



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

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Committee: IAASB

Meeting Location: Hong Kong

Meeting Date: March 6–10, 2006

Accounting Estimates

Objective of Agenda Item

1. To approve the proposed ISA 540 (Revised), revised in response to issues raised at the October IAASB and November CAG meetings, as the ‘final ISA under the existing drafting conventions.’

Task Force Members

2. The members of the Task Force are:

Philip Ashton (Chair)	IAASB 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

3. The IAASB CAG considered the Task Force’s analysis of, and recommendations in response to, comments received¹ on the Exposure Draft (ED) of proposed ISA 540 (Revised) as well as the IAASB’s reaction thereon as reflected in the draft minutes of its October meeting.
4. The Task Force met in January 2006 to consider the comments and views of the IAASB and the CAG.

¹ See October 2005 IAASB meeting agenda material.

Significant Issues for IAASB Consideration*Point Estimates and Ranges*

5. The IAASB and CAG raised a number of general concerns with respect to how the revised draft ISA deals with the auditor's development of point estimates and ranges. These concerns manifested during the discussion of:
 - The auditor's development of a point estimate to compare to management's point estimate, as a procedure in response to risks of material misstatements;
 - The proposed guidance dealing with developing a range of reasonable outcomes and narrowing the range; and
 - The measurement of misstatements.
6. The nature of the comments appears to indicate some remaining fundamental concern about how the ISA sets out the relationship between making a point estimate and making a range, when either or both are expected to be considered, and how they fit into the overall process of auditing an accounting estimate.
7. Specific comments include the following:
 - The ISA does not explain adequately the situation where, for a significant risk, the auditor develops a point estimate for comparison with management's point estimate, and how that work bears on the auditor's consideration of the need to develop a range (that is, where the auditor has a technique to come up with a point estimate, then is it necessary for the auditor to consider developing a range?).
 - There is a notion in the draft ISA that an auditor is capable of developing a point estimate that is more precise than management's point estimate. The reality is, however, that this would be rare. Rather, greater emphasis should be placed on the auditor's use of ranges in general, an approach that would be more consistent with practice.
 - Various approaches are taken in practice. In some cases, the auditor will deal with point estimates; in others, ranges. For example, the auditor may develop an initial point estimate as a basis for discussion with management, and then consider further the need to refine that point estimate or to develop a range. In other cases, the auditor may only develop a range (rather than a point estimate) for comparison with management's point estimate. The structure of the ISA seems to restrict the approaches that can be taken by dealing with point estimate and ranges separately. Further, while the ISA deals with the 'end game' of the auditor, it does not adequately reflect the underlying iterative process of the audit.
 - The ISA needs to clarify the cases where the auditor is likely to arrive at either a range or a point estimate.
 - The guidance on the measurement of misstatement, as presented, implies that the ability for the auditor to detect a misstatement, and the measurement thereof, is predicated on the approach taken by the auditor to auditing the estimate. The implications may drive behavior towards one method rather than another, or may be inconsistent with practice.

- Guidance should be added explaining that the auditor may make a preliminary estimate as a starting point for discussions with management and then, as appropriate, may seek further audit evidence through the development of a range. The auditor's use of a point estimate or a range may therefore be, at least initially, more akin to an analytical procedure, with the auditor's consideration of the relevant requirements in the ISA addressing analytical procedures becoming relevant in these circumstances.

Task Force Recommendation

8. The Task Force is of the view that further change is required to the approach taken in the ISA to the requirements and guidance pertaining to making of a point estimate and the development of a range. The Task Force proposes the following:
 - To expand the optional procedure of the auditor making a point estimate for comparison to management's point estimate to allow for the auditor to develop either a point estimate or a range, as appropriate in the circumstances.
 - To reposition the guidance pertaining to the development and narrowing of ranges from the section dealing with significant risks to the section dealing with the optional procedure of making a point estimate or a range in response to a risk of material misstatement.
 - To simplify the requirement and related guidance pertaining to the auditor's consideration of the need to develop a range, as part of the further substantive procedure to respond to significant risk.

For IAASB review purposes, original paragraphs references are shown in strike-through in Agenda Item 3-A in order to allow the movement of paragraphs to be traced.

9. The Task Force is of the view that this approach recognizes that the decisions to be made in the process of auditing an accounting estimate, and the situations where either a point estimate or a range, or both, is appropriate, do not lend themselves to a 'decision-tree-type' analysis. In effect, it moves the ISA away from attempting to establish a particular role for a point estimate or a range. Arguable, it therefore makes the ISA less complex in its structure, an important consideration in response to those that continue to have a nagging concern about whether the ISA can be simplified further.
10. Further, the Task Force believes that the above strengthens and clarifies the draft ISA in a manner more effective than 'tweaking' the guidance within the existing structure. It also emphasizes the following notions:
 - The development of point estimates or ranges, for all intents and purposes, are equivalent as a procedure to audit an estimate, for both estimates that give rise to risks of material misstatements and for significant risks.
 - If the auditor chooses to develop a point estimate or, the more likely case, a range for comparison with management's point estimate, the idea that the auditor needs to narrow the range still exists. This is true irrespective of whether the estimate gives rise to a 'risk' or a 'significant risk'.
 - The further additional substantive procedure for significant risks for the auditor to consider the need to develop a range is really only applicable where the auditor has not already

considered this as part of auditing an estimate. Making this clear should reduce the concern over the interplay between the approach taken to audit an estimate and additional work when dealing with a significant risk.

Narrowing the Range

11. Both the IAASB and CAG voiced concerns on how ranges, and the process of narrowing the range, are described in the draft ISA. Broadly, there was a call for a more workable and understandable (and less technical) description of ranges and the objective of narrowing the range. Specific concerns and comments include the following:

- Does the term “range of reasonable outcomes,” convey adequately the need for the auditor to be satisfied that both the range and the outcomes within the range are reasonable?
- The term “range of reasonable outcomes” is technically incorrect and, from the view of some, incomprehensible. The auditor should focus on whether the estimate is reasonable, rather than the outcomes *per se*.
- Use of the phrase “as likely to occur as not” in the definition of a narrow range is undesirable from an understandability point of view.
- The reality is that the auditor is able to narrow the range to a point of being able to identify a point estimate (i.e., an outcome that is likely to occur), or is able only to obtain audit evidence to a point where the range cannot be narrowed further and therefore contains outcomes that have an equal chance of occurring. This simple notion is not apparent in the guidance.
- Is it appropriate to circumscribe the range of reasonable outcomes as being equal to, or less than, tolerable error, recognizing that this may create an unrealistic expectation particularly in relation to certain industries?

Task Force Recommendation

12. The Task Force is of the view that the ISA can be simplified further while retaining the objective of guiding auditors to narrow the range. The following is proposed:

- To eliminate the coined-term “range of reasonable outcomes”. Instead, it is proposed that the range developed by the auditor for purposes of evaluating the reasonableness of management’s point estimate be referred to as “the auditor’s range” and that the characteristics necessary of such a range for audit purposes be described, rather than defined, in the explanatory material.
- To soften the technical orientation of the definition of a narrow range by emphasizing the desired end-state (i.e., a range, narrowed based on available audit evidence to a point where the auditor has identified one point within the range that is likely to occur or to the point where it is not possible to narrow the range further, such that the audit evidence indicates that all outcomes within the range have an equal chance of occurring).

13. With respect to whether a range is reasonable in relation to materiality or tolerable error, the Task Force is of the view that the ISA is correct in referring to tolerable error, as the ISA deals with

matters at the assertion level. However, the wording of the ISA has been softened slightly in relation to this aspect.

The IAASB is asked to consider, and to indicate whether it agrees with, the recommendations of the Task Force and the revised wording of the ISA.

Other Changes

14. Other changes made in response to IAASB and CAG comments, or as a consequence of the Task Force's deliberations, are shown in mark-up in the revised ISA.
15. One point raised at the October IAASB meeting, however, pertained to whether it is appropriate to limit the requirements dealing with: (i) the auditor's consideration of the sufficiency of audit evidence in relation to estimate recognition by management; and (ii) the adequacy of disclosure of estimation uncertainty, to significant risks, or whether they should be made applicable to all estimates.
16. The Task Force is of the view that the draft ISA is correct in emphasizing for significant risks the requirements to evaluate (i) recognition and (ii) disclosure of estimation uncertainty. The reason for this view is that performing work in relation to recognition and disclosure of estimation uncertainty is highly relevant to estimates with high estimation uncertainty, and less so for other estimates. The ISA therefore appropriately sets these out as further substantive procedures necessary to respond to a significant risk. Although these may be implicit in the overall requirement for the auditor to be satisfied that the accounting estimates are in accordance with the applicable financial reporting framework, making these requirements applicable to all estimates would be counter-intuitive to the risk-based approach, and may create unnecessary steps in a large majority of cases.

The IAASB is asked to review the changes to the proposed ISA, shown in mark-up in Agenda Item 3-A.

Re-Exposure

17. The Task Force does not believe that re-exposure of the ISA is necessary. The changes arising from comments on the ED and from subsequent IAASB and Task Force discussion are largely:
 - Structural (re: the flow of the requirements and guidance); or
 - Further clarification of the concepts that were introduced in the ED.

No new concepts or significant principles have been introduced, and the requirements are largely consistent with those proposed in the ED. Where requirements have been changed, they reflect a clarification in light of the explanatory material that existed in the ED or that were the subject of comments on exposure.

For IAASB reference, Agenda Item 3-C highlight the main decision made pertaining to the ISA after exposure, and compares the requirements of the proposed revised ISA to those of the ED.

The IAASB is asked for its agreement that re-exposure is not considered to be necessary.

Material Presented

Agenda Item 3-A (Pages 257 - 282)	Proposed revised ISA 540 (Revised) – (Mark-up showing changes from October 2005)
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Agenda Item 3-B (Pages 283 - 304)	Proposed revised ISA 540 (Revised) – (Clean)
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Agenda Item 3-C (Pages 305 - 312)	Comparison of proposed revised ISA 540 (Revised) with the Exposure Draft (for reference purposes)
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18. The Task Force will be using Agenda Item 3-A, Proposed revised ISA 540 (Revised) – (Mark-up showing changes from October 2005), for the purposes of discussion at the meeting.

Action Requested

19. The IAASB is asked to review and approve the proposed revised ISA as the ‘final ISA under the existing drafting conventions.’