Hong Kong Institute of
Certified Public Accountants
香港會計師公會

26 May 2005

By e-mail < Edcomments@ifac.org > and by fax (0062 1 212 286 9570)

Our. Ref.: C/AASC

Technical Director,
International Auditing and Assurance Standards Board,
International Federation of Accountants,
545 Fifth Avenue, 14th Floor,
New York,
New York 10017,
USA.

Dear Sir,

IAASB Exposure Draft on ISA 540 (Revised)
"Auditing Accounting Estimates and Related Disclosures
(Other than Those Involving Far Value Measurements and Disclosures)"

The Hong Kong Institute of Certified Public Accountants welcomes the opportunity to provide you with our comments on the captioned IAASB Exposure Draft.

We set out in the attachment our comments on the proposed revised ISA 540 for your consideration.

We trust that our comments are of assistance to you. If you require any clarifications on our comments, please contact the undersigned at schan@hkicpa.org.hk.

Yours faithfully,

Stephen Chan

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Executive Director

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Encl.

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ATTACHMENT

HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS COMMENTS ON THE IAASB EXPOSURE DRAFT ON ISA 540 (REVISED), "AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES (OTHER THAN THOSE INVOLVING FAIR VALUE MEASUREMENTS AND DISCLOSURES)"

We are supportive of the proposed revision to ISA 540 and believe it is both important and helpful to practitioners. However, we have the following general and specific comments which we request that they be considered carefully by the IAASB before finalizing the revised ISA.

GENERAL COMMENTS

1. Structure of the Proposed Standard

(a) Significant risks and other risks

As a general point, the standard would be easier to understand if there were clearer differentiation between the procedures required for "significant risks" and the procedures required for other risks. At present this is not clear enough and we are concerned that this structure will confuse practitioners because it is unclear what requirements are necessary in which circumstances.

(b) Approach to ISAs on specific topics

We note that the proposed ISA essentially parallels the entire audit process from planning to reporting, often repeating requirements from other ISAs (e.g., Planning (ISA 300), Audit Risk (ISAs 315 and 330) but modifying them to demonstrate how the auditor considers this particular topic in applying that requirement. We are of the view that this approach will result in unnecessary duplication, complexity and onerous documentation requirements. We are of the view that the ISAs should be viewed as an integral body of standards. ISAs that address specific topics, such as estimates or materiality, should include additional requirements needed to address those matters in the audit. It should not be necessary for each ISA to include principles that parallel each step in the audit process that is set out in other ISAs.

2. Audits of small and medium enterprises

As a general point, we note that the proposed revised ISA 540 is quite long and complex and the documentation requirements are onerous. We have some concern for auditors of smaller entities and question whether all of the requirements are necessary in the circumstances of smaller entities. It may be necessary to consider whether there are acceptable simplified approaches to fulfilling particular requirements for audits of smaller non-complex entities.

SPECIFIC COMMENTS

1. “Reasonable estimates” – Paragraph 4

Paragraph 4 states that 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.

In this regard, we are of the view that there is an absence of appropriate explanation of what is “reasonable” in the context of auditing accounting estimates. We suggest that some explanation on this term “reasonable estimate” would be useful.

2. Making an Independent Estimate – Paragraph 41

Paragraph 41 (non bold) states that making an independent estimate (for example by using auditor-developed model) to compare with management’s accounting estimate is likely to be an appropriate response when, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.
- The auditor’s review of the outcome, or re-estimation, of accounting estimates of a similar nature made in the prior period financial statements, suggests that management’s current period process is unlikely to be effective.
- The entity’s controls within and over management’s processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor’s report contradict the accounting estimate.

In this regard, we are of the view that the wording “by using an auditor-developed model” may create an unrealistic expectation that the auditor is in a position to develop a sophisticated model in order to make an independent estimate in all cases. We therefore suggest that further guidance should be provided to explain that auditor developed models are ordinarily going to exist in more complex industries and circumstances, and examples should be included.

3. Auditor to Develop a Reasonable Range of Outcomes – Paragraph 54

Paragraph 54 (bold) states that if management has not applied a sensitivity analysis or considered alternative outcomes, the auditor should consider whether it is practicable to develop a reasonable range of outcomes with which to evaluate the reasonableness of management’s point estimate.

We do not agree with the proposed paragraph and consider that where management has not adequately supported an estimate by applying a sensitivity analysis or considered alternative outcomes, auditors should request management to carry out the extra work. Alternatively, the auditors

should approach those charged with governance rather than take on the responsibility for resolving the shortfalls of management. We suggest that the development of ranges by the auditor should be given less emphasis despite the fact that auditors may in practice develop a reasonable range of outcomes with which to evaluate the reasonableness of management's estimate.

4. **Known misstatements – Paragraph 66**

Paragraph 66 (non bold) states that the proposed ISA 320 (Revised) divides misstatements into the categories like "Known misstatements" and "Likely misstatements".

In this regard, as noted in our submission on the proposed revised ISA 320 on Materiality, we do not agree that a "Misstatement involving subjective decisions" can be a "known misstatement" before there has been discussion with management. This is because it is not known, for a fact, which of the two estimates is the correct amount and hence what the misstatement is. Furthermore, both management and auditor's estimates could be equally incorrect. Accordingly, we would suggest that the term "Known misstatements" and "Likely misstatements" be replaced by the following three categories to avoid confusion:

- **Misstatement of fact**
- **Misstatement involving subjective decision**
- **Projected misstatements**

5. **Indicators of Possible Management Bias – Paragraphs 75 - 78**

Paragraphs 75 to 78 deal with indicators of management bias in the making of individual accounting estimates.

In this regard, we note that there is no discussion of the motivating factors which may incline management to bias and we are of the view that inclusion of some discussion on motivating factors would be useful.

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