



IAASB May 11-13, 2003

*Accounting Estimates Involving
Measurement Uncertainty*

Agenda Item 2-A

Background

- Project to revise ISA 540, *The Audit of Accounting Estimates*
- Joint Project of IAASB and the Auditing Practices Board of the United Kingdom & Ireland (APB)
- Close link to IAASB materiality project

Reasons for revision - 1

- Approach of extant ISA 540 is largely procedural and inconsistent with recently published IAASB exposure drafts of proposed Audit Risk Standards
- Align approach of ISA 540 with approach of ISA 545 “Auditing Fair Value Measurements and Disclosures” issued by IAASB in 2002

Reasons for revision - 2

- Align with developments in Accounting Standards
 - A number of accounting frameworks are considering requiring disclosure of sources of measurement uncertainty (e.g. IAS 1 revision)

Reasons for revision - 3

- Concerns about abuse of accounting estimates to support aggressive earnings management
 - Uncertainty about future outcomes often gives rise to a range within which an estimate might lie
 - Management can bias the results by changing the relative position of an estimate within a range (for example moving from aggressive to conservative)
 - Auditor's difficulty is that, frequently, the greater the uncertainty the less audit evidence is readily available

Progress since October 2002

- Issues paper presented to IAASB (Dec. 2002)
- Informal discussions with IASB staff
- Academic input obtained from an acknowledged expert in the field
- Task Force reached broad agreement on framework for a revised ISA 540
- Coordination with Audit Materiality Task Force

Issues addressed by Task Force - 1

- Three categories of accounting estimates:
 - 1) Estimates not subject to measurement uncertainty (no judgment required and give rise to factual errors)
 - 2) **Estimates subject to measurement uncertainty (uncertainty derives from need for judgment in assessing outcome of uncertain future events)**
 - 3) Not possible to make an estimate because range of possible outcomes is too wide (the item is not recognised in the primary financial statements)

Issues addressed by Task Force - 2

- Encouraging auditors to seek audit evidence to circumscribe the range within which an estimate involving measurement uncertainty might fall

Issues addressed by Task Force - 3

- Determining what constitutes a “misstatement” of the financial statements
 - A misstatement would be the difference between the amount recognized in the financial statements and the auditor’s own estimate

Issues addressed by Task Force - 4

- Evaluating adequacy of disclosure of measurement uncertainty
 - Auditors should evaluate the adequacy of disclosure in the financial statements
 - Inadequate disclosure may lead to an emphasis of matter paragraph in the auditor's report

Issues addressed by Task Force - 5

- Management bias
 - Management may introduce bias into the financial statements by changing the stance they adopt towards the location of estimates, within the range, from one year to another
 - Communicated to those charged with governance.

Timetable going forward

- IAASB reviews first draft of exposure draft at its July 2003 meeting
- Exposure draft issued by the end of 2003
- ISA ready for issuance by the end of 2004