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Accountability * Integrity * Reliability

Comptroller General
of the United States

United States Government Accountability Office
Washington, DC 20548

May 2, 2005

Mr. James M. Sylph
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017

Subject: *Proposed Revisions to International Standard on Auditing No. 540- Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures)*

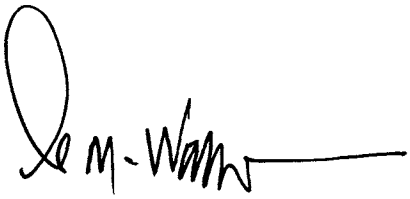
This letter provides the U.S. General Accounting Office's (GAO) comments on the International Auditing and Assurance Standards Board (IAASB) December 2004, proposed revisions to International Standard on Auditing (ISA) No. 540 - *Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures)*.

GAO actively coordinates with accountability organizations around the world, and actively participates in the International Organization of Supreme Audit Institutions (INTOSAI), the professional organization of the national audit offices of 184 countries. Through our international work, we strive to strengthen professional standards, promote best practices, provide technical assistance, leverage resources, and develop strategic working relationships that allow us to extend our institutional knowledge and experience around the world.

We commend the IAASB for providing guidance on the auditor's determination and documentation of misstatements and indicators of possible management bias relating to individual accounting estimates. Overall, we support the proposed revisions to ISA 540. GAO supports the requirements in the proposed revisions for greater rigor and skepticism in the audit of accounting estimates, including consideration of indicators of possible management bias. We believe that the proposed standard could be enhanced in several areas to strengthen audits in both the public and private sectors. Our specific comments are included in the comment letter of the INTOSAI Working Group on Financial Audit Guidelines dated April 22, 2005. GAO has been an active member of the INTOSAI Working Group, and we strongly endorse the Working Group's efforts to strengthen international standards and promote their use in the public sector. A copy of the INTOSAI Working Group comment letter is enclosed for your convenience.

We thank you for considering our comments on this very important issue. We look forward to working with the IAASB and the U.S. auditing standards setting organizations on future issues of mutual interest to strengthen auditing standards globally, both in the public and private sectors.

Sincerely yours,



David M. Walker
Comptroller General
of the United States

Enclosure

cc:
Mr. Kjell Larsson
Auditor General of Sweden and
Chair of the INTOSAI Financial Audit Working Group

The Honorable William H. Donaldson, Chairman
U.S. Securities and Exchange Commission

The Honorable William J. McDonough, Chairman
U.S. Public Company Accounting Oversight Board

Mr. John Fogarty, Chair
U.S. Auditing Standards Board

INTOSAI

Working Group on
Financial Audit Guidelines

Date April 22, 2005

Mr. James M. Sylph
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017

Subject: Proposed Revisions to International Standard on Auditing No. 540 – Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures)

This letter provides the comments of the Working Group on Financial Audit Guidelines of the International Organization of Supreme Audit Institutions (INTOSAI) on the proposed revisions to International Standard on Auditing (ISA) No. 540 - *Auditing Accounting Estimates and Related Disclosures (Other than Those Involving Fair Value Measurements and Disclosures)*, issued December 2004. The Working group on Financial Audit Guidelines comprise of experts from the Supreme Audit Institutions of Canada, Cameroon, Namibia, Norway, United States, United Kingdom and Sweden and the comments reflect the opinion of the experts. The Working group also encourages the respective Supreme Audit Institutions to provide comments to proposed International Standards of Auditing.

We commend the International Auditing and Assurance Standards Board (IAASB) for its proposal to enhance the current standard by adding: 1) an analytical framework throughout the proposed standard, 2) the increased emphasis on consideration of potential management bias, 3) the more comprehensive risk assessment procedures, and 4) the new requirement to review outcomes of prior period estimates. The proposed revisions build upon the existing ISA, adding new levels of guidance that provide an overall analytical framework to the auditor for evaluating evidence and determining whether misstatements exist in accounting estimates. We also believe that the proposed standard will add rigor and professional skepticism to the auditing of accounting estimates.

Overall, we support the proposed standard. The enclosure to this letter contains the INTOSAI Working Group's suggestions for adding clarity and rigor to the provisions of the proposed standard listed below. While we are not separately

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offering comments geared only toward public sector audits, we believe that our suggested changes to the proposed standard would strengthen audits in both the private and public sectors.[1]

- Examples of Common Accounting Estimates (paragraph 2)
- Identifying Circumstances that Require Accounting Estimates (paragraphs 4 and 9)
- Including Consideration of Management Bias in the Auditors' Risk Assessment (paragraph 9)
- Reviewing the Outcome of Prior Period Accounting Estimates (paragraph 20)
- Reliability of Data Used in Estimates (paragraphs 30 and 32)
- Accounting Estimates with Significant Risks (paragraph 48)
- Known Misstatements Involving Subjective Decisions (paragraphs 69 – 71)
- Examples of Management Bias (paragraph 77)
- Disclosure (paragraph 79)
- Documentation (paragraph 84)

Please note that throughout this document, our suggested additions are indicated with <u>underlined</u> text.

We thank you for considering our comments on this important standard, and we welcome the opportunity to work with the IAASB to develop strong globally accepted auditing standards for use in both the public and private sectors.

Sincerely yours,

Kjell Larsson
Auditor General

The Working Group on Financial Audit Guidelines

Enclosure

[1] In the future, INTOSAI Working Group may supplement this ISA with a practice note to provide supplemental guidance on implementing this standard in the public sector.

INTOSAI Working Group on Financial Audit Guidelines---Comments on the Proposed Revisions to International Standard on Auditing No. 540

Comment 1: Examples of Common Accounting Estimates (paragraph 2)

In order to enhance guidance in the ISA and make it more complete, we suggest including additional examples of accounting estimates in paragraph 2 of the ISA, as follows:

2. The term "accounting estimate" describes items recognized or disclosed in the financial statements. For example, accounting estimates may be required of:
   - Bad debts
   - Inventory obsolescence
   - Warranty obligations
   - Environmental remediation costs
   - Losses on long term contracts
   - Revenue recognition, specifically earned vs. unearned revenue
   - Costs arising from litigation settlements and judgments
   - Pension-related liabilities

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Comment 2: Identifying Circumstances that Require Accounting Estimates (paragraphs 4 and 9)

Assuring that all material accounting estimates are identified is critical in evaluating the fair presentation of financial statements. Therefore, we suggest adding a specific requirement in paragraph 4 for the auditor to consider whether all material accounting estimates have been identified, evaluated and disclosed, as follows:

> 4. The auditor should obtain sufficient appropriate audit evidence to evaluate the reasonableness of accounting estimates and related disclosures made by management, in the context of the entity's applicable financial reporting framework. The auditor also should consider whether all material accounting estimates have been identified, evaluated, and adequately disclosed.

Consistent with the above comment, we suggest that paragraph 9(b) include a requirement for the auditor to evaluate the risk of management failing to develop all estimates necessary, such as estimated losses on liabilities, as follows:

> 9. The auditor should perform risk assessment procedures to identify accounting estimates for which there is a risk of material misstatement, by:
>
> (a) Obtaining an understanding of the requirements of the entity's applicable financial reporting framework relevant to the accounting estimates;
>
> (b) Obtaining an understanding of how management identifies those transactions, events and conditions that may give rise to the need for accounting estimates in the financial statements and whether management's process is complete and identifies all material accounting estimates that affect the fair presentation of the financial statements;
>
> (c) Obtaining an understanding of the processes, including relevant internal controls, used to make accounting estimates, including the assumptions underlying them and whether, and if so how, management has assessed the effect of estimation uncertainty;
>
> (d) Reviewing the outcome, or re-estimation, of accounting estimates made in the prior period financial statements; and
>
> (e) Considering the potential for management bias.

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Comment 3: Including Consideration of Management Bias in the Auditors' Risk Assessment (paragraph 9)

In order to include consideration of the potential for management bias in the auditors' risk assessment, we suggest adding subparagraph (e), "Considering the potential for management bias" in paragraph 9, as illustrated above in comment 2.

Comment 4: Reviewing the Outcome of Prior Period Accounting Estimates (paragraph 20)

We believe paragraph 20 of the ISA should be moved and placed after paragraph 22 in order to provide a more logical flow in the guidance. We also believe the discussion in current paragraph 20 should be expanded to indicate that the auditor's review of the outcome of previous estimates is more than a fraud detection procedure. It also provides insight into management's estimation process and helps the auditor to consider errors as well as fraud. Accordingly, we propose reordering and revising paragraph 20 as follows:

> 21. The actual outcome of the condition, transaction or event that gave rise to an accounting estimate will often differ from the accounting estimate recognized in the prior period financial statements. This does not necessarily mean that there was a misstatement in the prior period's financial statements. By understanding the reasons for any variance between the actual outcome and the prior period's accounting estimate, however, the auditor:
>
> > (a) Obtains information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current period process;
> >
> > (b) Obtains audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates; and
> >
> > (c) Obtains audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.
>
> 22. A change in an accounting estimate that results from changes in the circumstances on which an accounting estimate was based, or from new information or more experience, does not represent the correction of a misstatement[2] in the prior period's financial statements. Subsequent changes in accounting estimates arising from information that:
>
> > (a) Was available to management when the prior period's financial statements were finalized; or
> >
> > (b) Could reasonably be expected to have been obtained and taken into account in preparing and presenting those financial statements,

[2] Such misstatements are sometimes referred to as "errors" in financial reporting frameworks.

do, however, provide evidence of misstatements in prior period financial statements. Such misstatements include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretation of facts, and fraud. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes in accounting estimates that do not constitute misstatements.

20. The auditor's review of the outcome, or re-estimation, of accounting estimates made in the prior period financial statements should consider possible errors and fraud that could occur. The fraud consideration is usually carried out in conjunction with the requirements of paragraph 80(b) of ISA 240 (Revised), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements."

Comment 5: Reliability of Data Used in Estimates (paragraphs 30 and 32)

We believe that the auditor's responsibility for validating data used to develop estimates should be clarified and emphasized in paragraphs 30 and 32, as follows:

30. If confirming transactions or events are not expected to occur up to the date of the auditor's report, the auditor should perform one or more of the following procedures:

(a) Test management's process used to make the accounting estimate, including the reliability and completeness of the data used, if applicable.

(b) Test the operating effectiveness of the controls over management's process for making the accounting estimate, together with appropriate substantive procedures.

(c) Make, or use an expert to make, an independent estimate for comparison with management's accounting estimate.

32. Testing the process and data used to make the accounting estimate involves:

(a) Testing whether the data on which the accounting estimate is based, is accurate, complete and relevant;

Deleted: internal

(b) Verifying the source of relevant external data;

(c) Recalculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency;

(d) Considering whether the significant assumptions made by management provide a reasonable basis for the accounting estimate;

(e) Considering management's approval processes; and

(f) Considering whether there are any indicators of possible management bias in the making of the accounting estimate.

INTOSAI Working Group on Financial Audit Guidelines---Comments on the Proposed Revisions to International Standard on Auditing No. 540

Comment 6: Accounting Estimates with Significant Risks (paragraph 48)

For accounting estimates that give rise to significant risks, management's review and approval is key. We believe paragraph 48 of the standard should require auditors to evaluate whether review and approval of assumptions was performed at an appropriate level of management or governance within the entity, as follows:

> 48. For accounting estimates that give rise to significant risks, in addition to any other substantive procedures performed to meet the requirements of ISA 330, the auditor should evaluate:
>
> (a) Whether the significant assumptions made by management taken individually, and as a whole, provide a reasonable basis for the accounting estimate;
>
> (b) Whether and how management has considered alternative assumptions or outcomes and why they have rejected them; <u>and</u>
>
> (c) <u>Whether the review/approval of the assumptions used was performed by an appropriate level of management or governance within the entity.</u>

INTOSAI Working Group on Financial Audit Guidelines---Comments on the Proposed Revisions to International Standard on Auditing No. 540

Comment 7: Known Misstatements Involving Subjective Decisions
(paragraphs 69 – 71)

We support the concept that there can be known misstatements of estimates, even when the amounts used are approximations. We believe, however, that valuable guidance can be provided by clarifying this section, as illustrated below. The IAASB might also consider adding a flowchart to further enhance the clarity of the proposed revisions. In addition, we believe it is important to clarify options for the auditor to consider when the range of outcomes is close to or greater than materiality, and we are adding suggested wording to paragraph 70 in that regard.

Known Misstatements—Misstatements Involving Subjective Decisions

69. If the auditor has developed a point estimate, then the known misstatement involving subjective decisions is the difference between management's point estimate and the auditor's point estimate. Alternatively, the auditor may develop a reasonable range of outcomes with which to evaluate the reasonableness of management's point estimate. For example, as discussed in paragraphs 54-57, the auditor may develop such an estimate where management has not applied a sensitivity analysis or considered alternative outcomes.

70. The auditor may be unable to make an assessment concerning the likelihood of outcomes within the reasonable range of outcomes. In such situations, the auditor may conclude that an accounting estimate is not misstated if 1) it falls within the auditor's range, and 2) the relative location of the accounting estimate within the range has not changed from the prior period without good reason. If the range of outcomes is close to or greater than materiality, the auditor should consider whether to 1) gather additional evidence to reduce the range, or develop a point estimate, 2) require additional management disclosure of estimation uncertainties to fairly present the financial statements, and/or 3) modify the auditor's opinion.

71. If management's accounting estimate lies outside the auditor's reasonable range of outcomes, where each outcome is equally likely to occur, there is a known misstatement involving subjective decisions of, at least, the difference between management's accounting estimate and the nearest point of the auditor's reasonable range.

Deleted: If the auditor is¶
able to make a probability assessment concerning the likelihood of various outcomes within¶
the reasonable range being the actual outcome, the known misstatement involving¶
subjective decision is the difference between management's point estimate and the auditor's¶
point estimate. This applies regardless of whether management's point estimate falls inside¶
or outside the auditor's reasonable range of outcomes.

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Comment 8: Examples of Management Bias (paragraph 77)

In the draft ISA, the bad debt example in paragraph 77 is not a clear example of management bias. We recommend that the IAASB replace the example in paragraph 77 with the following guidance to the auditor for considering indicators of possible management bias.

77. The following provide examples of indicators of possible management bias with respect to accounting estimates:

-management changing the relative location of an accounting estimate within management's reasonable range from the prior period without a good reason (as discussed in paragraph 72 of the ISA).

-management changing or expanding the range of possible outcomes for an accounting estimate without a good reason.

- management changing the nature or basis of a significant assumption, without a good reason.

When the relative location of a point estimate within the range is considered in conjunction with the location of other accounting estimates within their respective ranges, and with other qualitative aspects of the entity's accounting practices, the auditor may have grounds to be concerned that there is a cumulative risk that the financial statements as a whole may be misstated. Qualitative aspects of an entity's accounting practices are described further in proposed ISA 320 (Revised).

As described in paragraph 73, even if the audit evidence tends to support management's explanation for changing the location of an estimate from one period to another the auditor, nevertheless, should consider whether the change is an indicator of possible management bias.

Deleted: • Management has made a point estimate for a provision for bad debts of $105,000. The point estimate was determined with reference to management's reasonable range of outcomes of $100,000 to $120,000. The auditor has not obtained any audit evidence to indicate that any one outcome in management's range is more likely than any other. It follows that:¶

¶

• The provision for bad debts, when considered individually, is not misstated because it falls within the reasonable range of outcomes.

Deleted: the provision for bad debts

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Comment 9: Disclosure (paragraph 79)

We suggest adding wording to paragraph 79 to add clarity and specificity for the auditor's consideration of the fair presentation of disclosures related to estimation uncertainty, where the range of possible outcomes is close to or greater than materiality, as follows:

Evaluating the Disclosure of Estimation Uncertainty in the Financial Statements

79. Where an accounting estimate falls within a range of outcomes that is close to or greater than materiality, the auditor should determine whether disclosure of the estimation uncertainty is adequate/sufficient for fair presentation of the financial statements. The auditor should consider any additional requirements of the applicable financial reporting framework for disclosures regarding uncertainties. The auditor also should consider the need to 1) disclose where the point estimate falls within the range of outcomes, and/or 2) require management to refine its estimates.

Deleted: reasonable

Deleted: the applicable financial reporting framework requires

Deleted: and if so, evaluate the adequacy of such disclosure.

Comment 10: Documentation (paragraph 84)

To strengthen the documentation requirements of the proposed standard, we recommend adding the following wording to paragraph 84 of the ISA:

84. The auditor should document:

(a) The results of the auditor's risk assessment procedures;

(b) The assessed risks of material misstatement of accounting estimates at the assertion level, and the nature, timing and extent of further audit procedures responsive to the risks;

(c) The results of tests of controls and substantive procedures that respond to significant risks;

(d) Misstatements identified by the auditors;

(e) Indicators of possible management bias;

(f) The auditor's conclusion about the reasonableness of each significant estimate based on the audit evidence; and

(g) The auditor's conclusion about the adequacy of disclosure of estimation uncertainly.