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## **Agenda Item**

# **4**

**Committee:** IAASB

**Meeting Location:** Hong Kong

**Meeting Date:** March 6–10, 2006

### **Redrafted ISA 540 – Accounting Estimates, and Way Forward for ISA 545 – Fair Values**

#### **Objectives of Agenda Item**

1. The objectives of this agenda item are:
  - To obtain the views of the IAASB on the initial redrafting of ISA 540 (Revised and Redrafted), for purposes of input to the Task Force as it considers the implementation of the ‘clarity’ conventions.
  - To agree the way forward for revising and redrafting ISA 545, “Auditing Fair Value Measurements and Disclosures,” specifically in terms of dealing with the relationship between ISA 540 and ISA 545.

#### **Task Force**

2. The Task Force responsible for this project is the Estimates Task Force. The members of the Task Force are listed in Agenda Item 3.

#### **I. Matters for IAASB Consideration – *Redrafting of ISA 540 (Revised)***

3. The IAASB asked that the Task Force present for discussion in March a draft ISA 540 (Revised and Redrafted), redrafted in accordance with the new drafting conventions under the Clarity project.
4. The Board is asked to focus its consideration on the following aspects:
  - The draft objective to be achieved.
  - The disposition of sentences in the present tense, as either new requirements or as application material.
  - The overall structure and flow of the requirements section.
5. The Board is also asked for its views on areas where further drafting improvements might be made to the application material section of the redrafted ISA. Specific drafting suggestions can be submitted to Staff outside of the main meeting.

*Draft Objective*

6. The intent of the draft objective is to convey the underlying purpose or goal of the work of the auditor under the ISA, which the requirements that follow assist the auditor in achieving. This contrasts with the practice of the overarching bold type requirement which broadly summarized the requirements of the ISA.
7. One suggestion that has been made is that the objective should not hinge solely on the notion of determining the 'reasonableness' of an estimate. The concern expressed was that this may be understood commonly as being directed primarily towards the measurement assertion, to the avail of others. The issue of whether, and if so how far, the objective should move away from the wording of the auditor's report in this regard was acknowledged as one that may need to be addressed by the IAASB.
8. The Task Force has retained the link to 'reasonableness,' for consistency with ISA 700, but has given greater prominence to the need to obtain sufficient appropriate audit evidence, which subsumes consideration of all relevant assertions.
9. In addition, there have been generally inconsistent views on the form that the objective of an ISA dealing with a specific subject matter (under the umbrella of the audit risk standards) should take. Some see the need to refer to the auditor's identification, assessment and response to risks of material misstatements, in order to link to the requirements of the ISAs where they amplify the requirements of the audit risk standards. Others view that reference to obtaining sufficient appropriate audit evidence is sufficient to avoid unnecessary overlap in the objectives, given that the relationship between reducing audit risk and audit evidence is established.

**Action Requested**

The Task Force's recommendation for the 'objective' is shown in paragraph 7 of Agenda Item 4-A. The IAASB is asked for its views thereon.

*Requirements and the Present Tense*

10. Subject to comments on the October 2005 Clarity Exposure Drafts, the IAASB has adopted the following guidelines for use in determining the requirements of a Standard:
  - The requirement is necessary to achieve the objective stated in the Standard;
  - The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; and
  - The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.

In addition, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

**Action Requested**

The IAASB is asked to:

- Review Agenda Item 4-B and indicate whether with it agrees with the proposed treatment of sentences in present tense.
- Review the draft ‘requirements section’ of the redrafted ISA in Agenda Item 4-A and indicate whether:
  - It agrees with the presentation of the requirements; and
  - It believes that sufficient explanatory text has been included therein for a reader to understand the requirements section on a stand-alone basis.

**Material Presented**

Agenda Item 4-A            Draft ISA 540 (Revised and Redrafted) (Clean)  
(Pages 319-342)

Agenda Item 4-B            Summary and Disposition of the Present Tense  
(Pages 343-348)

11. The Task Force will be using Agenda Item 4-A for purposes of discussion at the meeting.

**II. Matters for IAASB Consideration – *Way Forward for ISA 545 – Fair Values****Background*

12. In response to the ISA 540 (Revised) Exposure Draft, several respondents raised the issue of the need to clarify the relationship between ISA 540 and ISA 545. The prevailing view was that the ISAs should be “combined” or “amalgamated,” on the following basis:
- ISA 545 needs to be revised in light of the audit risk standards, and should also be updated to incorporate the improvements made in ISA 540 (Revised). However, a separate and subsequent revision may result in inconsistencies with the final ISA 540 (Revised).
  - Similar, and frequently identical, audit approaches are taken to audit accounting estimates and fair values measurements and disclosures. The existence of two separate ISAs on similar topic may result in confusion.
  - The appropriateness of a separate standard on fair values is becoming less evident as changes in accounting standards make it increasingly difficult to distinguish between estimates and fair values.
13. In October 2005, the IAASB agreed that, in light of the effect on the timetable to finalize ISA 540 and the potential effect on the overall understandability of that ISA, the two ISAs should not be amalgamated. Rather, the IAASB asked that the Task Force identify a solution to address the overlap between the two ISAs.
14. Based on a preliminary analysis by Staff, it was suggested that one possibility may be to present additional requirements and guidance that are unique to the audit of fair values within a

separate ISA (i.e., ISA 545, clarified in accordance with the new drafting conventions) that supplements ISA 540 (Revised and Redrafted). The combination of the two ISAs could be completed in the future, if considered necessary and appropriate.

15. The IAASB and CAG supported the further exploration of this way forward.

#### *Issues*

16. The Task Force has considered a comparative analysis of ISAs 540 and 545, together with different models (ranging from a 'one combined ISA' to variation of ISA 545 presented as a supplement to ISA 540) that might serve to deal with the issue of overlap.
17. The Task Force has identified the following issues and observations that suggest the solution for dealing with the overlap between the two ISAs requires more extensive consideration by the Task Force and IAASB than perhaps originally envisioned.

#### *Structuring Options – Trading-off Repetition and Understandability*

18. None of the models considered by the Task Force dealing with the structure of, and relationship between, ISAs 540 and 545 were without significant drawback:
- Setting ISA 545 as a supplement to ISA 540 (to minimize duplication) results in a situation where the application material pertaining to fair values becomes too far removed from the relevant requirements to be understandable (i.e., a significant loss of context). Further, it creates for the reader a complex process of considering relevant application material in both ISAs 540 and 545.
  - Combining ISAs 540 and 545 creates an unwieldy and highly complex ISA.
  - Retaining ISA 540 and ISA 545 as separate, stand-alone ISAs results in significant duplication.
19. Although there are relatively few bold type paragraphs that remain unique to fair values (i.e., that have not been covered by the revised requirements of ISA 540), the difficulty in determining an appropriate solution is compounded by the fact that there is a significant amount of application material pertaining to the audit of fair values.
20. Further, the best option in the circumstances depends on whether it is in fact appropriate to continue to have a separate ISA on fair values (as discussed further below).

#### *The Need for a Separate ISA on Fair Values*

21. Different views exist on the issue of whether it is appropriate to promulgate the notion that there is a distinction between accounting estimates and fair values from an auditing perspective.
22. Some view that a separate ISA on fair values has little foundation from an auditing point of view, as similar approaches are often taken to the audit of either estimates or fair values. Further, it is contrary to the direction accounting standards appear to be taking; as accounting standards move further into fair value measurements, the distinction between estimates and fair values is becoming more difficult to draw. This view was supported by one CAG member who advised dealing with the conceptual distinction as a secondary concern. Accordingly, unless a

clear distinction between the two can be made, the auditor will be faced with the difficulty of establishing “which ISA the auditor should be in.”

23. Others appear to believe that a separate ISA is needed because of the prevalence of reference to fair value measurement in financial reporting frameworks. This is consistent with the general advice that the IAASB has received indicating that a separate ISA is warranted. Further, it has been noted that there is merit in retaining a separate ISA on fair values because, for example: (i) the measurement of fair values is premised on basis of exchange at a point in time and a focus on market-participant assumptions, whereas estimates deal with the outcome of future events and entity-specific / management-generated assumptions; and (ii) there are differences in the sources of reliable audit evidence. This suggests that the focus and orientation of ISA 540 may not be wholly suitable to the audit of fair value measurements. (It also suggests that the guidance in ISA 545 dealing with the auditor’s consideration of assumptions is incorrect; this and possibly other changes may therefore be needed to ISA 545 to reflect developments in accounting literature).

#### The Disposition of ISA 545

24. Irrespective of the structure to be taken for dealing with the overlap between the ISAs, the following matters are of concern in dealing with ISA 545, particularly in terms of its consideration vis-à-vis ISA 540:
- ISA 540 has not been drafted with the consideration of auditing fair values specifically in mind. It remains to be tested whether all of the requirements and application material in ISA 540 are fully applicable to the audit of fair values.
  - Adopting the requirements of ISA 540 effectively revises ISA 545, expanding it in a number of ways. Further, the Task Force does not see how ISA 545 could be redrafted without some revision to align it with the audit risk standards. This may preclude any notion that this exercise can be subsumed within the remit of redrafting.
  - If, in effect, ISA 545 is being revised, then there is an argument that full consideration be given to developments in accounting and auditing literature at the same time, to avoid the need for a future revision.

#### Avoiding the Need for Subsequent Change to ISA 540

25. ISA 545 contains a significant amount of explanatory material, within which a large number of sentences are in the present tense. The process of considering those sentences may result in identifying additional requirements that, although unlikely, may better be presented in ISA 540, or that may result in inconsistency between the two ISAs. Exposure of the redrafted ISA 540 in advance of ISA 545 may create the potential need to re-open ISA 540, which would be highly undesirable.

#### IAPS on Derivatives

26. Some respondents to the ED, and other stakeholders, have suggested that IAPS 1012, “Auditing Derivative Financial Instruments,” and ISA 545 be amalgamated, as part of the process of updating and revising ISA 545. This would entail considering whether IAPS 1012 needs to be revised. If so, this would have a significant impact on the ability of the IAASB to conclude on

ISAs 540 and 545 in a timely manner. Further, doing so may prejudice the outcome of future IAASB deliberations on future role of IAPSs, if any.

### *Recommendations*

27. The Task Force's recommendations for the way forward for ISAs 540 and 545, taking account of the above, are as follows:

- ISA 545 should be dealt with, in the first instance, as a revision. The standards and guidance in draft ISA 540 (Revised and Redrafted) would be taken account of, but the issue of duplication ignored.
- The exposure of redrafted ISA 540 (Revised and Redrafted) should be deferred until work on a draft exposure draft of revised ISA 545 is completed.
- The Estimates Task Force should continue to be responsible for dealing with both ISA 540 and ISA 545, to ensure consistency. Its membership, however, should be expanded to include fair value subject matter experts.
- The consideration of the treatment of IAPS on derivatives should be excluded from the work to revise ISA 545.
- When the revision of ISA 545 is progressed to the point of exposure, a comparison with ISA 540 (Revised and Redrafted) should be made, the options for combining the two ISAs explored in full, and a solution agreed.
- Exposure of the revised and redrafted ISA(s) should be undertaken concurrently.

28. The anticipated timeline is as follows:

Activity	Timing of IAASB Discussion
<b>Phase I – Deal with ISA 545</b>	
• Revise and redraft ISA 545, on the basis of a 'stand-alone' ISA.	September 2005
<b>Phase II – Deal with Structure and Relationship between ISAs 540 and 545</b>	
• Consider alternatives for dealing with overlap between ISAs 545 and 540 ('one combined ISA', 'two stand alone ISAs', or 'ISA 540 umbrella-ISA 545 supplement' model), and agree model	December 2006
• Issue exposure draft of ISA(s)	
• Approve final ISA(s)	December 2007

### **Action Requested**

The IAASB is asked to indicate whether it agrees with the recommendations of the Task Force, and for its views on other options, if any, that should be considered.