



OICV-IOSCO

Organización Internacional de Comisiones de Valores  
International Organisation of Securities Commissions  
Organisation internationale des commissions de valeurs  
Organizaçào Internacional das Comissões de Valore

August 9, 2007

Mr. James M. Sylph  
Executive Director, Professional Standards  
International Auditing and Assurance Standards Board  
International Federation of Accountants  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, NY 10017

Email [Edcomments@ifac.org](mailto:Edcomments@ifac.org)

Re: Proposed Redrafted International Standard on Auditing ISA 540 (Revised and Redrafted),  
*Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related  
Disclosures*

Dear Mr. Sylph:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (SC 1) appreciates the opportunity to comment on the Exposure Draft of proposed redrafted ISA 540, *Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures* (the ED). As an international organization of securities regulators representing the public interest, IOSCO SC 1 is committed to enhancing the integrity of international markets through promotion of high quality accounting, auditing and professional standards.

Members of SC 1 seek to further IOSCO's mission through thoughtful consideration of accounting, auditing and disclosure concerns and pursuit of improved global financial reporting. As we review proposed auditing standards, our concerns focus on whether the standards are

Calle Oquendo 12  
28006 Madrid  
ESPAÑA  
Tel.: (34.91) 417.55.49 • Fax: (34.91)  
555.93.68  
[mail@oicv.iosco.org](mailto:mail@oicv.iosco.org)  
• [www.iosco.org](http://www.iosco.org)

sufficient in scope and adequately cover all relevant aspects of the area of audit being addressed, whether the standards are clear and understandable, and whether the standards are written in such a way as to be enforceable. Our comments in this letter reflect those matters on which we have achieved a consensus among the members of SC 1; however, they are not intended to include all comments that might be provided by individual members on behalf of their respective jurisdictions.

### ***Scope of this ISA***

In general, we believe the scope of this ISA is appropriate; however, we believe the proposed ISA does not provide enough coverage of the different audit considerations and techniques necessary for auditing accounting estimates where models have been used to generate the estimates (particularly fair value estimates). Please see our comment on paragraph A 65 later in this letter.

### ***Objective***

The objective as written, i.e., "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 in the context of the applicable financial reporting framework" focuses on the auditor carrying out evidence gathering procedures rather than the desired outcome or purpose of those procedures.

We think the objective should be stated more directly and clearly, for example as "The objective of the auditor is to achieve a determination of whether the accounting estimates, including fair value estimates, and related disclosures are free from material misstatement and are in accordance with the applicable financial reporting framework."

### ***Definitions***

#### ***Paragraph 7 (a) Accounting Estimate***

We request that this paragraph make it clear that the term applies to all estimates of monetary amounts, including both those recognized in the financial statements and those presented only in disclosures, as well as explanatory disclosures about estimates.

### ***Requirements***

#### ***Responses to the Assessed Risk of Material Misstatement***

Paragraph 12 requires the auditor to determine the need to use the work of an auditor's expert to obtain sufficient appropriate audit evidence regarding accounting estimates that give rise to risks of material misstatement; however, no mention is made of what the auditor should do in the circumstance in which management has utilized an outside expert to provide accounting estimates. It would seem reasonable to provide some coverage regarding auditor actions and

decisions that will be needed in connection with management's use of an expert, particularly in matters involving valuation.

Paragraph 13 provides a list of procedures to respond to the assessed risks of material misstatement and directs that the auditor shall perform one or more of the procedures listed as items (a) through (d). However, item (a) "Determine whether events occurring up to the date of the auditor's report provide evidence regarding the accounting estimate" would seem to be a procedure that would always occur as part of normal subsequent event audit work (i.e., the auditor would routinely look for resolutions of outstanding items). In addition to the procedure described in (a), we believe the auditor should perform one or more of items (b) through (d) as determined appropriate, taking into account the nature of the accounting estimate.

In paragraph 13 (b) (ii), we believe the text should read (*italics reflect our addition*) "The assumptions used by management are reasonable *in light of the measurement objectives in the applicable accounting framework.*"

We also note that neither in paragraph 13 or elsewhere in this ISA can we find any mention of the need to audit for validity or completeness of estimates, that is, to determine whether all estimates are for valid (real) assets and liabilities, and also that none are omitted.

### ***Further Substantive Procedures to Respond to Significant Risks of Material Misstatement***

#### ***Estimation Uncertainty - Paragraph 15***

When an auditor determines that management has not adequately addressed the risks of estimation uncertainty in estimates that give rise to significant risks, we do not think it is sufficient for the auditor only to *consider* (*italics ours for emphasis*) whether it is necessary for the auditor to develop a range with which to evaluate the reasonableness of the estimate. In the situation described, we think the auditor would either need to develop a range or take some other action, and that the standard should make this clear.

#### ***Application and Other Explanatory Material***

##### ***Reviewing the Outcome or Re-estimation of Prior Period Accounting Estimates - Paragraphs A34 and A35***

We understand that these paragraphs may be trying to provide cautionary guidance to explain that fair values may change considerably from time to time due to market forces rather than due to any deficiency in management's estimation process; however, we think they go too far in the suggestion that the auditor may narrow his focus to concentrate more on management's process than on other reasons for the outcomes involved. Certainly evaluating management's process is part of the audit procedures involved, but the ISA should not omit the obvious need to look back at the prior estimate and compare it with the later outcome and develop a full understanding of the differences involved.

##### ***Method of Measurement - Paragraph A65***

We do not believe the proposed ISA provides enough coverage of the different audit techniques necessary for auditing accounting estimates where models have been used to generate the estimates (particularly fair value estimates). We also do not believe the proposed ISA distinguishes sufficiently between the different audit risks and therefore possible differential audit procedures necessary to deal with accounting estimates derived from inputs that the auditor is unable to corroborate from external data.

As an example of additional coverage regarding models, paragraph A 65 could cover additional considerations such as:

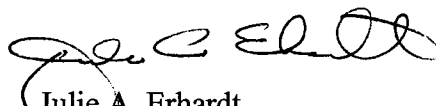
- Independence of review, sourcing and reasonableness of observable market data
- Completeness and appropriate inclusion of all relevant observable market data
- Appropriateness and validity of classification of instruments
- Rationale justifying the use of values that cannot be corroborated with external data
- Access controls over input to valuation models
- Mathematical integrity and calculations in the model
- Adequate documentation of the model

***Considerations specific to smaller entities - Paragraph A90***

A90 states "In addition, management may not have the expertise and experience to address the estimation uncertainty of the accounting estimate. In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof." Paragraph A90 as written seems broadly to excuse management from responsibility for financial reporting and the required duties associated with that responsibility, and furthermore raises concerns about auditor independence if the auditor performs work that management should be doing. We suggest that the Board temper and clarify the statements in this paragraph and further clarify that the term "smaller entities" does not include public listed companies.

We appreciate the Board's thoughtful consideration of the points raised in this letter. If you have any questions or need additional information about the comments that we have provided, please do not hesitate to contact me or Susan Koski-Grafer at 202-551-5300 or any member of the IOSCO Auditing Subcommittee.

Sincerely,



Julie A. Erhardt  
Chair

IOSCO Standing Committee No. 1

## Responses to the Particular Questions for Respondents Raised in the ED

*1. Is the objective to be achieved by the auditor, stated in the proposed revised and redrafted ISA, appropriate?*

We believe the objective should be restated to be more direct and outcome oriented. Please see our comment earlier in this letter.

*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 judgement by auditors?*

We have noted a case where a requirement should be strengthened - please see our comment regarding paragraph 15 in the ISA. In general, we are also not convinced that Paragraph 13 of the proposed ISA and its associated application material (paragraphs A52-85), is sufficiently robust or focused enough to promote consistency in performance and the appropriate use of professional judgment. In addition to the points made earlier in this letter, we recommend the following changes be made to paragraph 13 to make it more robust:

- A requirement should be added for the auditor to determine which estimates arise from data that cannot be independently corroborated, and those that arise from observable variables, e.g. market inputs. If valuation models are used, there should be application material covering the auditor's consideration of whether these are models which are generally accepted by and frequently used in the respective industry, or whether these models are self-developed by the entity and particular/specific to it. There could then be additional guidance on how to audit such models as suggested in our comment above regarding A 65.
- The auditor should also assess whether a model used is in conformity with the applicable financial reporting framework.

*3. What comments do respondents have 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 welcome the proposed combination of ISAs 540 and 545; however, we believe there needs to be additional guidance about what an auditor should undertake in relation to the audit of fair value accounting estimates. Please also see the comments we have raised on objectives, requirements and application material earlier in this letter.

*4. Is it appropriate to include in this ISA documentation requirements on the reasonableness of accounting estimates that give rise to significant risks and indicators of management bias?*

We are not clear as to why there is a particular need for clarification of the documentation requirement in this ISA 540. However, in principle, we have no objection to the inclusion of specific documentation requirements in individual ISAs as long as the rationale is clear and it does not undermine the principles for documentation laid out in ISA 230.