

May 17, 2005

Mr. James Sylph  
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International Federation of Accountants  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, NY 10017

**Exposure Draft, *Proposed ISA 540, “Auditing Accounting Estimates and Related Disclosures (Excluding Those Involving Fair Value Measurements and Disclosures)”***

Dear Mr. Sylph:

The American Institute of Certified Public Accountants (the AICPA) is pleased to comment on the above referenced exposure draft, *Proposed ISA 540, “Auditing Accounting Estimates and Related Disclosures (Excluding Those Involving Fair Value Measurements and Disclosures).”* We believe that this draft provides much-needed guidance to auditors who are auditing estimates; however, we have some concerns that we believe require attention before the final standard is issued.

### **Reasonable Ranges of Outcomes**

We agree that the auditor should not be required to calculate reasonable ranges for all estimates. The proposed ISA requires the auditor to calculate reasonable ranges only in those circumstances where management has not been able to support a specific amount for the estimate. We believe that this requirement is clearly articulated in this draft, but we suggest that the IAASB review the balance of the guidance provided on the discussion of ranges vis-à-vis point estimates because we believe that, as currently written, in most cases management will be able to support a point estimate.

### **Known versus Likely Misstatements**

Proposed ISA 320 (Revised), *Materiality in the Identification and Evaluation of Misstatements*, categorizes differences in estimates as known misstatements. Because the calculation of the auditor’s estimate is based on a sample or some other estimation technique, we believe that the

difference between management's estimate and the auditor's estimate is more appropriately categorized as a likely misstatement.

We believe paragraph 69 of Proposed ISA 540 is inconsistent with paragraph 74 of Proposed ISA 540. Paragraph 74 of Proposed ISA 540 suggests that likely misstatements are misstatements the auditor considers likely to exist from an extrapolation from audit evidence; for example, the amount obtained by projecting known misstatements identified in an audit sample to the entire population from which the sample was drawn. A sample result is also based on a probability assessment, so in our view, the nature of the misstatement arising from this process should be the same in either a subjective or objective (sample) estimation. Paragraph 69 suggests that if the auditor is able to make a probability assessment concerning the likelihood of various outcomes within the reasonable range of the actual outcome, the known misstatement involving subjective decisions is the difference between management's point estimate and the auditor's point estimate, regardless of whether management's point estimate falls inside or outside the auditor's reasonable range of outcomes. We believe that it is inconsistent that a probability assessment of a subjective estimate would result in a known misstatement, whereas a probability assessment of an objective estimate would result in a likely misstatement.

We understand that Proposed ISA 540 needs to relate the concepts of estimates to known and likely misstatement. However we suggest the guidance for what constitutes a known and likely misstatement and how these amounts are treated in the aggregation process, contained in paragraphs 66-74 of the Proposed ISA, more appropriately (or also) belong in Proposed ISA 320. We believe auditors are more likely to seek guidance on this matter in conjunction with their consideration of materiality.

## **Management Bias**

We are concerned with the discussion of bias, particularly the linkage to Proposed ISA 320. It is not clear if indicators of bias are misstatements. Paragraph 75 requires the auditor to consider whether there are indicators of possible management bias, but the proposed ISA does not provide guidance on the evaluation of such indicators of bias. Paragraph 78 refers the auditor to Proposed ISA 320 for this guidance. However, Proposed ISA 320 also lacks guidance on the evaluation of possible management bias, and the confusion is aggravated when paragraph 40 of Proposed ISA 320 refers the auditor to proposed ISA 540 for guidance. We continue to believe that the notion of management bias will be extraordinarily difficult for an auditor to implement.

We suggest that some language clarifying the relationship between indicators of possible management bias and misstatements might be helpful. We propose the following:

**Some indicators of possible management bias may be present in entities where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor should consider indicators of possible management bias individually, and in combination, and should consider whether there are specific controls that mitigate the risk. If indicators of management are present, the auditor should undertake sufficient audit procedures to be satisfied that the accounting estimates are neutral and thus free of bias. The auditor should use a neutral estimate for purposes of assessing the reasonableness of management's estimates and differences, if any, are evaluated as uncorrected misstatements.**

### **Other**

In paragraph 18, it is unclear whether the list of matters that an auditor considers in obtaining an understanding of management's process for making estimates is all inclusive, i.e., whether the auditor needs to consider all of matters in the bullet list or if these are examples of the types of matters that the auditor considers. In addition, there might be factors other than those listed that an auditor may consider, for example, industry practices or regulatory requirements.

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Thank you for the opportunity to comment on this Exposure Draft. If you have any questions regarding the comments in this letter, please contact Sharon Walker at +1-212-596-6026, [swalker@aicpa.org](mailto:swalker@aicpa.org) or Hiram Hasty at +1-212-596-6011, [hhasty@aicpa.org](mailto:hhasty@aicpa.org).

Respectfully submitted,

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