



April 25, 2007

Mr. Jim Sylph
Executive Director, Professional Standards
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017

Dear Mr. Sylph:

We appreciate this opportunity to comment on proposed International Standard on Auditing (ISA) 540 (Redrafted and Redrafted), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (the “proposed standard”) as developed by the International Auditing and Assurance Standards Board (IAASB). We are supportive of the development of this guidance and believe, overall, that the redrafting of the proposed standard was completed in accordance with the clarity conventions and criteria adopted by IAASB.

Within our recommendations for editorial changes, additions are noted in “bold underline” and deletions in “double strike-through.”

Responses to Questions Posed in the Explanatory Memorandum

1. *Is the objective to be achieved by the auditor, stated in each of the proposed redrafted ISAs, appropriate?*

Overall, we are concerned with the frequent use of the term “reasonable” within the proposed standard because its meaning is unclear, and refer you to our overall comment below regarding its use.

In terms of the objective, we recommend that the IAASB eliminate the term “reasonable”. We suggest that the objective instead focus on whether the estimates and related disclosures are appropriately accounted for and disclosed within the context of the financial reporting framework as well as within the specific circumstances of the engagement. Therefore, we recommend the following changes:

“The objective of the auditor is to obtain sufficient appropriate audit evidence about whether the accounting estimates, including fair value accounting estimates, and related disclosures in the financial statements are ~~reasonable~~ **appropriately accounted for and**

disclosed in the context of the applicable financial reporting framework **and in the circumstances of the engagement.**”

2. *Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgment by auditors?*

Our understanding of the clarity conventions to be employed in redrafting the standards was that the use of present tense would be limited, particularly in regard to the auditor’s actions. In reading the proposed standard, we noted a prolific use of the present tense in the application material which we believe could lead to inconsistency in practice, due to its ambiguity.

For example, paragraph A102 has three present tense statements:

1. In such cases [where the auditor’s estimate differs from management’s estimate], where the auditor has used a range, a misstatement exists when management’s point estimate lies outside the auditor’s range.
2. The misstatement is measured as the difference between management’s point estimate and the nearest point of the auditor’s range.
3. Where the audit evidence supports a point estimate, the difference between the auditor’s point estimate and management’s point estimate constitutes a financial statement misstatement.

We believe that these statements define what a “misstatement” is, in the context of the auditor’s evaluation of management’s point estimate using the audit procedure described in paragraph 13(d) (i.e., developing an independent point estimate or range to evaluate management’s point estimate), where management’s point estimate differs from the auditor’s estimate or lies outside the auditor’s range. For that reason, we believe it would be more appropriate to include these statements as part of the definition of “Auditor’s point estimate or auditor’s range” in paragraph 7(b).

“7(b) Auditor’s point estimate or auditor’s range – The amount, or range of amounts, respectively, derived from audit evidence (whether obtained by the auditor or provided by a third-party expert engaged by the auditor) for use in evaluating management’s point estimate. **Where the auditor uses a range, a misstatement exists when management’s point estimate lies outside the range, measured as the difference between management’s point estimate and the nearest point of the auditor’s range. When the auditor derives a point estimate, the difference between the auditor’s point estimate and management’s point estimate constitutes a misstatement.**”

In addition to our comment on paragraph A102, we have noted other application material paragraphs in our Comments by Paragraph section below where we believe the use of present tense leads to ambiguity, and we have made suggested changes.

We acknowledge that the use of present tense should not be eliminated altogether (for example, we believe its use to describe facts is appropriate). We understand that the IAASB discussed the use of present tense at its February 2007 meeting and decided to adopt a convention whereby present tense statements representing further explanation of a requirement, but not requirements

in and of themselves would include a cross-reference to the corresponding requirement paragraph to aid the reader's understanding that those present tense statements are guidance rather than requirements.

We recommend that the IAASB revisit the present tense statements in the proposed standard and apply the convention described above. For present tense statements that do not represent further explanation of a requirement, we recommend that the IAASB review such statements, and revise the wording in any paragraphs where there may be confusion about the requirements and responsibilities of the auditor. Where a present tense statement relates to a certain condition, and the nature of the statement is such that it should be applied in all cases where that condition is met, we believe the statement represents a requirement.

3. Comments are sought on the proposed combination of ISAs 540 and 545, its effect on the content of the ISA, and the proposed withdrawal of ISA 545.

We agree with the proposed combination of ISA 540 and ISA 545 and therefore, agree with the proposed withdrawal of ISA 545.

However, we believe that the order of requirements and guidance in the proposed standard could be revised to make clearer to the reader which requirements relate to all estimates and which requirements relate only to accounting estimates that give rise to significant risks.

We recommend that the proposed standard be structured such that the requirements that relate to all estimates are specified first (paragraphs 8 – 13 and 18 – 21), followed by the additional requirements which relate only to estimates that give rise to significant risks (14 – 16).

4. Respondents are also asked to comment on whether the special considerations in the audit of small entities and public sector entities in relation to fair value accounting estimates have been dealt with appropriately in the proposed revised ISA 540.

In general, we believe that the special considerations in the audit of small entities and public sector entities in relation to fair value accounting estimates have been dealt with appropriately in the proposed standard.

However, we believe that paragraph A10 describes an issue that does not necessarily relate only (or more frequently) to public sector entities. Further, while the paragraph notes that fair value measurements may be complex and may not be possible at all in rare cases, no actual guidance is provided for these situations. We recommend that the paragraph be deleted.

5. Respondents' views are sought on the inclusion of the specific proposed documentation requirement in ISA 540 (Revised and Redrafted), having regard to proposed ISA 230, Audit Documentation (Redrafted).

We believe that the matters addressed in paragraph 21 are covered by the requirements of ISA 230 as discussed in the explanatory memorandum accompanying the proposed standard. Further, we believe that paragraph 21(a) may mislead a reader to infer that there is a requirement to document the auditor's basis for conclusions only in relation to estimates that give rise to significant risks.

For these reasons, we recommend that paragraph 21 be deleted from the proposed standard.

Overall Comment – Use of “Reasonable” in the Proposed Standard

As noted in our response to Question 1 above, we are concerned about the use of the term “reasonable” within the proposed standard. We believe that readers could infer that “reasonable” in the proposed standard has the same meaning as “reasonable” assurance in ISA 200, *Objective and General Principles Governing an Audit of Financial Statements* (i.e., high, but not absolute) and we are not sure that meaning is intended throughout the proposed standard. We also believe that it would be clearer to use more descriptive language than “reasonable” in certain requirements to convey the intention of the requirement.

For example, paragraph 18 requires the auditor to evaluate whether the estimates and disclosures are either “reasonable... or are misstated”. We recommend “reasonable” be replaced with the following language, which we believe more clearly describes the purpose of the evaluation.

“18. The auditor shall evaluate, based on audit evidence, whether the accounting estimates and related disclosures in the financial statements are either ~~reasonable~~ **appropriately accounted for and disclosed** in the context of the applicable financial reporting framework, or are misstated.

We recommend that the IAASB revisit the paragraphs of the proposed standard that use the term “reasonable” to determine whether clearer language could be used to enhance the reader’s understanding of the paragraph.

Comments by Paragraph

• Paragraphs 2 – 4

We agree with the general observations made in paragraphs 2 – 4. However, we believe that these paragraphs would be more appropriately placed in the application material section of the proposed standard because they include guidance beyond that relating to the “Scope of this ISA”.

• Paragraph 9

We believe this requirement is too broad. While we agree that the outcome of past estimates may provide the auditor with a sense of management’s “track record”, and may help the auditor identify risks, we do not agree with a requirement to review the outcome of all prior period estimates. We recognize that the essential explanatory material accompanying paragraph 9 is intended to provide some flexibility regarding the application of the requirement itself, but we believe it would be more appropriate to change the wording of the requirement itself. Additionally, we note that the second sentence of paragraph 9 has been drafted in the present tense. As noted earlier in this letter, we believe that the use of present tense may be confusing to the reader. Therefore we recommend the following changes:

“The auditor shall ~~review~~ **obtain an understanding of** the outcome, or re-estimation, of accounting estimates made in the prior period financial statements. **The nature and extent of that understanding auditor shall be determined** ~~←The nature and extent of the auditor’s review understanding is determined~~ taking account of the nature of the accounting estimates, and whether the information obtained from the understanding

would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.”

Based on our proposed change above, similar wording changes would need to be made to the corresponding application material paragraphs (A32 and A33).

- **Paragraph 11(b)**

We recommend the following change to clarify the meaning of the requirement:

“(b): Whether the methods for making the accounting estimates **are appropriate** and have been applied consistently, and **whether** the basis for changes, if any, in accounting estimates from the prior period **are appropriate in the circumstances**.”

- **Paragraph 13 (a)**

We believe that the wording used in the close-off version of ISA 540 is clearer and therefore recommend its use in the proposed standard:

“Determine whether events occurring up to the date of the auditor’s report ~~provide audit evidence regarding~~ **confirm or contradict** the accounting estimate”.

- **Paragraphs 13 (b)(ii) and 14(b)**

Paragraph 13(b) (ii) indicates that the auditor’s evaluation of the reasonableness of assumptions is one of several options that can be selected to respond to the assessed risks of material misstatement. However, paragraph 14(b) seems to indicate that this evaluation is required for significant risks. Therefore, listing it as an optional procedure in paragraph 13 may be confusing to the reader.

In accordance with our comment earlier in this letter relating to the use of the term “reasonableness”, we recommend that the IAASB reconsider its use in these paragraphs. In addition, we recommend that a reference is made in paragraph 14 to the procedure in paragraph 13, as follows:

“14(b) Whether the significant assumptions used by management are reasonable. **This evaluation may be carried out in conjunction with the procedures specified in paragraph 13 (b) if performed by the auditor.**”

- **Paragraphs 17 and 18**

Paragraphs 17 and 18 have the same meaning, except for the term “significant” in paragraph 17. We believe that the auditor should assess the adequacy of disclosure of the estimation uncertainty for all accounting estimates, not just those giving rise to significant risks. Therefore, we recommend that paragraph 17 be deleted and that paragraph 18 be revised as follows:

“The auditor shall evaluate, based on the audit evidence, whether the accounting estimates and related disclosures in the financial statements are either ~~reasonable~~ **appropriately accounted for and disclosed** in the context of the applicable financial reporting framework, or are misstated. **As part of that evaluation, the auditor shall assess the adequacy of disclosure of the estimation uncertainty for accounting estimates.**”

- **Paragraphs 19, A107 and A108**

We recommend revising the requirement in paragraph 19 to clarify that the auditor's determination about whether there are indicators of possible management bias should occur on an individual basis (by estimate), as well as on an overall basis (e.g. have all estimates been determined using "aggressive" assumptions?).

"The auditor shall determine whether there are indicators of possible management bias in the making of **individual** accounting estimates, **as well as in accounting estimates taken as a whole.**"

Additionally, we believe the proposed standard should include application material on how the auditor makes such determinations.

- **Paragraph A17**

We recommend that the first sentence of the paragraph be deleted. We are unsure why completeness has been highlighted as a primary consideration, and further believe that the use of present tense is confusing.

- **Paragraph A52**

We suggest the following change to eliminate the use of present tense:

"The auditor's decision as to which response identified in paragraph 13 to undertake, individually or in combination, to respond to the risks of material misstatement ~~is~~ **may be** influenced by such matters as:..."

- **Paragraph A82**

The use of present tense in the paragraph is confusing. We believe that it would be clearer if a link to the underlying requirement (paragraph 13) was included in the application material. Therefore, we recommend the following change to paragraph A82:

"When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the 'auditor's range'), **paragraph 13(d)(ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes.** ~~The~~ **T**he range cannot be one that comprises all possible outcomes if it is to be useful, ~~as~~ **as** such a range would be too wide to be effective for purposes of the audit..."

- **Paragraph A85**

We suggest that the second sentence of the paragraph be deleted. The use of present tense is confusing, and we believe that the reader will be able to infer from the first sentence that if he or she is able to narrow the range until the audit evidence indicates a point estimate, that estimate would be used to evaluate management's estimate.

- **Paragraph A90**

We suggest the following change to eliminate the use of present tense:

“Often, smaller entities may use simpler means to assess the estimation uncertainty. In these circumstances, in addition to the auditor’s review of available documentation, the auditor ~~generally obtains~~ **may obtain** audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management....”

- **Paragraph A91**

The last sentence of the paragraph infers that the auditor can obtain sufficient appropriate audit evidence about the significant assumptions used by management in making estimates based on “inquiries of and discussions with management” alone. We believe this sentence should be clarified as follows:

“Even without established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management, **along with other audit procedures in order to obtain sufficient appropriate audit evidence.**”

- **Paragraphs A96 - 98**

We believe that the use of present tense in these paragraphs to describe the focus of the auditor’s evaluation may cause confusion about whether they are actually requirements. We suggest adding a link to the requirements in paragraph 16 in each of these paragraphs, to make it clearer that the guidance within paragraphs A96 – A98 does not represent additional requirements, but rather provides further detail on the implementation of paragraph 16.

We would be pleased to discuss our letter with you or your staff at your convenience. If you have any questions, please contact Jens Simonsen, Director of Global Audit Services at + 1 212 492 3689 or John Fogarty, Chairman – DTT Assurance Technical Policies and Methodologies Group at + 1 203 761 3227.

Very truly yours,

