



**International Federation of Accountants**

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA  
Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

## Agenda Item

# 6

**Committee:** IAASB

**Meeting Location:** London

**Meeting Date:** December 4–8, 2006

### Accounting Estimates

#### Objective of Agenda Item

1. To approve for exposure the proposed revised ISA 540 (Combined ISA 540-545), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.”

#### Task Force Members

2. The members of the Task Force are:

|                       |                         |
|-----------------------|-------------------------|
| Philip Ashton (Chair) | IAASB Technical Advisor |
| Jon Grant             | IAASB Technical Advisor |
| Edmund R. Noonan      | External Member         |

The Task Force has been supported by Mr Chris Taylor, Partner in PwC’s London Financial Services Practice, in relation to issues pertaining to fair values.

#### Background and Activities Since Last IAASB Discussions

3. At its September meeting, the IAASB approved the close off version of ISA 540 (Revised), “Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures).” The IAASB also discussed the first draft of a proposed Combined ISA 540-545, representing the redrafting of ISA 540 (Revised) in accordance with the agreed clarity conventions, and the incorporation of material from ISA 545, “Auditing Fair Value Measurements and Disclosures.”
4. The IAASB expressed supported for the proposed combination of ISAs 540 and 545, and the general manner in which the combination had been done. The IAASB also agreed largely with the manner in which ISA 540 had been redrafted, including most of the dispositions of sentences in the present tense.
5. The Task Force has revised the proposed Combined ISA in response to comments received from the IAASB and IAASB Consultative Advisory Group (IAASB CAG) at their September meetings, and from the IFAC Small and Medium Practices Committee. It has also updated the proposed Combined ISA to reflect the agreed close off version of ISA 540 (Revised).

## **Matters for IAASB Consideration**

### **SCOPE AND INTRODUCTION**

6. In September, the IAASB CAG noted that a pivotal factor in how management makes an accounting estimate, and the auditor's consideration thereof, is the measurement objective of the accounting estimate. That measurement objective will vary depending on the nature of the accounting estimate: from a forecast or prediction of the future outcome of a transaction, event or condition giving rise to the need for the accounting estimate ('regular' estimates); to the estimation of the price at which a hypothetical current transaction would have occurred ('fair value' estimates).
7. The IAASB CAG also expressed concerned with the proposal to exclude from the scope of the Combined ISA audit considerations relating to items measured at fair value where there are active and open markets. It noted that even in such cases there may be some degree of estimation uncertainty, for example where there is a need for judgment about adjustment to listed market price if the holding of quoted securities is significantly large in size or subject to restrictions in marketability, or in considering whether the right market was chosen when there are multiple sources of quoted market prices.
8. The Task Force agrees with these observations. Setting out in the introduction to the Combined ISA the fact that different measurement objectives exist provides essential context for the proper application of the requirements of the ISA, and the necessary 'framework' for the differences that exist between 'regular' estimates and 'fair value' estimates. Proposed changes are shown in paragraphs 3 and 4 in Agenda Item 6-A.
9. The Task Force has also revised the draft Combined ISA to include those fair value measurements where there may be estimation uncertainty despite the existence of open and active markets. Proposed changes are shown in paragraphs 2 and A8 in Agenda Item 6-A.

### **REVIEW OF OUTCOME OR RE-ESTIMATION OF ACCOUNTING ESTIMATES**

10. The IAASB and IAASB CAG questioned whether the requirement for the auditor to review the outcome or re-estimation of the accounting estimates made in the prior period financial statements is applicable fully to fair value accounting estimates, having regard to the fact that their measurement objective deals with conditions and circumstances at a point in time. Furthermore, it was questioned whether the ISA is sufficiently clear in terms of the extent to which the requirement is to be applied.
11. The Task Force is of the view that the objective of the requirement – essentially, to consider management's past 'track record' – is equally important in the context of fair value accounting estimates as it is to other accounting estimates. It accepts, however, that the extent to which the review is conducted depends on the nature of the accounting estimates and the circumstances of the engagement. It also accepts that in the case of fair value accounting estimates, what is possibly more relevant is the consistent application of the method of measurement, as this is how management may introduce bias in different ways. Accordingly, the Task Force has retained the wording of the requirement in accordance with the close-off version of ISA 540 (Revised), but introduced additional 'essential' explanatory

material and application material in the draft Combined ISA to explain further how the requirement may be applied in differing circumstances. Proposed changes are shown in paragraphs 9 and A34-A35 in Agenda Item 6-A.

#### REVIEW OF EVENTS OCCURRING UP TO THE DATE OF THE AUDITOR'S REPORT

12. Because of the measurement objective of fair value accounting estimates, it was also questioned whether the optional procedure to review events occurring up to the date of the auditor's report is applicable fully to fair value accounting estimates.
13. The Task Force notes that the ISA does not require this procedure to be applied; it is an optional response among others that could be taken individually or in combination with others, taking account of the nature of the accounting estimate. This in principle deals with concerns about applicability.
14. However, the Task Force has concluded that as originally drafted, the requirement could be understood to permit reliance on subsequent events review to conclude that a fair value accounting estimate is appropriate, whereas it is unlikely to be enough to obtain sufficient appropriate audit evidence because of the measurement objective of fair value (although in some cases it may provide relevant audit evidence). Accordingly, the Task Force proposes the removal of the wording in the requirement that directs the auditor to determine whether events 'confirm' or 'contradict' an accounting estimate. Further, it has amplified the discussion of the application of the procedure in the context of auditing fair value accounting estimates. Proposed changes are shown in paragraphs 13(a) and A57 in Agenda Item 6-A.

#### USE OF ASSUMPTIONS DIFFERENT FROM MANAGEMENT'S

15. Paragraph 69 of the close off version of ISA 540 (Revised) states: "When the auditor makes a point estimate or a range, the auditor may use assumptions different from those used by management. In such circumstances, to the extent not already done, the auditor obtains an understanding of management's assumptions in order to establish that the auditor's model takes into account relevant variables, and to be able to understand and evaluate any significant differences from management's point estimate." The IAASB asked that the Task Force consider whether the present tense sentence should be elevated as a conditional requirement.
16. Paragraph 8(c) of the Combined ISA already requires the auditor to obtain an understanding of the assumptions used (in effect, one of the bases on which the auditor decides how to respond to assessed risks of material misstatement). Arguably, there should be no need to require the auditor to do so again. Further, it may discourage the auditor from developing and using assumptions that differ from management, which is the real power of the 'independent-estimate' approach.
17. However, the Task Force believes that the matter should be elevated as a conditional requirement. This recognizes that a further understanding of the assumptions used by management, beyond that obtained for purposes of the risk assessment procedures, is essential to ensure that the basis upon which the auditor evaluates the reasonableness of an estimate (in this case, an auditor-developed range) is sound. Further, the Task Force believes

that this type of consideration needs to go beyond just assumptions – that is, the same logic applies to those circumstances where the auditor uses a method for making the accounting estimate that differs from management's. Proposed changes are shown in paragraphs 13(d)(i) and A82 in Agenda Item 6-A.

#### DOCUMENTATION OF CONCLUSIONS ABOUT THE REASONABLENESS OF ACCOUNTING ESTIMATES

18. The IAASB asked that the Task Force consider whether the requirement to document the basis for the auditor's conclusions about the reasonableness of accounting estimates that give rise to significant risks is in fact necessary.
19. The Task Force has deleted the requirement. The Task Force considered it unnecessary in light of the proposed amendments to ISA 230. The Task Force also deleted the related application material which merely summarized the requirements of ISAs 315 and 330. Proposed changes are shown in paragraphs 21 and A112 in Agenda Item 6-A.

#### WRITTEN REPRESENTATIONS

20. The IAASB asked that the Task Force consider further whether the requirement for the auditor to obtain written representations about significant assumptions remains appropriate in light of work being done on proposed revised ISA 580, "Written Representations." This matter remains subject to IAASB discussion in December in relation to proposed revised ISA 580. However, based on the material submitted to the IAASB, the requirement in the Combined ISA would appear appropriate as written.

#### Way Forward – Exposure

21. ISA 540 (Revised) was exposed and considered on the basis that it excluded considerations relating to the audit of fair value measurements and disclosures. The combination of ISAs 540 and 545 changes the scope of ISA 540 (Revised), and effectively revises ISA 545. The Task Force therefore recommends that the proposed Combined ISA be issued as an exposure draft with a 120 day comment period.
22. For purposes of exposure, the Task Force intends to ask for comments on:
  - The application of IAASB's clarity conventions to the redrafting of the close off version of ISA 540 (Revised);
  - The appropriateness of the revised requirements and application and other explanatory material to the audit of fair value accounting estimates; and
  - The proposed withdrawal of ISA 545 and its replacement by the proposed Combined ISA.

Comments will not be sought on matters addressed and considered in the first exposure of ISA 540.

**Material Presented (Note: Agenda Item 6-A will be used for purposes of the discussions at the meeting.)**

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| Agenda Item 6-A<br>(Pages 2695 – 3000) | Proposed Combined ISA 540-545 (Mark-up from September IAASB Meeting)               |
| Agenda Item 6-B<br>(Pages 3000 – 3034) | Proposed Combined ISA 540-545 (Clean)  |
| Agenda Item 6-C<br>(Pages 3035 – 3070) | Proposed Combined ISA 540-545 (Mark-up from approved closed-off ISA 540 (Revised)) |

**Action Requested**

The IAASB is asked to consider the above matters, and to approve the proposed Combined ISA 540-545 for exposure.

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