

ISA 540 “Auditing Accounting Estimates and Related Disclosures (Excluding those Involving Fair Value Measurements and Disclosures)”

Response to Comments of the SMP Task Force

[Note to the IAASB: These comments from the SMP Task Force were received in May and refer to the draft that was presented to the April 2004 meeting of the IAASB. The italic annotations explain how the points are addressed in the current draft.]

It was noted that the most common estimates in small and medium clients are inventory valuation, percentage of completion calculations, allowances for doubtful accounts, and third party claims, including law suits. Auditors in small and medium firms often have a very solid understanding of their clients, and are often able to quite confidently audit these estimates. The imposition of the requirements to calculate “reasonable ranges” for many small and medium practices will be a waste of time, and will supplant professional judgment with artificial documentation and quantification requirements.

[The Task Force has never intended to impose a requirement to calculate reasonable ranges and there is no such requirement in the latest draft of the proposed ISA. Responses to the risk of material misstatement paragraphs 36 to 51 outline three responses at the assertion level,

- *Events between period end and the date of the auditor’s report*
- *Testing the Process Used to Develop the Accounting Estimate*
- *Making an Independent Estimate.*

These responses are directed at straightforward (Category A) estimates and none of them require the auditor to calculate reasonable ranges.

For significant risks (Categories B and C) the auditor is only required to independently develop a range of outcomes where management has not adequately supported an estimate (see paragraph 71). Paragraph 58 now makes clear that where management determines a best estimate without establishing a range that the auditor’s response is likely to include evaluating the reasonableness of management’s assumptions. If the assumptions are reasonable then management is likely to have adequately supported the estimate and there is no need for the auditor to develop a range.]

Auditors in small and medium practices do not often calculate “reasonable ranges” in which estimates will fall. More often, the client proposes the estimate, and the auditor tests it for reasonableness. If the IAASB decides to retain the concept of reasonable ranges, auditors may need more advice on how to come up with reasonable ranges, including advice on using the work of experts.

[The Task Force’s response to this point is largely dealt with in the preceding point. Paragraph 72 now provides some fairly high-level guidance as to how the auditor might develop a range.]

The Rapid Response Team recognized the value of the reasonable range in flushing out bias; however they were not convinced that the difference between the mid-point of the range and the client's estimate would always be an indicator of bias. If the client consistently estimates at one or other end of the reasonable range, it is not clear that this is bias. In fact, from year to year, the current year "bias" will have a roll-forward effect, and offset the bias in the next year.

[The Task Force has considered very carefully issues involving bias and neutrality. In the revised draft, the circumstances under which bias arises have been narrowed and are now restricted to circumstances where the financial reporting framework does not specify which point in the range should be recognized (see appendix 2). In those circumstances the Task Force believes that the mid-point of the range represents information that is neutral and therefore free from bias.]

The Rapid Response Team was more comfortable with a look-back method of flushing out bias. Auditors should look at prior years' estimates, and see how well the client was able to make those estimates. Any bias that turns up from this procedure should be classified as a Fraud Risk Factor. If bias is calculated using the look-back method, the additional effort of calculating reasonable ranges in the current year will not be worthwhile.

[The revised draft at paragraph 15 requires the auditor to review the outcome, or re-estimation, of significant estimates made in prior periods. The purpose of this review is described in paragraph 16 as being to provide qualitative evidence of the effectiveness of management's estimation processes in prior periods which may be indicative of the likely effectiveness of management's processes in the current period; and provide audit evidence that is pertinent to the re-estimation of accounting estimates made in prior periods. The Board decided at its April meeting that changes in location of accounting estimates within the range from one period to another should be a misstatement, rather than bias, and this is now dealt with in paragraphs 86 to 88.]

Finally, it was noted that auditors in small and medium practices are unlikely to discuss bias with those charged with governance as required in the proposed standards. The auditors will only go to management and those charged with governance with misstatements. The concept of bias is difficult to explain, and it will be difficult to convince clients that they must correct something if it is not a misstatement.

[ISA 540 deals with the identification of bias arising in accounting estimates and ISA 320 deals with the evaluation of all bias identified during the audit. ISA 540 does not contain any requirements concerning discussions with those charged with governance. In the revised draft the section on bias has been rewritten to include much more guidance on the quantification of bias. The draft recognizes that bias in an individual accounting estimate may give rise to a misstatement when the estimates are considered collectively. The collective consideration of bias is dealt with in ISA 320.]