



International Federation of Accountants

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Agenda Item

10

Committee: IAASB

Meeting Location: New Orleans

Meeting Date: December 6-10, 2004

Accounting Estimates

Objectives of Agenda Item

To approve for issue as an exposure draft, proposed revised ISA 540, “Auditing Accounting Estimates and Related Disclosures (Excluding those Involving Fair Value Measurements and Disclosures)”.

In view of the extensive reconfiguration of the flow of the document, arising from the IAASB’s second read at its September 2004 meeting, it is not helpful to present a marked up draft. At the meeting, the presentation and discussion of the revised proposed exposure draft will, therefore, be based on a clean rather than a marked up draft (Agenda Item 10-A).

A recurring observation of Board members has been the need to streamline and simplify the draft ISA. In response, the Task Force has undertaken a detailed review of the content and detailed drafting, which has given rise to a reduction in the overall number of paragraphs from 102 to 87. This includes a reduction in the number of black letter paragraphs from 19 to 15. To assist Board members in reviewing changes since the September Board meeting, the Appendix to this paper is a table of concordance showing the correspondence between the black letter paragraphs in the September draft with those in the draft submitted for approval.

Task Force Members

The Task Force comprises members of both the IAASB and the Auditing Practices Board of the United Kingdom and Ireland. The members of the Task Force are:

Philip Ashton (Chair)	IAASB member and former APB member
Jon Grant	APB member and IAASB technical advisor
Edmund R. Noonan	Former IAASB member
Andrew Palmer	Former APB member
David Thomas	APB Member
Gérard Trémolière	IAASB Member

Professor William R. Kinney Jr., of the University of Texas at Austin, attends meetings of the Task Force at the invitation of the IAASB.

Activities Since Last IAASB Discussions

The Task Force has met three times since the September meeting of the IAASB. Two of these meetings were conference calls. Representatives of the Materiality Task Force attended parts of two meetings. The objective of the meetings was to consider the implementation of the comments received at the September meeting of the IAASB. Arising from those meetings revisions have been made to the proposed exposure draft of a revised ISA 540. The draft has benefited from recommendations made by Mr. Bob Waller, the expert on “use of English” retained by the IAASB.

Significant Changes Made in Response to the Comments of IAASB at its September meeting**WORDING OF THE OVERARCHING STANDARD**

Paragraph 4 is the overarching black letter paragraph of the proposed ISA. The draft presented to the September IAASB meeting included the following paragraph:

The auditor should obtain sufficient appropriate audit evidence that accounting estimates are appropriately measured, and recognized or disclosed in the financial statements in accordance with the entity’s applicable financial reporting framework and are reasonable.

The IAASB agreed with the Task Force that the overarching requirement should be that accounting estimates are both reasonable, and in compliance with the applicable financial reporting framework. Members of the ISA 700 Task Force, in particular, are concerned that the notion of “reasonable accounting estimates” be explicit in ISA 540 because it is proposed that this expression be used in the auditor’s report. The IAASB instructed the Task Force to amalgamate the ideas of reasonableness and compliance with the Framework. This is accomplished in paragraph 4 of the draft, as follows:

The auditor should obtain sufficient appropriate audit evidence to evaluate the reasonableness of accounting estimates and related disclosures made by management, in the context of the entity’s applicable financial reporting framework.

SENSITIVITY ANALYSIS

Some concern had been expressed by members of IAASB, and other commentators, that earlier drafts placed an undue emphasis on management and the auditor developing “ranges of outcomes”. Although it was never the intention of the Task Force to overly focus on, or appear to mandate, the development of ranges the draft has been re-engineered to seek to avoid creating this impression. With respect to management there is an emphasis on them performing sensitivity analysis and scenario planning, rather than developing ranges per se. This change in focus can be seen in paragraphs 52 to 55 under the heading “Evaluating whether and how management has considered alternative assumptions or outcomes”.

The idea of management ranges, however, has not been abandoned and remains implicit in the guidance that is provided. The difference from earlier drafts is that ranges are now depicted in the context of being a consequence of activities, such as sensitivity analysis, that are undertaken by management in the normal course. The Task Force has striven to avoid creating an impression that the development of ranges is an obligation on management imposed through auditing standards.

REASONABLE RANGE OF OUTCOMES

The Task Force has concluded that the auditor should be required to develop a reasonable range of outcomes when, and only when, the auditor concludes that management has not adequately supported a point estimate (See paragraph 58). Guidance is provided to the effect that this situation is most likely to arise when an estimate is sensitive to assumptions and the auditor is not satisfied that management determined the most likely outcome with sufficient rigor.

The requirement for the auditor to develop a range is preceded by guidance that encourages the auditor to request management to perform further work to provide adequate support.

The auditor's range of outcomes is described as "A reasonable range of outcomes". Such a range is defined, "as not having high and low outcome values whose likelihood of occurrence is judged, by the auditor, to be remote or otherwise 'less likely to occur than not' ". In developing this description of the range the Task Force is seeking to describe the narrowness of the range in a way that avoids the controversy that surrounds the meaning of adjectives such as "possible" or "probable".

MISSTATEMENTS AND INDICATORS OF POSSIBLE MANAGEMENT BIAS

The Task Force has worked closely with the ISA 320 Task Force to ensure that the standards and guidance in ISAs 320 and 540 relating to

- (a) Determining misstatements; and
- (b) Possible indicators of management bias,

are consistent with each other. The material in ISA 540 relating to misstatements has not changed significantly from the draft reviewed in September. The one change, worthy of note, concerns the new guidance surrounding what constitutes a "good reason" for moving location within a range. This guidance is in paragraph 75, and indicates that auditors consider the adequacy of management's explanation for a change. Even where the audit evidence tends to support management's explanation the auditor nevertheless considers whether the change is an indicator of possible management bias.

The material on possible management bias has changed in the following respects:

- (a) The requirement to quantify bias has been removed; and
- (b) The description of bias has been revised to be "Indicators of Possible Management Bias".

The Task Force decided to remove the requirement to quantify bias because such a requirement may give the erroneous impression that bias is a form of misstatement. In ISA 540, which addresses individual accounting estimates, the auditor concludes whether or not an estimate is misstated when looked at individually. ISA 320 includes a discussion of misstatements, bias and other qualitative aspects of the financial statements based on an overall "stand back". The information on possible management bias that ISA 540 requires the auditor to document is intended to contribute to the stand back required by ISA 320. This is described in paragraph 79 (a)(ii) along the following lines "The auditor may be concerned that the apparent lack of neutrality may contribute, along with other qualitative aspects of the entity's accounting practices, to a cumulative risk that the financial statements as a whole may be misstated".

CATEGORIES OF ACCOUNTING ESTIMATES

Earlier drafts of the proposed revised ISA categorized accounting estimates as follows:

- Category A estimates with low estimation uncertainty
- Category B estimates with high estimation uncertainty that give rise to a significant risk
- Category C estimates where the measurement is not sufficiently reliable to meet the accounting recognition criteria.

The draft no longer explicitly categorizes accounting estimates as between A, B and C. A distinction continues to be made between accounting estimates having a risk of material misstatement and accounting estimates that give rise to significant risks requiring special audit consideration. This distinction is in conformity with the recently promulgated risk model standards.

The requirement to determine whether an identified risk is a significant risk is set out in paragraph 23. Separate sections of the ISA address:

- (a) “Responses to the Risks of Material Misstatement” (paragraphs 27 to 46) which applies to all accounting estimates; and
- (b) “Responses to Significant Risks” (paragraphs 47 to 63) which applies only to those accounting estimates that give rise to significant risks.

Paragraph 25 addresses risks that were formerly in Category “C”, and explains why the risks associated with such accounting estimates are significant risks.

GUIDANCE ON ASSUMPTIONS

Paragraphs 34 to 37 have been relocated within the draft. In earlier drafts the discussion of assumptions was restricted entirely to the section on significant risks, and these paragraphs were located in sequence with, what is now, paragraph 51. The Task Force now takes the view that accounting estimates which do not give rise to significant risks may, nevertheless, require management to make assumptions and, consequently, the making of assumptions ought to be discussed as part of testing management’s process.

RISK ASSESSMENT PROCEDURES (PARAGRAPHS 9 TO 22)

In September, a number of members of IAASB expressed concern with the content and flow of this section. The Task Force has responded to these concerns in the following ways:

- Having separate sub-headings relating to each of (a) to (d) in paragraph 10.
- Including “back testing” as (d) in paragraph 10. Previously back testing had been the subject of separate black letter paragraph 15. It had been unclear to some IAASB members how backtesting was intended to fit into the flow of risk assessment procedures.
- Understanding the requirements of the financial reporting framework has become the first risk assessment procedure for which guidance is provided.
- Developing guidance paragraphs 16 and 17 to address “Management’s identification of accounting estimates”.

OVERALL RESPONSES AT THE FINANCIAL STATEMENT LEVEL

Following the recommendation of the Board at the September meeting the section dealing with overall responses at the assertion level has been deleted from the draft. Paragraph 28 now notes that ISA 330 addresses responses at both the financial statement and assertion levels and that ISA 540 focuses on specific responses at the assertion level only.

In the previous draft there was a standard and guidance relating to using the work of an expert under the heading of “overall responses at the financial statement level”. As instructed by the Board much of this material has been retained. In black letter paragraph 31(c) there is reference to the use of an expert in making an independent estimate.

CONFIRMING EVENTS

There are two developments in the draft relating to the standards and guidance provided in respect of events that occur between the year-end and the date of the auditor’s report.

- (a) Paragraph 29 is now a discrete black letter paragraph dealing with such subsequent events. The requirement is now more neutral as it now requires the auditor to determine whether subsequent events confirm or contradict the accounting estimate made. When subsequent events contradict an accounting estimate made, paragraph 43 provides guidance that making an independent estimate may be an appropriate response.
- (b) In responses to significant risks paragraphs 47 through 49 provide guidance to the effect that confirming events may mitigate or eliminate a significant risk. The possibility of including such guidance was mooted at the September IAASB meeting.

TESTING OF CONTROLS

The draft reviewed in September set out two possible responses to the risk of material misstatement at the assertion level. These were:

- (a) Testing the operating effectiveness of the process used to develop the accounting estimate...; and
- (b) Making an independent estimate.

The Board concluded that the expression “operating effectiveness of the process” may confuse users of ISAs, as “operating effectiveness” is a term used, in the risk model, with respect to internal control. The Task Force has decided (see paragraph 31) that the procedures, which auditors should consider using when subsequent events do not confirm an estimate made should be:

- (a) Testing management’s process to establish whether it operated in accordance with the auditor’s understanding;
- (b) Testing the operating effectiveness of the controls over management process, together with appropriate substantive procedures; and
- (c) Making an independent estimate.

Paragraphs 39 to 42 have been drafted to support (b). Guidance paragraphs already existed for (a) and (c).

APPENDICES

As recommended by the Board, arising from the second read in September, both appendices have been deleted.

CHANGES IN, AND OTHER MATTERS RELATING TO, TERMINOLOGY

- As discussed at the September meeting the expression “**estimation uncertainty**” replaces “measurement reliability”. It is defined as “the susceptibility of a financial statement item to a lack of precision in its measurement because the outcome of future events is not known”. See paragraph 1 of the draft.
- The expression “range of probable outcomes” has been replaced by “**reasonable range of outcomes**”. This is defined as a range that “does not include high and low outcome values whose likelihood of occurrence is judged to be remote or otherwise less likely to occur than not”. See paragraph 59 of the draft.
- The expression “**sensitivity analysis**” has been given greater prominence in the draft and consequently a description of what is meant by the expression is now provided. Paragraph 53 provides guidance to the effect that a sensitivity analysis involves determining the degree of variation in the monetary amount of an accounting estimate from varying assumptions.
- The expression “**significant assumption**” was previously used in the draft without definition. A significant assumption is defined as an assumption in respect of which an accounting estimate is highly sensitive.
- The expression “**point estimate**” has replaced “best estimate”. This is because in some financial reporting frameworks the point estimate that has to be used by preparers is not “the best estimate” as defined in IFRSs.
- The expression “**operating effectiveness**” is now used in the draft only in connection with internal control. Its use in connection with management’s process has been discontinued. This brings the draft more in conformity with the risk model terminology.
- A number of expressions were used in earlier drafts to refer to “**management’s process**” of preparing accounting estimates. Expressions such as “management’s methods” or “methods and related controls” have been discontinued so as to avoid the potential for misunderstanding.

Previous Board decisions

At its April 2004 meeting the IAASB voted on two issues relating to ranges.

- (a) The IAASB concurred with the Task Force that there is not a misstatement if management’s estimate falls within a range of reasonably possible outcomes with the proviso that such a range should also be of equally possible outcomes. Since April the use of the descriptor “range of reasonably possible outcomes” has been discontinued. However, guidance consistent with the Board decision can be found in paragraph 72 of the draft.
- (b) The IAASB decided that if an accounting estimate moves within the range from period to period, with no justification, that this gives rise to a misstatement rather than bias. Guidance to this effect is set out in paragraphs 74 and 75 of the draft.

The Task Force considers that the Board’s decision in (a) should continue to stand. However, following the substantive changes made to the draft regarding ranges and indicators of bias, since the decision was taken, the Task Force recommends the IAASB to reconsider (b). The issue is whether movement within an auditor developed range, without good reason, should continue to be regarded as

a misstatement or should, instead, be regarded as an indicator of possible management bias. The Task Force does not have a unanimous recommendation to the Board on the issue.

Material Presented

Agenda Paper 10-A Estimates – Proposed Exposure Draft of Revised ISA 540
(Pages 2447 – 2466)

Action Requested

The IAASB is asked to review and approve the proposed exposure draft for approval for issue.

Comparison of black letter paragraphs in the proposed Exposure Draft with the September draft considered by IAASB

Bold letter para. in Sept. draft	Equivalent in Agenda Paper 10-A	Comments
3	4	“Reasonableness” directly related to “in the context of the entity’s applicable financial reporting framework”.
10	10(a) to (c)	
15	10(d)	
32	23	Two black letters combined into one. The examples in paragraph 34 have been relegated to grey letter in new paragraph 26, which is derived from what was Appendix 1.
34	23	
36	27	At IAASB request reference removed to “financial statement level”.
39	31(c)	
(41)	29	Confirming and contradictory subsequent events now a stand-alone black letter as suggested by IAASB.
41	31	New distinction (supported by new grey letter material) between “testing management’s process” and “testing the operating effectiveness of controls”
53	49	As instructed by IAASB the paragraph has been modified to restrict the additional requirements where significant risks have not been mitigated or eliminated by confirming events. The parenthetical references now make it clearer that ISA 540 deals with (c) and that ISAs 315 and 330 deal with (a) and (b).
60	50(a)	
68	50(b)	The focus of this paragraph has been changed away from ranges of outcomes to the consideration by management of alternative assumptions or outcomes
71	58	
75	63	
78	66	68 has been conformed to paragraph 4
90	77	Requirement to quantify management bias removed.
95	81	
97	84	
99	86	
100	-	Merged into 88
19 Bold Letter Paras	15 Bold Letter Paras	Net reduction of 4 Bold Letter Paragraphs