


International Federation of Accountants

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Agenda Item
4
Committee: IAASB

Meeting Location: New York

Meeting Date: February 16-18, 2004

Auditing Accounting Estimates and Related Disclosures
Objectives of Agenda Item

1. To consider the revised proposed exposure draft of ISA 540 *Auditing Accounting Estimates and Related Disclosures (Excluding Those Involving Fair Value Measurements and Disclosures)*, which is presented at this meeting for a first read.
2. To note the connections with the latest working draft of ISA 320 *Materiality in the Identification and Evaluation of Misstatements* that is being considered by the Materiality Task Force.

Background

The objectives of the project are:

- a) 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 is an opportunity to conform the approach taken to the audit of accounting estimates to the revised risk model recently issued by the IAASB and which forms the basis of ISAs 315 and 330.
- b) To provide a framework for analyzing and communicating to those charged with governance, not only financial statement misstatements, but also more subtle evidence of earnings management (described in the draft as "possible management bias").

Activities Since Last IAASB Discussions

At the July 2003 IAASB meeting, the Task Force presented a number of issues on which IAASB views were sought. Since that meeting, the Task Force has met three times, has held two conference calls, and the Chairman presented the topic to the IAASB's Consultative Advisory Group in November, based on the material in the two appendices to the draft exposure draft.

An earlier draft has been reviewed by the "plain English" expert engaged by the IFAC Staff, and a number of his recommendations have been adopted in the latest draft before the Board. Further work will be required in this area to ensure that all the various revisions projects that he is involved with pick up the recommendations in a consistent manner.

Points to consider

The Task Force has debated at length a number of areas, and specifically seeks comments on:

- 1) **What constitutes a misstatement?** It will be useful if members, when considering this issue, refer to paragraphs 67 to 77 of the draft and to Appendix 2 (Agenda Paper 4-A). The Appendix

sets out examples of different situations and how they might be treated. At the heart of this issue is the distinction between "indicators of possible bias" (which the majority of the Task Force believes do not necessarily constitute misstatements) and the three categories of misstatement, as described in paragraph 69.

The majority of the Task Force is of the view that an estimate made by management that falls within a range of reasonably possible outcomes (i.e. a range that has been narrowed as much as it can be by both management and the auditors, see for example paragraphs 57 and 58 of draft ISA) is acceptable for audit purposes, even if it falls at one or other end of the range. On the grounds that the auditor would ordinarily believe that the mid-point of a range is likely to be the "best estimate", the Task Force is proposing that the difference between the booked amount and the mid-point of the range should be noted as an indicator of potential management bias -- but not as a misstatement. Example 1 in appendix 2 deals with this case.

A minority within the Task Force believe that the draft ISA treats inconsistently management's estimates that are respectively inside or outside the range of reasonably possible outcomes. The minority consider that where management's estimate is within the range of reasonably possible outcomes that the difference between management's estimate and the mid point of the range should be recorded as a misstatement.

2) Whether the three categories of misstatements (paragraph 69), together with the additional category of indicators of possible bias are helpful especially in relation to communications with those charged with corporate governance? A minority of the Task Force believe that the differences among the categories are more apparent than real, and will not enhance audit quality in practice.

Connections with working draft of ISA 320

Agenda Paper 4-B provides extracts of a number of paragraphs of the latest working draft of ISA 320. These are presented solely to demonstrate how some of the ideas and concepts discussed in ISA 540 either originate from, or are further developed in, ISA 320:

- Paragraph 9 of ISA 320 is the origin of the classification of misstatements in paragraph 69 of ISA 540
- Paragraphs 12 to 15 provide a discussion of materiality for the financial statements as a whole. Paragraphs 21 to 23 discuss the concept of "acceptable misstatement for classes of transactions, account balances and disclosures". This links to paragraph 78 and Appendix 2 of ISA 540
- Paragraph 46 links to paragraph 69 of ISA 540
- Paragraphs 54 to 56 link to paragraphs 75 to 77 in ISA 540.

Material Presented

Agenda Item 4-A Draft exposure draft of ISA 540
(Pages 143–166)

Agenda Item 4-B Extracts from the latest working draft of ISA 320 that is being
(Pages 167–170) considered by the Materiality Task Force

Action Requested

The IAASB is asked to review the attached draft, in preparation for a discussion at the forthcoming IAASB meeting. It is planned that a revised version, taking into account members' comments, will be submitted to a later meeting (in April or June) for approval to be issued as an exposure draft.