



Financial Audit and Accounting Subcommittee of INTOSAI (FAAS)

IAASB Request for Comments on ED-540

We would like to thank the IAASB for the opportunity to comment on the revised ISA 540. In general, FAAS finds the revised ISA 540 to be a step in the right direction. The proposed revisions should help improve the quality of the audit work performed by public sector auditors on accounting estimates. In our response below, we have focused primarily on identifying relevant public sector considerations but we have also commented on the consistency and understandability of the proposed standard when deemed necessary.



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IAASB Questions and FAAS Responses

1) *Has ED-540 been appropriately updated to deal with evolving financial reporting frameworks as they relate to accounting estimates?*

Public sector considerations:

Numerous financial reporting frameworks are presently applied by governments and other public sector entities. Some governments and public sector entities apply IFRS and IPSAS while others apply financial reporting frameworks developed specifically for their respective jurisdictions. In general, we are seeing an increase in the application of accrual-basis accounting in the public sector (particularly IPSAS-based). This trend has increased the volume and significance of accounting estimates in public sector financial statements therefore we believe the suggested revisions to ISA 540 are timely and appropriate to address these developments.

Also, public sector activities are continuing to become more complex. For example, governments and public sector entities commonly enter into commitments on financial markets and engage in larger and increasingly complex infrastructure projects. This increased complexity in public sector activities is introducing increasingly complex accounting estimates into public sector financial statements.

In recognition of the above, we suggest including examples of accounting estimates that are specific to the public sector environment in addition to those already mentioned. We suggest adding the following to the application material:

“Accounting for the following public sector activities may require significant estimation:

- Social insurance programs;
- Health care programs;
- Veterans’ benefits programs;
- Government guarantee programs;
- Public debt
- Environmental liabilities;
- Tax revenue and receivables;
- Infrastructure assets;
- Specialized property and equipment such as military equipment and heritage assets;



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- 2) *Do the requirements and application material of ED-540 appropriately reinforce the application of professional skepticism when auditing accounting estimates?*

Public sector considerations:

No public sector considerations requiring communication to the Board were identified.

Other comments:

In general, we find that the requirements and application material appropriately reinforce the application of professional skepticism however the Board is encouraged to include a clear requirement that the auditor conclude whether any of the accounting estimates identified give rise to an inherent risk that is not low.

- 3) *Is ED-540 sufficiently scalable with respect to auditing accounting estimates, including when there is low inherent risk?*

Public sector considerations:

The guidance provided in paragraph A10 for smaller entities may not always apply to smaller entities in the public sector.

In the public sector, it is not uncommon for smaller entities to make significant accounting estimates. Smaller entities sometimes present a higher inherent risk of error due to lack of skills and competence, and the size of the entity is not necessarily a determining factor for assessing risk.

Other comments:

It is unclear whether the risk assessment requirements in paragraph 10 (a-f) should be applied for all the estimates or just those that are significant. When considering scalability and effectiveness, the question is whether it is relevant to proceed to paragraph 10f) if the auditor concludes that the estimate is not material nor significant (nor complex).

The required audit procedures for items assessed as a low inherent risk, especially the requirements for testing set out in paragraph 15a) 9ii) could more clearly differentiate how the auditor's work effort will differ based on their risk assessment.

Further, while specific requirements for audit procedures are suggested for low inherent risk areas, ISA 315 and ISA 330 emphasize audit procedures for areas with risk of material misstatement and not those with low risk. This inconsistency may impede the application of the proposed standard. We suggest further explanation and guidance on this matter in the proposed standard and/or conforming amendments to other ISAs.



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- 4) *When inherent risk is not low (see paragraphs 13, 15 and 17–20):*
- a) *Will these requirements support more effective identification and assessment of, and responses to, risks of material misstatement (including significant risks) relating to accounting estimates, together with the relevant requirements in ISA 315 (Revised) and ISA 330?*

Public sector considerations:

In general, we find the requirements to be relevant to the public sector but please also consider the following circumstance that is unique to the public sector which could be mentioned in the application material.

Political influence within the public sector is always a relevant factor to consider when gaining an understanding of the entity and assessing risks. It is highly relevant for public sector auditors to consider political motives that could influence the management bias and ultimately the accounting estimates.

Other comments:

The proposed standard requires the auditor to understand accounting estimates by performing risk assessment procedures without consideration of significance to the financial statements and related disclosure. We are supportive of this approach. In making accounting estimates however, management will typically operationalize estimation activities at the class of transaction, account balance and disclosure level rather than as one overall general process for preparing estimates. As such, most risk procedures and related activities set out in paragraph 10 of the proposed standard and its supporting application guidance, commencing at paragraph 10(e), would more appropriately be considered in the context of a specific accounting estimate or class of transactions.

Further, not all accounting estimates are significant to the financial statements and related disclosures. We recommend the same risk assessment procedures and related activities commencing at paragraph 10(e) be directed at accounting estimates that are significant to the financial statements and related disclosures. Additional guidance may be necessary to assist auditors in determining the significance of an accounting estimate relative to the financial statements and related disclosures.

There is inconsistency in the terminology used for risks. In paragraph 13 the auditor should identify significant risks and address them. Paragraph 15, which stipulates the required audit procedures, does not address significant risks, instead it only addresses low inherent and not low inherent risks. At a conceptual level, we also note an emphasis on identifying and responding to a broader range of risks ('not low' risks), while the extant ISA and current supporting standards (ISA 315, ISA 330 and ISA 500) focus on prescribing specific audit procedures only when inherent risk has been assessed as significant. Auditors rely on the ISAs as a framework for applying their professional judgment, especially when assessing and responding to risk; however, this new emphasis along with new risk terminology which has not been defined could result in the standard not being clearly understood and consistently interpreted and applied. As such, we recommend the Board provide a discussion of this new approach for classifying risk and include conforming amendments to ISA 315, ISA 330 and ISA 500 which integrate these new concepts and terminologies.



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- b) Do you support the requirement in ED-540 (Revised) for the auditor to take into account the extent to which the accounting estimate is subject to, or affected by, one or more relevant factors, including complexity, the need for the use of judgment by management and the potential for management bias, and estimation uncertainty?***

Public sector considerations:

No public sector considerations requiring communication to the Board were identified.

Other comments:

Yes we support the requirements for the auditor to take into account the relevant factors.

- c) Is there sufficient guidance in relation to the proposed objectives-based requirements in paragraphs 17 to 19 of ED-540? If not, what additional guidance should be included?***

Public sector considerations:

No public sector considerations requiring communication to the Board were identified.

Other comments:

The guidance appears to be sufficient.

- 5) Does the requirement in paragraph 20 (and related application material in paragraphs A128–A134) appropriately establish how the auditor’s range should be developed? Will this approach be more effective than the approach of “narrowing the range”, as in extant ISA 540, in evaluating whether management’s point estimate is reasonable or misstated?***

Public sector considerations:

No public sector considerations requiring communication to the Board were identified.

Other comments:

We found the requirements and guidance concerning the auditor’s range acceptable.



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- 6) *Will the requirement in paragraph 23 and related application material (see paragraphs A2–A3 and A142–A146) result in more consistent determination of a misstatement, including when the auditor uses an auditor’s range to evaluate management’s point estimate?*

Public sector considerations:

No public sector considerations requiring communication to the Board were identified.

Other comments:

Yes, the requirement in paragraph 23 and related application material are expected to result in more consistent determination of a misstatement, including when the auditor uses an auditor’s range to evaluate management’s point estimate.

- 7) *With respect to the proposed conforming and consequential amendments to ISA 500 regarding external information sources, will the revision to the requirement in paragraph 7 and the related new additional application material result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources?*

Public sector considerations:

No public sector considerations requiring communication to the Board were identified.

Other comments:

Please consider the amendments to ISA 315 noted in our response to question 4a).

- 8) *In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:*

(a) Translations - Recognizing that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comments on potential translation issues respondents note in reviewing the ED-540.

Public sector considerations:

No public sector considerations requiring communication to the Board were identified.



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(b) Effective Date - Recognizing that ED-540 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.

Public sector considerations:

The implementation of revised ISA 540 will require a significant effort to update audit methodologies and to train audit staff. We suggest that the effective date be no sooner than the financial reporting period ending 24 months after the approval of the final revised ISA 540 to allow public sector audit offices, commonly subject to strict resource constraints, sufficient time to prepare for the implementation of these changes.