Categories (b) and (c). Paragraphs 36 through 69, for example apply to accounting estimates in these categories. Guidance with respect to accounting estimates in Category (a) is set out in paragraphs 32 through 35 under the overarching requirement set out in paragraph 30(c).

- 18 Do members of the IAASB concur with categorizing accounting estimates in this way and using the categories to drive the nature and extent of audit procedures performed?

LINKAGE BETWEEN SIGNIFICANT MEASUREMENT UNCERTAINTY AND SIGNIFICANT RISKS REQUIRING SPECIAL AUDIT CONSIDERATION

- 19 This issue is closely connected to the previous issue and relates to the content of paragraph 36 of the draft ED. This states that “Accounting estimates that give rise to a risk of material misstatement because of significant measurement uncertainty (i.e. categories b and c) are significant risks that require special audit consideration”.
- 20 The immediately following paragraph sets out the basic requirements in respect of auditing such estimates. Paragraph 37(a) is derived from paragraph 104 of the Exposure Draft of ISA 400 and Paragraphs 37(b) and (c) are derived respectively from paragraphs 40 and 44 of the Exposure Draft of ISA 401.
- 21 Paragraphs 38 through 69 provide Standards and guidance that support the overarching requirements of paragraph 37. Some of these guidance paragraphs also support the requirements of paragraph 34 with respect to auditing those accounting estimates that are not subject to significant measurement uncertainty.
- 22 Do members of the IAASB agree that accounting estimates that give rise to a risk of material misstatement because of significant measurement uncertainty should be regarded as “significant risks that require special audit consideration”?

DEGREE OF PRESCRIPTION OF RISK ASSESSMENT PROCEDURES

- 23 Paragraphs 27 to 29 sets out the Standards and guidance with respect to the auditor’s risk assessment procedures when obtaining an understanding of those accounting estimates where there may be a risk of material misstatement of the financial statements.
- 24 What the auditor is required to do is set out in paragraph 27 and this has been written in the style of the revised risk model. It requires the auditor to obtain an understanding of the entity’s objectives, strategies and business risks that may create a need for management to make accounting estimates. The auditor is also required to obtain an understanding of the entity’s processes for determining such estimates.
- 25 Some members of the Task Force have a concern that the expression “Obtain an understanding of the entity’s objectives, strategies and the related business risks that may create a need for management to make accounting estimates” may not make it sufficiently clear that the auditor is in effect required to have a complete knowledge of those accounting estimates where there is a risk of material misstatement of the financial statements. Guidance to this effect is, however, provided in the last sentence of paragraph 28.
- 26 Do members of the IAASB concur with those who suggest that the requirements regarding risk assessment procedures should be more explicit and specifically require the auditor to have an understanding of all those accounting estimates that may give rise to a risk of material misstatement of the financial statements?

SHOULD THE AUDITORS BE REQUIRED TO TEST THE DATA UNDERLYING ACCOUNTING ESTIMATES?

- 27 The second sentence of paragraph 43 provides guidance concerning the testing of underlying data by the auditors. The sentence is derived from paragraph 51 of ISA 545. ISA 545 also contains the following bold letter requirement. “**The auditor should test the data used to**

develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions”.

- 28 ISA 545 predates the development of the revised audit risk model and the issue for the IAASB is whether a similar explicit requirement is required in ISA 540. The Draft ED has been drafted to be used in conjunction with the revised ISAs 400 and 401. ISA 401 envisages that the nature and extent of substantive procedures are responsive to the auditor's assessment of the risk of material misstatement.
- 29 If ISA 540 were to prescribe the testing of data for all significant accounting estimates this might be considered to be contrary to the philosophy underlying the revised risk model.
- 30 Do members of the IAASB consider that ISA 540 should require auditors to respond to accounting estimates having significant risks by testing the data used to develop the estimates and ensuring that the estimates have been properly determined from such data and management's assumptions?

MANDATING SUBSTANTIVE PROCEDURES

- 31 Paragraphs 44 through 64 describe substantive procedures that might be performed by auditors in response to the risk of material misstatement of an accounting estimate having significant risks. As described in the previous issue, and as agreed by IAASB in December 2002, the Draft ED adopts a risk based rather than a procedural approach.
- 32 There are three bold letter requirements under the overarching requirements in paragraph 35. They are:
- (a) A requirement to evaluate whether the assumptions provide a reasonable basis for the estimates (paragraph 47);
 - (b) To consider the need to develop an independent accounting estimate (paragraph 58); and
 - (c) To consider the effect of subsequent events on accounting estimates (paragraph 62).
- 33 All members of the Task Force are supportive of auditors being required to perform these three procedures. With respect to independent estimates the auditor is not required to make an independent estimate but is required to consider the need to make one where the entity's estimation processes are unlikely to give rise to a reasonable estimate.
- 34 Members of the Task Force have, however, debated whether a retrospective review of the outturn of previous estimates (paragraph 45) and aspects of assessing the sensitivity of changes in assumptions (paragraph 54) should also be requirements of ISA 545. Some members of the Task Force believe that the ISA would not be credible if it did not require auditors to perform retrospective reviews. Other members do not support retrospective reviews being mandated.

- 35 Do members of IAASB consider that the Draft ED strikes an appropriate balance between establishing requirements for auditors and providing guidance to auditors with respect to substantive responses to significant risks? More specifically would members of the IAASB support requiring auditors to perform retrospective reviews and to evaluate the sensitivity of accounting estimates to the achievement of management's intent?

REDUCING THE NUMBER OF POSSIBLE OUTCOMES

- 36 At paragraph 3 of the Draft ED an auditor is required to obtain sufficient appropriate evidence that accounting estimates are recognized, measured and disclosed in accordance with the entity's financial reporting framework and are reasonable in the circumstances.
- 37 One of the objectives of the revision of ISA 540 is to introduce greater rigor and skepticism into the audit of accounting estimates. One way to improve rigor is in respect of the auditor's evaluation of "reasonable in the circumstances".
- 38 When management recognizes an accounting estimate involving measurement uncertainty they make a point estimate of their assessment of the most likely outcome of uncertain future conditions, transactions or events. As there is measurement uncertainty the point estimate they make is likely to be just one of a range of reasonably possible outcomes (If not there is no measurement uncertainty). The point estimate may seem "reasonable" to the auditor even if it is not the "most likely" outcome. The auditor's understanding of an accounting estimate, therefore, needs to include an understanding of the range of reasonably possible outcomes as a prerequisite to evaluating whether management's point estimate is the most likely outcome.
- 39 Consequently paragraph 21 states that "An accounting estimate is not considered to be reasonable solely on the grounds that the point estimate is a reasonably possible outcome. An equally important consideration for the auditor is evaluating the process used by management to determine the most likely outcome".
- 40 Management may have a process that explicitly involves them in considering a range of possible outcomes and then determining the most likely outcome. Alternatively, through choosing which assumptions to use about the outcome of uncertain future events management is implicitly limiting the range of possible outcomes.
- 41 Clearly there may be circumstances where it may not be readily apparent what the most likely outcome will be. In such circumstances, the Draft ED is premised on the basis that a point estimate is reasonable if it falls within a range of reasonably possible outcomes that is less than the materiality of the financial statement item. If a point estimate falls within a range of reasonably possible outcomes that is greater than the materiality of the financial statement item the auditor is required to seek additional audit evidence to reduce the number of possible outcomes.
- 42 If additional audit evidence cannot be obtained then the auditor's response (see paragraph 83) is to consider:
- (a) Whether the measurement is so uncertain that it does not meet the recognition criteria of the financial reporting framework;
 - (b) The adequacy of the note disclosures in the financial statements;

- (c) The effect of the measurement uncertainty on the auditor's report on the financial statements.

43 Do members of the IAASB support the approach taken in the Draft ED with respect to “Reducing the number of possible outcomes”? If so the Task Force would welcome guidance as to whether these paragraphs merit their own separate section within the ISA or should be subsumed within either the substantive procedures section or the evaluation of audit procedures section?

EVALUATING THE RESULTS OF AUDIT PROCEDURES

- 44 Paragraphs 75 to 83 of the Draft ED deal with the auditor's evaluation of the results of audit procedures. This Section of the Draft ED is closely linked to the proposed revision of ISA 320 “Materiality in the identification and evaluation of misstatements” and in particular Appendix 3 which is an extract of a “Summary of Unadjusted Misstatements”.
- 45 The purpose of this section of the proposed ED is to provide guidance as to what constitutes a misstatement to be posted to the Summary of Unadjusted Misstatements (Appendix 3). (ISA 320 deals with the auditor's evaluation of the complete Summary of Unadjusted Misstatements.)
- 46 The ISA adopts the classification of misstatements used in the proposed revision to ISA 320.
- (a) Known misstatements.
 - (b) Likely misstatements.
 - (c) Differences in judgment
- 47 Paragraph 76 addresses the auditor's identification of “known misstatements” and paragraph 77 through 81 address “differences in judgment”. “Likely misstatements” are not addressed in ISA 540 because these misstatements arise from projecting the effect of known misstatements identified in audit samples.
- 48 A member of the Task Force does not support the categorization of misstatements in this way or the inclusion in ISA's of appendices such as Appendix 3 (Summary of Unadjusted Misstatements”). This member of the Task Force considers the Appendix to be inappropriate for inclusion in, or appending to, an ISA because it is a “methodological how-to” rather than a matter of generic principle or guidance.

49 Do members of the IAASB:

- (a) Support the categorization of misstatements described in ISAs 320 and 540.
- (b) Consider it appropriate to append an example “Summary of Unadjusted Misstatements” to ISA 540?
- (c) Consider that Standards and guidance on evaluating the results of audit procedures should be included within this ISA?

DIFFERENCES IN JUDGMENT

50 Differences in judgment are dealt with in the proposed ED as follows:

- (a) Differences between the point estimate recognized by management and the auditors independent point estimate (supported by sufficient appropriate audit evidence) are regarded as misstatements and posted to the “Differences in judgment” column of the Schedule of Unadjusted Misstatements.
 - (b) Where the auditor can only obtain evidence to support an interval estimate the evaluation of what constitutes a misstatement is a function of the magnitude of the range of possible outcomes of the interval estimate and where management’s point estimate lies in relation to that range.
 - (i) If the range of possible outcomes is less than materiality of the financial statement item and management’s point estimate is within the range the estimate is reasonable and no misstatement arises.
 - (ii) If the range of possible outcomes is less than materiality and management’s point estimate falls outside the auditor’s range of possible outcomes there is an unadjusted misstatement of the difference between management’s point estimate and an appropriate point within the auditor’s range of likely outcomes. If there is a normal distribution of possible outcomes within the range the mid-point of the range is regarded as the appropriate point estimate in the absence of audit evidence that supports a different conclusion.
- 51 The guidance to default to the mid point of the range in the absence of evidence to support any other point is likely to be controversial in some countries. Standards in some countries require the misstatement to be the difference between management’s point estimate and the nearest point in the auditor’s range. It is contended by many, however, that this provides management with too much latitude especially where there are many, or a wide range of, reasonably possible outcomes.
- 52 By defaulting to the mid-point of the range there is a presumption that there is a normal distribution of possible outcomes. The guidance suggests that unless there is evidence to the contrary that this should be the default position. Those who support this position believe that:
- (a) it is the most neutral position for the auditor to adopt; and
 - (b) may also encourage management to be more up-front with the auditors about their rationale in choosing a point estimate. (Expressed another way, choosing the mid point provides the auditor with a stronger bargaining position than using the nearest point in the range to management’s point estimate)

53 Do members of the IAASB support the guidance that is proposed for the ISA with respect to differences in judgment?

EVALUATING DISCLOSURES IN THE FINANCIAL STATEMENTS

- 54 One of the objectives of the ISA set out in paragraph 3 is that the auditor should obtain sufficient appropriate audit evidence that accounting estimates are recognized, measured and disclosed in accordance with the entity’s financial reporting framework and are reasonable in the circumstances. The extant ISA 540 requires auditors to obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances.

- 55 Paragraph 84 applies to those accounting estimates where the measurement uncertainty is so great that the recognition criteria of the financial reporting framework are not met. It requires the auditors to evaluate the adequacy of the disclosure. Paragraph 85 provides guidance that suggests that auditors should encourage management to describe, in the financial statements the circumstances giving rise to the uncertainty, the range of possible outcomes and the potential effects of the best and worst case scenarios on the financial statements.
- 56 Some members of the Task Force are concerned that this guidance may be stepping out of Auditing Standards territory and into accounting territory.
- 57 Do members of the IAASB support the requirements regarding evaluating disclosures in the financial statements? If so would they support the requirement being extended to category (b) accounting estimates (i.e. accounting estimates where there is significant measurement uncertainty)?

MANAGEMENT BIAS

- 58 Paragraphs 92 to 94 deal with management bias. Bias is defined as “A judgment relating to an accounting estimate that although reasonable is influenced by the subjectivity that arises when management has a pre-determined goal such as earnings management”. The expression “reasonable” is used in the context of the discussion in paragraphs 21 to 26.
- 59 Bias arises when for example:
- (a) Management consistently uses conservative or aggressive assumptions with respect to a number of accounting estimates.
 - (b) When accounting estimates move from one consistent location within a reasonable interval estimate to another in successive reporting periods. For example, management may change from recognizing estimates of assets from the mid point of the range to the top end of the range.
- 60 The auditor is required to consider if the audit evidence obtained indicates bias on the part of management in the development of accounting estimates. Although bias does not give rise to unadjusted misstatements the auditor is encouraged to keep track of their concerns about bias on the form illustrated in Appendix 4.
- 61 ISA 320 discusses the same form in a broader context and has a similar appendix. It requires the auditor to discuss the matters recorded on the Summary of Other Audit Findings with those charged with corporate governance.
- 62 Do members of the IAASB support the approach to management bias. In particular, do they support the position taken by the Task Force that management bias as defined should not be treated as misstatements?.