

Issues Paper - Summary of Significant Comments on Exposure Draft, ISA 540 (Revised), and Recommended Dispositions**Introduction**

1. This paper summarizes significant comments received on the ED, ISA 540 (Revised), and the Task Force's recommended dispositions for consideration by the IAASB. The IAASB is requested to approve the dispositions proposed by the Task Force or provide input on the direction the Task Force should take to address the issues.
2. Agenda Item 2-B presents a clean version of the proposed revised ISA 540 (Revised). Agenda Item 2-C presents proposed changes to the ED (shown in mark-up) as a result of comments received. The IAASB is requested to provide input on the proposed changes to the ED.

Overall Comments

3. A significant majority of respondents expressed support of the initiative and related proposals to enhance the rigor and skepticism in the audit of accounting estimates. Specifically, respondents were pleased to see the introduction of a risk based approach to the ISA and were supportive of addressing the issue of management bias, as part of the overall goal of improving audit quality.
4. Of the forty respondents, eight indicated general support for the ED with a few editorial suggestions. The remainder of respondents commented variously on issues that are the subject of this paper. None of these issues received comments from more than fifteen respondents.
5. Respondents representing national standard setters, practitioners and professional organizations generally, on balance, were concerned with the structure of the ED and practicality of some of the proposals, particularly in relation to ranges, misstatements and bias. Responses from regulators, however, were generally concerned with opportunities to further strengthen the ED. The balance of responses suggests that there is strong support for the overall direction and the fundamental concepts underpinning the ED.
6. The issues raised by respondents cover areas generally where the IAASB itself has had the greatest challenge in reaching consensus. Significant comments have been analyzed as follows:
 - A. Scope and Structure of the ED
 - I. Relationship between Risks of Material Misstatement and Significant Risks
 - II. Considerations in the Audit of Smaller Entities
 - B. Ranges, Misstatements and Bias
 - III. Auditor-Developed Range of Reasonable Outcomes
 - IV. Defining a Sufficiently Narrow Range of Reasonable Outcomes
 - V. Point Estimates, Treatment of Differences as a Misstatement, and Classification of Misstatements
 - VI. Change in the Location of an Estimate within a Range of Reasonable Outcomes

VII. Indicators of Possible Management Bias

C. Other Matters

VIII. Scope of the ED and Its Relationship with ISA 545

IX. Miscellaneous Matters

Significant Comments

A. Scope and Structure of the ED

I. Relationship between Risks of Material Misstatement and Significant Risks

(Reference: ED Paragraphs 27-44, and 47-63)

Responses to Risks of Material Misstatement and Significant Risks

7. Ten respondents (CNCC, DT, EY, FEE, GTI, ICAEW, IdW, KPMG, PKF, PwC) were uncertain as to the sequence of the auditor's work, specifically application of the sections dealing with responses to the risks of material misstatement (ED paragraphs 27-44) and responses to significant risks (ED paragraphs 47-63). Respondents noted that the ED was unclear as to whether the procedures to respond to the risks of material misstatement were applicable to significant risks and vice versa, and whether the guidance on evaluating audit evidence and concluding on the reasonableness of the estimate was applicable to all estimates.
8. Respondents also noted that the proposed separation of the guidance on responses to the risks of material misstatement from responses to significant risks is inconsistent with the structure of both ISA 315 and ISA 330, which indicate incremental requirements in relation to significant risks. This inconsistency could possibly create confusion, misinterpretation or inconsistency in practice.
9. In addition, the structure of the ED raised concerns by respondents in terms of the interrelationship between, and overlap of, guidance in specific areas. In particular, guidance on developing a range of reasonable outcomes (ED paragraphs 54-57) and making an independent estimate (ED paragraphs 28c and 41-44) were seen as dealing with the same topic. Similarly, concerns were raised with respect to the split of the guidance on significant assumptions between the section on testing management's process and significant risks, which was seen as confusing.
10. Further, a few respondents noted that the ED omits guidance for identifying and assessing the risks of material misstatements (that is, it only provides guidance on the assessment of significant risks), and that it does not address consideration of estimates that do not pose a risk of material misstatement but for which audit evidence should be obtained.

DISCUSSION AND RECOMMENDATIONS

11. In light of respondents' comments, the Task Force has reconsidered whether the structure of the ED is sufficiently clear in terms of the intended cumulative process to be followed by auditors in the audit of estimates and of the applicability of guidance to risks of material misstatement and significant risks. The Task Force is of the view that there is in fact a

potential for misinterpretation and that, therefore, the structure should be revised and clarified.

12. The Task Force believes that a principal cause of the respondents' concerns relates to the placement of the guidance on significant risks as a separate section in the ED distinct from the section dealing with responses to the risks of material misstatement. Although aligned in principle with the audit risk standards, having a separate section on significant risks may have caused confusion as to whether responses to risks of material misstatements are also applicable to significant risks.
13. The structure of, and guidance in, the ED has therefore been revised:
 - To “combine” in one section responses to risks of material misstatement and significant risks, with requirements relating to significant risks identified therein as further substantive procedures to those required in responding to the risks of material misstatements (see revised headings in Agenda Item 2-B).
 - To clarify the applicability of the procedures in paragraph 40 of the ED to both risks of material misstatement and significant risks (see paragraphs 41, 45, 58 and 63 in Agenda Item 2-B).
 - To reposition the guidance pertaining to significant assumptions to clarify that it is applicable to both risks of material misstatement and significant risks, and to improve the flow of the document (see paragraphs 49-54 and 65 in Agenda Item 2-B).
 - To reposition the guidance on evaluating the disclosure of estimation uncertainty in the financial statements as part of the section on further procedures to respond to significant risks (see paragraphs 78-83 in Agenda Item 2-B).
14. With respect to the observation by respondents that ISA 540 needs to deal with estimates that do not pose a risk of material misstatement, the Task Force notes that the proposed revised ISA is consistent with audit risk standards in this regard.
15. The Task Force also considered the option, as suggested by some respondents, of addressing structural concerns by introducing a decision tree (or “flow chart” or “wiring diagram”) to explain how the sections addressing the risks of material misstatements and significant risks should be applied. The Task Force concluded, however, that restructuring of the ED presents a more effective solution.

Does the IAASB agree with the proposed restructuring of the sections on risks of material misstatements and significant risks?

Events Occurring Up to the Date of the Auditor's Report

16. Some respondents (ACAG, CNCC, DT, EY, IdW, PwC) raised concern with the structure of the ED in terms of the emphasis placed on the proposed requirement to review events occurring up to the date of the auditor's report. Although it was generally acknowledged that this procedure is likely to be an efficient and effective way to obtain evidence, particularly in the case of the audit of SMEs, respondents noted the following:
 - The structure of the guidance implies that events occurring up to the date of the auditor's report are the primary procedures the auditor carries out. As such, there is a

risk that it may be too late for other procedures should events occurring up to the date of the auditor's report fail to provide audit evidence. At least one respondent had interpreted the guidance in this manner, and requested additional guidance in terms of determining the point at which the auditor is able to determine that there are no such events and apply other procedures.

- In many cases, particularly when dealing with a difficult or longer term accounting estimate, the review of events occurring up to the date of the auditor's report will not necessarily allow the auditor to collect sufficient appropriate audit evidence on the estimate. In addition, audit evidence from such events does not always confirm or contradict an accounting estimate, but may only lead to additional information about that estimate.
- Given that many estimates may be assessed as having the risk of material misstatement, the obligation to determine whether events occurring up to the date of the auditor's report provide contradictory evidence in relation to the estimates places an undue obligation on the auditor. One respondent suggested linking this requirement solely to accounting estimates that are considered significant risks.

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17. The Task Force concluded that the auditor's review of events occurring up to the date of the auditor's report should form part of the combination of procedures that could be performed in response to risks of material misstatement, rather than as a separate requirement. This change does not undermine the fact that this procedure may be a more appropriate approach in some circumstances than in others; however, it clarifies that this procedure – as a technique in auditing accounting estimates – is not necessarily the primary procedure to be considered, and would also give it equal prominence with the other types of procedures that the auditor could choose to perform. The Task Force also agreed that additional guidance should be provided clarifying that:
 - Other procedures may be necessary where other than a relatively simple estimate is involved, as events occurring up to the date of the auditor's report may not confirm or contradict the estimate, but only lead to additional information (see paragraph 45 in Agenda Item 2-B).
 - The procedure is a consideration that is separate from the requirements of ISA 560, "Subsequent Events" (see paragraph 46 in Agenda Item 2-B).
18. The Task Force, however, does not accept the suggestion that it may be more appropriate to link this requirement solely to accounting estimates that are considered significant risks, as such risks are often unlikely to be resolved by events occurring up to the date of the auditor's report.

Does the IAASB agree with the proposed treatment of the requirements and related guidance pertaining to events occurring up to the date of the auditor's report?

Making an Independent Estimate

19. One respondent (PwC) suggested that it may not be necessary for the auditor to carry out additional procedures for significant risks when the auditor has made an independent estimate.

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20. The Task Force does not agree with the proposition by the respondent that the making of a point estimate by the auditor (or an expert if one has been engaged by the auditor) reduces or eliminates the need to perform additional procedures for a significant risk. Even where the auditor has made a point estimate, there remains a need for the auditor to evaluate the significant assumptions made by management and management's process for considering and rejecting alternative assumptions. These steps are essential because of the influence that such assumptions are likely to have on an accounting estimate and to validate further any findings that may arise from the development of a point estimate by the auditor.

Does the IAASB agree with the recommendation to retain the requirement for those procedures associated with significant risk even when the auditor or an expert made a point estimate?

II. Considerations in the Audit of Smaller Entities

21. Fourteen respondents (ACAG, AASB-ZA, ACCA, CICA, FEE, ICAEW, ICAI, ICANZ, ICAS, CAZ, IRE, KPMG, PKF, PwC) expressed concerns variously in relation to the applicability of the ED to small- and medium-sized entities (SMEs). Generally, it was felt that the omission of specific considerations applicable to audits of SMEs is “one of the main defects of the draft;” that the draft was written “primarily from a larger company perspective, whereas it should be appropriate for audits of all companies;” and that a “think small first” approach should be applied. A recurring theme in the comments is the lack of capacity in smaller entities to perform work the ED expects to be performed by management.
22. Respondents' concerns included the following:
 - SMEs frequently rely on the auditor to assist them in making accounting estimates, and the ED omits guidance pertaining to the related ethical issues that may arise.
 - A specific and identifiable process for making accounting estimates may not exist in smaller entities.
 - Auditors of smaller entities may not have the resources to develop a range of reasonable outcomes.
 - The ED does not acknowledge that some estimates may be relatively simple to audit (e.g. estimates that do not have a high level of measurement uncertainty); since not all estimates are equal, a different level of effort by the auditor will be required to obtain sufficient appropriate audit evidence.
23. One respondent (CNCC/CSOEC) urged the IAASB to reintroduce the “accounting estimate categories” (that is, a category identifying estimates with high measurement reliability “Category A,” and a category identifying estimates with low measurement reliability “Category B”) that was included in earlier drafts of the ED, to help with the applicability of the ED for audits of SMEs.

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24. The Task Force is not convinced that the ED raises particular issues relating to SMEs. The Task Force observed the following:
- The ED acknowledges that there are alternative approaches to the audit of estimates, depending on the circumstances, and therefore does not prescribe a specific approach.
 - It should be relatively easy for the auditor to discharge the requirements of the ED in the SME context, taking into account that the estimates likely to be present in SMEs are relatively simple and do not have high estimation uncertainty.
 - ISA 315 and ISA 330 provide guidance on owner-manager processes and controls; it is, therefore, unnecessary to further address such considerations beyond that which is done by those ISAs.
25. The Task Force concluded, however, that there is an opportunity to provide additional guidance for considerations on the audit of SMEs to explain the relevance and application of the requirements. Specifically, it recommends that guidance be incorporated into the proposed revised ISA emphasizing, for example, that:
- Some estimates, particularly in the SME environment, are more likely to be relatively simple, as opposed to those encountered in larger entities (see paragraph 7 in Agenda Item 2-B).
 - For smaller entities, the range of business activities and transactions to which the entity is party is often more limited than that of a larger entity. Consequently, management process for making estimates may be simple and the estimates straightforward (see paragraphs 7 and 20 in Agenda Item 2-B).
 - The procedure of reviewing events occurring up to the date of the auditor's report may be effective in the SME environment where there is ordinarily a longer post balance sheet date period for review of such events (see paragraph 42 in Agenda Item 2-B).
26. The Task Force is also of the view that the changes recommended to simplify and improve the guidance in connection with ranges should also serve to enhance the applicability of the ISA to SMEs – See Sections III-VI of this paper.
27. With respect to the suggestion to reintroduce the “categories of estimates,” the Task Force recognizes that some auditors may find this helpful. However, the Task Force did not find the arguments to reintroduce the categories sufficiently compelling to warrant recommending to the IAASB to reconsider its previous conclusion that descriptive language, consistent with that of audit risk standards, should be used for drafting purposes.
28. The Task Force also concluded that it is inappropriate to address ethical issues that arise where an owner-manager requests and receives assistance from the auditor in developing estimates. Such issues are applicable to a variety of ISAs broadly and are governed by the IFAC Code of Ethics.

Does the IAASB agree that the proposed changes provide appropriate guidance to the considerations in the audit of SMEs? Are there any other steps that should be taken to address the considerations of SMEs?

B. Ranges, Misstatements and Bias**III. Auditor-Developed Range of Reasonable Outcomes**

(Reference: ED Paragraphs 54, and 56-57)

29. While some respondents expressed support in principle for the auditor to consider developing a range of reasonable outcomes (subject to clarification as to the circumstances when developing a range would be appropriate), eleven respondents (AuASB, CPA Aus, CNCC, FEE, GTI, HKICPA, IAA, ICAEW, IdW, KPMG, PwC) raised concerns variously about the proposal. These respondents were of the view that the ED appears imbalanced with respect to the responsibilities of the auditor and management. In particular, it does not place sufficient emphasis on the need for the auditor to request management to carry out additional work before considering the practicality of developing a range. Respondents were strongly concerned that an incorrect message – that management’s refusal to perform the necessary work results in an obligation of the auditor to resolve the shortfalls of management – is being communicated in the ED.
30. Further, some respondents were of the view that the current wording raises the expectation that auditors will often be able to, and therefore should, develop a range. This could possibly lead to a situation where management relies on the auditor to develop the range, thus providing legitimacy for the management’s point estimate. The proposed requirement was seen as too demanding as to what can be reasonably expected from the auditor.
31. Respondents also noted that the proposed standard lacks guidance or factors as to when it may be considered “practicable” for the auditor to consider developing a range. Arguments against the formulation in the ED revolved around the following issues raised by the respondents:
 - If management refuses to consider alternative assumptions or outcomes, the auditor is faced with a reporting consideration (scope limitation), rather than a requirement to develop a range. The proposed requirement should align in principle with the requirement of paragraph 37 of ISA 540, “Going Concern,” which does not impose an obligation on the auditor to extend management assessment of the going concern assumption when management is unwilling to do so. Rather, the absence of management consideration of alternative assumptions or outcomes in the case of a significant risk is, in effect, an absence of management’s demonstration that there is a reliable measurement of the estimate.
 - The requirement for the auditor to consider whether it is practicable to develop a range is premised on the circumstances where management has not applied a sensitivity analysis or considered alternative outcomes. Management may have undertaken alternative steps to assess the effects of estimation uncertainty on the accounting estimate. This requirement therefore may result in the auditor’s developing of a range where in fact such action is not necessary or appropriate.

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32. The Task Force is of the view that the ED does demarcate the responsibilities of management and the auditor, but additional guidance may provide useful points of reference for auditors. It

was not the intention of the Task Force to suggest that the auditor perform work that is essentially a management's task. The Task Force agrees that ordinarily, management should consider alternative assumptions or outcomes (e.g. sensitivity analysis) and why it has rejected them, and the auditor should audit management's work. Where management has not considered alternative assumptions and outcomes, the auditor should request that management provides support as to whether and how it assessed the effects of estimation uncertainty on the accounting estimate. Guidance on the sequence of work and the interaction between management and the auditor has therefore been added to the proposed revised ISA (see paragraphs 69-71 in Agenda Item 2-B).

33. The Task Force remains of the view that there may be circumstances where the auditor may consider it necessary to develop a range to obtain sufficient appropriate audit evidence. For example, in some cases, even when management has assessed the effects of estimation uncertainty on the accounting estimate, the auditor may believe that additional analysis is necessary to reduce risk to an acceptably low level, for example, by developing a range in order to obtain a different perspective on the risk. In such circumstances, the development of a range may be a useful tool for the auditor in relation to evaluating the reasonableness of the estimate. The Task Force believes that some of the issues raised by respondents arose because the purpose of the requirement was not made sufficiently clear in the ED. The Task Force has, therefore, clarified the intended purpose and wording of the requirement (see paragraph 69 in Agenda Item 2-B).
34. The Task Force does not agree with the view that the requirement to consider whether it is necessary to develop a range is onerous. The comments suggest that some respondents perceive the requirement as being applicable frequently. The fact is, however, that many estimates may not give rise to significant risks and, in many instances, management will have considered alternative assumptions or outcomes, or otherwise assessed the effects of estimation uncertainty. Accordingly, the requirement would likely not be applicable in such circumstances. It remains, however, an important consideration in those circumstances where additional effort is needed.

Does the IAASB agree with the proposed requirement for the auditor to consider the need to develop a range in circumstances described in paragraphs 69 – 71 of the proposed revised ISA?

IV. Defining a Sufficiently Narrow Range of Reasonable Outcomes

(Reference: ED Paragraph 55)

35. Related to the issue of the development of a range of reasonable outcomes, seven respondents (AASB-ZA, AuASB, EY, GTI, IAA, IdW, KPMG) argued that although it is appropriate to narrow the range of all possible outcomes to obtain a reasonable range of outcomes, the proposed method is confusing or potentially inaccurate. Respondents variously noted the following issues and suggestions:
 - “Reasonable range of outcomes” is an accounting term and in connection with “outcomes less likely to occur than not” does not provide useful guidance to the auditor as to the reasonability of the range.

- It is unnecessary to introduce two steps; eliminating “remote” and then “unlikely to occur” outcomes. The auditor should be guided to simply “narrow the range of outcomes to those that the auditor considers more likely than not to occur.”
 - The “high and low outcome values whose likelihood of occurrence is remote” are effectively a subset of “those outcome values that are unlikely to occur.”
 - The term “unlikely to occur” is ambiguous, particularly in terms of whether it implies that the range needs to be narrowed to include only the possible outcomes with greater than 50% probability of occurring (in which case, one respondent felt that this may result in narrowing the range too much, whereas another respondent believed that it would not lead to a sufficiently narrow range, leaving the auditor with a range greater than materiality).
36. Respondents also noted that there is no guidance for situations where a reasonable range of outcomes is greater than materiality. It was suggested that the definition of a range should be expanded to include the notion that the range is ordinarily no greater than materiality, and that if this is not the case, the auditor should question whether the applicable financial reporting framework’s measurement criteria have been met or whether a scope limitation has been imposed.

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37. The Task Force agrees that the term “reasonable range of outcomes,” as used in the ED, may be confusing. It recommends that the term be replaced with “range of reasonable outcomes,” for the following reasons:
- It aligns better the terminology with the intended outcome of the process of narrowing the range; that is, narrowing the outcomes to those that have a “reasonable” likelihood of occurrence. In addition, it better reflects the notion that the auditor is not principally concerned with the reasonableness of the range, but rather with the reasonableness of the possible outcomes.
 - The intent of the ED was to propose an audit-based term. The proposed change avoids, therefore, potential confusion arising from possible overlap with accounting terminology.
 - It may reduce concern as to the definition of what constitutes a ‘reasonable range’ when considered in relation to materiality (see discussion in paragraph 40 below).
38. The Task Force also agrees with the view that the two-step determination of the range of reasonable outcomes is not necessary to obtain a sufficiently narrow range of reasonable outcomes. Accordingly, it concluded that the description of the process should be consolidated to simplify and streamline the guidance and to eliminate possible confusion about the differences between the two steps (see paragraphs 72 and 73 in Agenda Item 2-B).
39. In addition, in order to preclude ambiguities and translation issues, the Task Force concluded that the phrase “as likely to occur as not” should be adopted to describe the reasonable outcomes within the range under consideration. The Task Force considers that this phrase is a practical definition in that “as likely to occur as not” is not necessarily determined by a

probabilistic method. It is therefore preferable over alternative terms such as “unlikely to occur” or “less likely to occur than not” (see paragraph 72 in Agenda Item 2-B).

40. With respect to the relationship between the range of reasonable outcomes and materiality, the Task Force believes that the objective, where possible, is to narrow the range below tolerable error (tolerable error being the correct “gauge” since estimates are made at the account level). It does not agree, however, with the suggestion that the range should ordinarily be no greater than tolerable error. There are circumstances, particularly in certain industries, where the auditor is frequently unable to narrow the range below a certain point due to the magnitude of the estimate in relation to the financial statements as a whole and the estimation uncertainty inherent in such estimates. This fact does not necessarily preclude recognition of the estimate nor does it indicate that the outcomes are not reasonable where management’s inputs are based on a reasonable evaluation of significant and valid alternative assumptions. The Task Force accepts, however, the need to include guidance for the auditor to consider whether in such cases the recognition criteria and disclosure requirements of the financial reporting framework have been addressed appropriately (see paragraphs 73 and 74 in Agenda Item 2-B).

Does the IAASB agree with the views and conclusions of the Task Force in relation to the guidance on ranges of reasonable outcomes?

V. Point Estimates, Treatment of Differences as a Misstatement, and Classification of Misstatements

(Reference: ED Paragraphs 67-74)

41. Eleven respondents (ACCA, CNCC/CSOEC, GTI, IAA, ICAEW, ICANZ, ICAS, IdW, KPMG, PKF, PwC) raised various concerns about the proposed guidance in paragraph 69 of the ED to require the auditor to treat the difference between the auditor’s and management’s point estimate as a misstatement, including the following issues:
- The notion that the auditor may be able to develop a point estimate may be highly theoretical. An estimate with high estimation uncertainty represents a situation where neither the auditor nor management is in the position to determine a point estimate with negligible variability. Undue weight is therefore being afforded to any point estimate that the auditor may be able to develop in view of the nature of the estimates involved.
 - The distinction between the different measurement criteria for misstatements in the ED is problematic in terms of the precision in describing the probability assessment that may result in distributions that are statistically equivalent. Further, there is limited guidance provided for the auditor to determine how to assess whether a probability assessment can be made, and there is too great an emphasis on the determination of the characterization of the range, which in many cases will be difficult.
 - It appears that the determination and measurement of a misstatement will depend on whether management applied sensitivity analysis or considered alternative outcomes. Such method does not constitute an appropriate basis for decisions about misstatements.

42. Further, the respondents argued that where the auditor's and management's point estimates are within the auditor's reasonable range, then there cannot be a misstatement. That is, where issues of subjective judgments are involved, there is no logical basis for treating differences of opinion, reasonably held, as actual misstatements, especially if the differences concern point estimates within an agreed range.
43. Consistent with the above views, respondents disagreed with the proposed classification of differences arising as a result of subjective decisions as "known misstatements" in both this ED and the proposed ISA 320 (Revised), "Materiality in the Identification and Evaluation of Misstatements."

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44. For risks of material misstatements, the ED does not require the auditor to make a point estimate; rather, it permits the auditor to select a number of techniques in the audit of management's point estimate. The outcome of the audit process (irrespective of the approach taken), however, is that the auditor is either satisfied that management's point estimate is reasonable, or that audit evidence points to another, more reasonable point estimate. This is clearly the case when the auditor makes a point estimate; it is also that case when the auditor tests the process, including assumptions, and is of the view that the assumptions, outcomes or judgments in that process are unreasonable or inappropriate. That is, after considering audit evidence obtained, the auditor is either in agreement with, or in disagreement with, management's point estimate based on audit evidence and subjective decisions.
45. For significant risks, the same logic applies: in some cases, the auditor may obtain audit evidence that directs the auditor to a 'better' point estimate within a range of reasonable outcomes – the fact that the auditor has identified a range of reasonable outcome should not preclude the consideration of evidence of a more reliable estimate; in other cases, audit evidence may exist only to allow the auditor to determine a range, with no evidence pointing to a specific outcome within that range – there is no misstatement if management's point estimate is within that range.
46. The above is consistent with the position that was taken in the ED and the Task Force does not recommend that it be changed. Where the auditor has come up with a point estimate that differs from management's, the Task Force believes a misstatement does exist. Such differences do not supplant management's judgments, but rather represent a valid, reasonable difference of opinion. Excluding the auditor's judgment and expertise from this process limits the role of the auditor to verifying accuracy and completeness.
47. The Task Force accepts, however, that the ED may have: (i) implied that the determination and measurement of a misstatement depend on whether management applied sensitivity analysis or considered alternative outcomes; and (ii) placed too great an emphasis on the determination of the range and the specific characteristics that such ranges may have; to the avail of the underlying concept. Such considerations may better be presented as examples of the circumstances that the auditor may encounter, and the Task Force has redrafted the proposed revised ISA as such (see paragraphs 86-90 in Agenda Item 2-B).
48. The Task Force discussed the issue of the categorization of misstatements and has formulated some views in relation to estimates. These will be reported on at the meeting during the

IAASB's discussion of the revision of proposed ISA 320 (Revised), "Materiality in the Identification and Evaluation of Misstatements."

Does the IAASB agree with the views and conclusions of the Task Force in relation to point estimates and misstatements?

VI. Change in the Location of an Estimate Within a Range of Reasonable Outcomes
(Reference: ED Paragraphs 72-73)

49. Some respondents (FEE, GTI, PwC) disagreed with the proposal that an accounting estimate should be considered to be misstated if, without good reason, management changes the relative location of the estimate within management's reasonable range from the prior period.
50. The basis for the disagreement is that the reasonableness of the accounting estimate needs to be evaluated in the context of the financial reporting framework. Where the financial reporting framework does not provide guidance on determining point estimates from within the range of outcomes, the auditor is not in a position to conclude that there is a misstatement (that is, management's point estimate would still be in compliance with the applicable financial reporting framework). Accordingly, the ED was seen as extending beyond the confines of the applicable financial reporting framework.
51. Respondents also noted that the guidance on a change in the location of an estimate within a range as a misstatement presumes that: (i) management develops a rigorous range; and (ii) the auditor is aware of such range. It was noted that this does not frequently occur in practice (particularly for risks other than significant risks), thereby diminishing the ability of the auditor to comply with the ED.
52. Respondents also expressed concern over the proposal that the auditor considers whether the change in the location of an estimate is an indicator of possible management bias, even though the audit evidence supports management's explanation. This was seen as confusing and unacceptable, particularly in the case where other indicators of possible management bias are absent. It was suggested that the statement be removed, or additional guidance be provided.

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53. The Task Force is of the view that an arbitrary change in an accounting estimate by management is a misstatement, irrespective of whether the estimate is within a range of reasonable outcomes or whether the financial reporting framework is silent on treatment. The basis for this conclusion (as explained in the ED) is the principle that arbitrary changes from period to period affect the consistency of the financial statements, and as such should be considered a misstatement.
54. In light of respondent's comments, however, the Task Force concluded that the guidance should be revised to strengthen the following fundamental points:
 - The auditor needs to be satisfied that management's basis for a change is not arbitrary (see paragraph 89-90 in Agenda Item 2-B).

- Management is often able to content that a change is not arbitrary and the auditor has to exercise professional judgment in the evaluation of evidence supporting management's contention of changes in circumstances (see paragraph 90 in Agenda Item 2-B).
55. The Task Force concluded that the relative location within a range is ancillary to this consideration.
56. The Task Force also concluded that the basis for changes in an accounting estimate is often subjective in nature and that frequent changes may in fact suggest a potential indicator of possible management bias. It agrees with respondents' observation that such consideration may be more applicable when there are other indicators of possible management bias, and therefore has repositioned this guidance to the section in the proposed revised ISA dealing with management bias (see paragraph 94 in Agenda Item 2-B).

Does the IAASB agree with the views and conclusions of the Task Force in relation to change in the location of an estimate?

VII. Indicators of Possible Management Bias

57. In general, there was broad support for the IAASB to establish requirements and guidance for the auditor in relation to possible management bias. However, some respondents raised various concerns with respect to: (i) the emphasis given to the issue in the ED; (ii) the obligation that is to be imposed on the auditor; and (iii) the adequacy of the related guidance.
58. With respect to the emphasis given to the issue of management bias, some respondents (PKF, BCBS) were of the view that management bias deserves more attention in the standard, and that consideration thereof is "a crucial consideration in risk assessment" which has significant implications for the reasonableness of estimates. It was recommended that the consideration of management bias be dealt with explicitly in the risk assessment procedures along with guidance with respect to factors that influence the risk of management bias, or which motivate or may cause management to be biased.
59. With respect to the obligation to be imposed on auditors, respondents variously were of the view that:
- The ED does not adequately explain management bias or the different elements of bias which the auditor should be concerned with. Accordingly, any obligation imposed to consider management bias should be appropriately circumscribed to that which is not inherent in the measurement process, and a clearer description of bias, such as "undue bias" should be considered (IdW, ICAI, ICAEW).
 - The use of terminology such a "is alert to" is not clear as to the auditor's responsibilities; it is too general and raises practical issues as to documentation and compliance. In addition, the phrase may create translation difficulties (PwC, FEE, EY, IOSCO).
 - The proposed requirement is too passive, and should be restated as more active obligations (e.g., "...should determine if there are instances of possible management bias"/ "...should evaluate the likelihood of possible management bias" - IOSCO).

- The ED appears to address only situations where a range of reasonable outcomes has been developed, thereby possibly not addressing the auditor's consideration of estimates where management has not prepared a range, or for which the estimate is not considered a significant risk. As a result, the ability of the auditor to identify indicators of possible management bias depends to a large extent on the development and evaluation of a range.
60. One respondent (AICPA) noted that neither the ED nor ED ISA 320 (Revised) concludes as to whether possible management bias is or is not a misstatement. If indicators of management bias are present, the auditor should undertake sufficient audit procedures to be satisfied that the accounting estimates are neutral and thus free of bias.
61. With respect to the proposed explanatory guidance, respondents (GTI, BCBS, IOSCO) noted that the guidance was very general in nature and that the ED lacked guidance on:
- The types of indicators of possible management bias.
 - The correlation of such indicators with the risk of fraud.
 - Further audit procedures to address the indicators that the auditor has identified as being present.

It was recommended that a more comprehensive list of indicators be provided, or that the requirement to consider or document indicators be eliminated if a comprehensive list cannot be developed. It was also recommended that cross-references be added to, or that additional guidance on bias be considered for, ISAs 315, 330 and 240.

62. Some respondents (BCBS, EY, FAR, FEE, IAA, ICAS, INTOSAI) also raised concerns about the purpose and clarity of the example provided in the ED and about the extent to which it assists in demonstrating indicators of possible management bias. One respondent believed the example could be misleading.

DISCUSSION AND RECOMMENDATIONS

63. The Task Force agrees that greater emphasis on the consideration of indicators of possible management bias may be useful in identifying and assessing risks and in determining appropriate response when auditing estimates. It therefore recommends that additional guidance be provided describing the nature of management bias, including, as some respondents suggested, an acknowledgement that management bias is a common, perhaps inevitable aspect in all subjective endeavors and does not necessarily carry pejorative connotations (paragraphs 9 and 10 in Agenda Item 2-B).
64. Given that risk assessment procedures are directed towards obtaining a satisfactory basis for making an assessment of the risks of material misstatement, to which management bias is one element, the Task Force believes that a discussion of indicators of possible management bias could be linked to the risk assessment procedure of reviewing the outcome of re-estimation of accounting estimates from the prior period – being the one most relevant to such considerations (paragraph 30 in Agenda Item 2-B).
65. The Task Force does not agree, for purposes of ISA 540, with the suggestion that the auditor's responsibility for the determination of indicators of possible management bias

should be extended to concluding whether management bias exists and if so, determining whether it represents a misstatement. The auditor's responsibility at the assertion level is to conclude whether, based on audit evidence, an accounting estimate and related disclosures are reasonable. Management bias is often neither apparent nor easily quantifiable at the assertion level or in relation to individual estimates – it is only when indicators of bias are aggregated, and taken account of along with other qualitative factors, that the auditor is in a position to evaluate the effect of bias on the financial statements, a matter addressed more appropriately in ISA XXX, ["Identifying and Evaluating Misstatements"]. Accordingly, the Task Force is of the view that the presence of an indicator does not constitute a misstatement on an individual accounting estimate basis nor does it undermine the auditor's conclusion about its reasonableness. It therefore recommends that no further requirement to determine whether an indicator is a misstatement be established in ISA 540 (see paragraph 93 in Agenda Item 2-B).

66. The Task Force also noted that the placement of the guidance on indicators of possible management bias in the ED may be presented better as a sub-section of the guidance on evaluating audit evidence, rather than as a separate section of the ISA (see paragraphs 92-94 in Agenda Item 2-B).
67. The Task Force also agrees with respondents' concern over the potential ambiguity in language (for example, use of the term "alert to") and has recommended wording changes in this regard (see paragraph 9 in Agenda Item 2-B).
68. With respect to guidance on possible indicators of bias, the Task Force recommends that the example in the ED be replaced by a more extensive list of examples of indicators of possible bias to make the guidance applicable more broadly than only to situations where the auditor has developed a range (see paragraph 94 in Agenda Item 2-B).

Does the IAASB agree with the views and conclusions of the Task Force in relation to management bias?

C. Other Matters

VIII. Scope of the ED and Its Relationship with ISA 545

69. Seven respondents (ACCA, BCBS, CNCC, FEE, FSR, IAA, IOSCO) raised the issue of the need to clarify the relationship between ISA 540 and ISA 545, "Auditing Fair Value Measurements and Disclosures." The prevailing view is that the ISAs should be "combined" or "amalgamated" on the following basis:
 - The greater emphasis on significant risks and management bias in ISA 540 necessitates an update of ISA 545 and a separate (subsequent) revision of ISA 545 may result in inconsistencies and impede clarity.
 - It is also important that similar, and frequently identical, audit approaches are applicable to auditing accounting estimates and fair values measurements and disclosures.

- As a result of changes in accounting standards it becomes increasingly difficult to make the distinction between estimates and fair values, for example in valuations. The appropriateness of a separate standard on fair values is therefore becoming less evident.
- The existence of two ISAs may be confusing to the public and, possibly, practitioners.
- The Clarity project offers an efficient opportunity to integrate the two ISAs and thereby eliminate duplicative guidance arising from two separate ISAs on similar topics.

DISCUSSION AND RECOMMENDATIONS

70. The IAASB previously debated this issue at its December, 2002 meeting and concluded that ISA 545 should remain a separate ISA and that the Task Force should proceed to revise ISA 540 as a framework document. In providing this direction, the Board recognized that there will be some inconsistency between the two ISAs and suggested that conforming changes to ISA 545 should be considered when it is conformed to the proposed Audit Risk Standards. Further, the IAASB Consultative Advisory Group advised that there is a need to have a separate ISA on fair values.
71. The Task Force agrees in principle with the arguments put forward by respondents for combining the two ISAs. The Task Force believes that evolving accounting standards are blurring the distinction between estimates and fair values and maintaining two separate ISAs may not be sustainable. Further, given the overlap of the ISAs it may make sense to consider subsuming ISA 545 within ISA 540.
72. However, the Task Force has identified certain questions that bear on the direction to be taken as follows:
 - Will combining the two ISAs make the process of “clarifying” ISA 540 (under the Clarity work program) overly complex?
 - Will the resulting combined ISA be so lengthy as to giving rise to issues of understandability?
 - Is there is a need, or expectation, to update ISA 545?
 - Is a delay of 6-9 months acceptable if the ISA on fair values is to be updated and then combined with ISA 540?

In light of the respondents’ comments, does the IAASB believe that, for practical reasons, the previous decision to maintain ISA 540 and ISA 545 as two separate ISAs is still valid?

IX. Miscellaneous Matters

73. Respondents offered a number of drafting suggestions, which the Task Force considered and incorporated in the draft revised ISA, as appropriate. Respondents also raised other comments of relevance which the Task Force has considered and adopted or concluded not to accept, as follows:

FRAMEWORK REFERENCES

74. Some respondents argued that the ED should be “framework-neutral,” and that frequent references to “financial reporting frameworks” are not consistent with this objective. Other

respondents suggested that the ED should be strengthened in its consideration of the varying requirements of financial reporting frameworks.

75. The Task Force concluded that it would be difficult, if not impossible to draft a standard without general reference to the entity's financial reporting framework because the frameworks underpin reporting requirements. However, to avoid the perception that some reporting frameworks receive preferential treatment, the Task Force reconsidered the references and removed them where appropriate.

RISKS AT THE FINANCIAL STATEMENTS LEVEL VERSUS THE ASSERTION LEVEL

76. Some respondents objected to limiting the scope of the ED to the assertion level, arguing that misstatements caused by elements such as management bias may be identified at the financial statements level only.
77. The Task Force's view is that a topic-specific standard, such as ISA 540, should not address issues relating to the financial statements as a whole. The proposed revised ISA appropriately guides the auditor to consider the affect of such matters at the financial statement level through references to ISA XXX, ["Aggregating and Evaluating Misstatements"].

COMPLEXITY, LENGTH AND LANGUAGE OF THE STANDARD

78. Some respondents stated that the ED is too complex, long and difficult to read. It was observed that the ED essentially parallels the entire audit process from planning to reporting, often repeating requirements from other ISAs but modifying them to demonstrate how the auditor considers this particular topic in applying that requirement. The concern expressed was that this approach will result in unnecessary duplication, complexity and onerous documentation requirements.
79. The interrelationship between subject-specific ISAs and the audit risk model – in particular, the extent to which it is necessary to repeat the requirements – is a fundamental issue under consideration by the Clarity Task Force. The Task Force has redrafted certain requirements, however, such as the proposed documentation requirement, to eliminate duplication in the requirements to the extent practicable and to improve the flow of the proposed revised ISA.

BALANCE OF THE ED IN TERMS OF RESPONSIBILITIES OF THE AUDITOR AND MANAGEMENT

80. One respondent voiced concern in relation to the extent of material devoted to describing management responsibilities, as opposed to guidance on the auditor's considerations in applying the requirements of the ED.
81. Although the Task Force is of the view that the ED took a balanced approach, further guidance on the considerations of the auditor in applying the requirements of the ISA has been added variously throughout the proposed revised ISA.

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