



31 July 2017

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The International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, 10017
United States of America

Dear Members of the International Auditing and Assurance Standards Board,

RESPONSE TO THE IAASB'S EXPOSURE DRAFT: PROPOSED INTERNATIONAL STANDARD ON AUDITING 540 (REVISED) – AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES (ED-540)

We appreciate the opportunity to review and provide comments on the IAASB's Exposure Draft *Proposed International Standard on Auditing 540 (Revised) – Auditing Accounting Estimates and Related Disclosures*.

The Auditor-General of New Zealand is an Officer of Parliament who is independent of the executive government. The Auditor-General audits all public entities in New Zealand that are required to prepare general purpose financial reports.

The Auditor-General's work is carried out by two business units, which collectively make up "the Office". These two business units are the Office of the Auditor-General (OAG) and Audit New Zealand.

The OAG sets auditing standards, carries out performance audits, provides reports and advice to Parliament, and carries out inquiries and other research.

Audit New Zealand carries out annual audits of public entities allocated by the Auditor-General. It also provides other assurance services to public entities that are within the Auditor-General's mandate and in accordance with the Auditor-General's auditing standards.

We are making this submission on behalf of the OAG and Audit New Zealand.

In making our submission, we have identified the matters below for the attention of the IAASB:

1. The focus of ED-540's application is too narrow.
2. ED-540 is unnecessarily long and complicated.
3. There is confusion around applicability of ED-540 to all situations ("scalability").

4. There is an inconsistent approach to risk assessment.
5. There are concerns around the practical consequences for auditors.
6. Disclosure is not sufficiently emphasised.

A number of our comments relate to matters that are broader than the individual questions asked about ED-540. Where relevant, we have made reference to specific questions in our attached response.

If you have any questions about our submission, please contact me on +64 21 244 0727 or email me at todd.beardsworth@oag.govt.nz.

Yours sincerely,



Todd Beardsworth

Assistant Auditor-General

Accounting and Auditing Policy

RESPONSE TO THE IAASB'S EXPOSURE DRAFT: PROPOSED INTERNATIONAL STANDARD ON AUDITING 540 (REVISED) – AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES (ED-540)

We have not directly responded to all the questions that were asked by the IAASB. Instead we have commented on the aspects we consider to be the most relevant to auditors. We have also included our responses to the specific questions asked by the IAASB in the Appendix.

1 The focus of ED-540's application is too narrow

- 1.1 In our view, the existing standard does not adequately reflect the public sector. Likewise, we think that ED-540 does not adequately consider public sector entities. We question whether there has been sufficient consideration of how ED-540 would be applied to audits of entities that are neither financial institutions nor have complex accounting estimates, especially those in the public sector.
- 1.2 It is clear that audits of financial institutions and complex estimates were the main consideration when ED-540 was prepared. It is also clear that the main focus of outreach activities was to engage with regulators and auditors of financial institutions.¹
- 1.3 In our view, ED-540 fails to adequately consider the significant range of accounting estimates that are likely to be encountered outside banking and insurance institutions. This lack of consideration of how ED-540 will apply, and the consequential impact that any changes will have on an auditor's workload, is an important concern for us.
- 1.4 There can be a high degree of complexity, uncertainty, and judgement involved in preparing accounting estimates for many entities. Auditors must exercise their own judgement and professional scepticism in the audit of those estimates.
- 1.5 However, unlike the examples cited in ED-540 (such as expected credit losses from internationally active banking institutions), there are also many accounting estimates that are frequently prepared without any significant degree of estimation uncertainty, or where there is no complex model involved in the estimation process.
- 1.6 Some examples from the public sector include:
 - valuing infrastructure assets and property, plant and equipment carried at fair value;
 - estimating impairments or liabilities arising from natural disasters;
 - providing for the post-closure restoration costs of a landfill site; and
 - accruing for taxes receivable.

¹ This is apparent from the information contained in paragraphs 4 and 5 of the background section of the Explanatory Memorandum accompanying ED-540

1.7 As it is currently written, we think that the application of ED-540 should be limited to the audit of banks and financial institutions, or engagements which involve significant financial instruments. If ED-540 is to be applied more broadly, we are of the view that it needs to be written in a way that auditors can relate to for a wider range of accounting estimates.

2 ED-540 is unnecessarily long and complicated

2.1 In our view, ED-540 is significantly longer than it needs to be, and this adds to its complexity.

2.2 Accounting estimates are common throughout all financial statements, and they represent a significant proportion of the audit work undertaken by auditors. It is, therefore, reasonable to expect auditors to be familiar with the requirements and expectations set out in the Standard.

2.3 Auditing accounting estimates is difficult and there is an elevated audit risk. It is important that relevant guidance and expectations are set out in a way that is clear to auditors, so that they complete the appropriate level of work. Otherwise there remains a risk of a material misstatement not being identified.

A lack of clear and concise language

2.4 We think that the length of ED-540 makes it difficult for auditors to properly understand and apply. ED-540 is twice as long as the existing Standard, and the application guidance section is considerably longer than the main body.

2.5 Also, ED-540 uses some excessively long sentences, and some vague language, which makes it difficult to understand. For example, paragraph 4 states:

“This ISA focuses the auditor’s attention on designing and performing further audit procedures (including, where appropriate, tests of controls) responsive to the reasons for the assessment given to the assessed risks of material misstatement, particularly when those reasons include complexity, judgment or estimation uncertainty.”

2.6 This sentence is confusing. The effectiveness of a standard is dependent on how easy it is to read and understand. In our view, ED-540 fails to meet the “understandability” test.

Confusion, inconsistencies, and conflicts in ED-540

2.7 We are concerned that the large number of possible procedures included in the application guidance section could lead to regulators and reviewers using those procedures as a checklist to “tick off” whether auditors have performed them. One of the stated intentions of the revisions proposed in ED-540 is to enhance “the auditor’s application of professional scepticism”.

2.8 We do not think that the inclusion of so many possible procedures gives effect to this intention. Instead, it interferes with the expectation that auditors should apply their own professional judgement and scepticism to each engagement, based on their knowledge and understanding of the business and operating environment of the entity subject to audit.

- 2.9 We also consider some of the paragraphs in the application guidance section to be requirements rather than guidance (for example, paragraphs A96² and A135³). These paragraphs would be better placed in the main body of ED-540.
- 2.10 In addition, there are a number of instances in ED-540 where it is not readily apparent whether the procedures described are required or if they are merely illustrative examples of the types of work an auditor could choose to undertake. An example of this is paragraph A49, which could be interpreted either as a requirement that the internal controls must be tested or as a suggestion that such testing is a possibility.
- 2.11 There are also sections that appear to be contradictory. An example is paragraph A97 in the application guidance section, which states “*when inherent risk is low, this ISA does not specify the nature of the further audit procedures to be performed*”. However, the same paragraph goes on to list a number of procedures in a manner that could be interpreted as suggesting that the auditor is expected to carry them out.
- 2.12 Collectively, these examples demonstrate the difficulty in identifying the areas where there is scope for auditor judgement and scepticism to be applied.

Unnecessary content

- 2.13 There are also a number of sections that we consider to be unnecessary because they:
- **State the obvious.** Paragraphs A39-A41 give examples of types of data, sources of data, and matters that auditors might consider when assessing data. None of these appear to be particularly new, unusual, surprising, or complex. It is our view that concepts such as these are widely understood and do not require specialist accounting or auditing knowledge or expertise.
 - **Discuss fundamental concepts that should be well understood by auditors (and are not specific to auditing estimates).** Paragraph A96 states “*If the further audit procedures in paragraph 15(a) do not provide sufficient appropriate audit evidence, the auditor is required by ISA 330 to design and perform other procedures.*” An experienced or competent auditor should be able to reach the same conclusion without needing to refer to these paragraphs.
 - **Repeat issues already discussed in ED-540.** Paragraph A71 states that “*Paragraph 13 requires the auditor, in identifying and assessing the risks of material misstatement, to take into account the extent to which the accounting estimate is subject to, or affected by relevant factors, including complexity, the need for the use of judgement by management in making the estimate, and estimation uncertainty.*” This essentially summarises and repeats the content of Paragraph 13, without providing any additional guidance.

² “*If the further audit procedures in paragraph 15(a) do not provide sufficient appropriate audit evidence, the auditor is required by ISA 330 to design and perform other procedures.*”

³ “*Paragraph 21 applies regardless of whether the auditor is required to perform procedures under paragraph 19.*”

- 2.14 The two appendices contain even more material that auditors are expected to read, consider, and, where appropriate, apply. It is not entirely clear what the purpose of this extra material is or what value it adds for auditors. Removing these Appendices will not adversely affect the way in which auditors and engagement teams plan and execute their approach to auditing accounting estimates.
- 2.15 Being focused about the content of ED-540, and reducing the number of pages would make it more useful and relevant to auditors. And, making ED-540 more accessible and relevant to auditors is likely to lead to an improvement in audit quality.

3 Confusion around the applicability of ED-540 to all situations

What is meant by “scalable”?

- 3.1 In seeking comments on ED-540, the IAASB has specifically asked “*Is ED-540 sufficiently scalable with respect to accounting estimates, including when there is low inherent risk?*” The term “scalable” is not defined in any standard, and in our view, there is a lack of clarity around what is intended by the IAASB in using it.
- 3.2 In our experience, when auditors consider the concept of an audit being “scalable”, it is applied with reference to the level of audit work required in response to the level of risk and complexity of the audit (that is, less risk means less work required).
- 3.3 The distinction auditors are required to make between “low” and “not low” inherent risk appears to be overly simplistic and does not adequately reflect the full breadth of potential risk assessments. By creating a threshold based on inherent risk assessment, with the designations being either “low” or “not low”, it is our view that the balance of work required has been inappropriately shifted. Especially when compared to the approach required in other standards, where additional audit procedures must be designed and performed only where *significant* risks are identified.
- 3.4 The model should be reconsidered. We believe that more balance would be provided by drawing a distinction between inherent risks that are assessed as either “high” or “not high”. Alternatively, the distinction should be consistent with other auditing standards where the risk is assessed as “significant”.
- 3.5 We agree that some of the changes proposed should enable auditors to develop a more scalable approach. For example, paragraph 15 no longer requires the auditor to undertake at least one of the listed procedures. Instead, the auditor is required to determine which of the procedures are appropriate.
- 3.6 However, it is not clear that ED-540 will result in audit effort being directed to the areas of greatest risk. We believe that there is a risk that a disproportionate amount of time could be spent on risk assessment activities.

At what point should further audit procedures be applied?

- 3.7 We also have concerns about the new requirement at paragraph 10(f), which requires auditors to “*consider each of the components of internal control as they relate to making accounting estimates*”.
- 3.8 Because paragraph 10(f) appears in ED-540 before the auditor is required to complete their initial risk assessment, it seems to apply to *all* audits. This is unusual, since initial risk assessments are generally determined only by considering inherent risk factors and without allowing for any relevant controls.
- 3.9 There are few accounting estimates where auditors would seek to place the bulk of their reliance on internal controls. One exception might be complex estimates, where models are used to prepare figures for inclusion in financial statements, and where there are controls in place over the input of data to the model.
- 3.10 Because of the significant amount of audit judgement required and the limited assurance available, it is unlikely that auditors would seek to rely on controls for most estimates. As a result, the requirement for auditors to consider the components of internal control before confirming the initial assessment of risk seems excessive and provides no additional assurance.
- 3.11 In our view, if the requirement to consider elements of internal control *is* retained, it would be better placed elsewhere in ED-540. An appropriate place may be in the section titled *Responses to the Assessed Risks of Material Misstatement*, which comes after the auditor has classified inherent risks as either “low” or “not low”.

Application of a scalable approach based on the nature of the entity

- 3.12 The existing ISA 540 contains a paragraph (A11) in the application guidance section, *Considerations Specific to Public Sector Entities*. This paragraph has been removed in the proposed revision and ED-540 instead has a paragraph at A23, *Considerations Specific to Smaller Entities*.
- 3.13 It is unclear what the purpose of this paragraph is. It permits auditors to tailor their audit approach for smaller entities, but auditors should already be tailoring their approach for all engagements, regardless of the size of the entity. Designing and following an appropriate audit approach enables the auditor to demonstrate that audit judgement has been applied, and that the engagement has been completed in a manner that should meet expected quality standards.
- 3.14 The intention for including this paragraph is not clear. ED-540 should identify any specific audit considerations that are unlikely to be relevant to the audit of smaller entities. Conversely, if the expectation is that all audits require the same procedures, regardless of the entity’s size, then paragraph A23 adds no value.

4 An inconsistent approach to risk assessment⁴

⁴ When inherent risk is not low (see paragraphs 13, 15 and 17-20): *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?*

- 4.1 The auditor's assessment of risk is fundamental to planning and performing appropriate audit procedures. It is crucial for concepts to be clearly understood so that they are consistently applied.
- 4.2 We are concerned that the assessment of risk in ED-540 is not clear. It is confusing that ED-540 refers initially to significant risk,⁵ but later refers to inherent risk.
- 4.3 We are also concerned that the assessment of risk in ED-540 is not consistent with other standards. ISA 200 clearly states that the inherent risk should be assessed "*before consideration of any related controls*", but ED-540 appears to contradict this, through the requirements of paragraph 10(f) referred to in 3.8 above.
- 4.4 Paragraph A42 of ISA 200 also goes on to state that "*the ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the 'risks of material misstatement'.*" ED-540, however, clearly sets an expectation that the inherent risk is assessed separately, after considering the components of internal control as they relate to making accounting estimates.

5 Concerns around the practical consequences for auditors

- 5.1 We have some concerns around the practical implications of applying ED-540.
- 5.2 Our interpretation of how ED-540 will apply indicates potential for:
- A greater burden of work for auditors;
 - An increased "self-review" threat to independence; and
 - An increased use of experts by auditors.

A greater burden of work for auditors

- 5.3 ED-540 could lead to a greater level of work for auditors of public sector entities, where the largest items on the balance sheet are assets recognised at fair value, such as:
- roads and bridges;
 - water, wastewater, and stormwater reticulation networks; and
 - special purpose buildings such as hospitals and stadiums.
- 5.4 It is unlikely that the auditor would assess those assets as being of low inherent risk (the relative size of the item(s) alone could mean it is the account area most likely to be at risk of a material misstatement).
- 5.5 In many cases, it is probable that such estimates would be determined on the basis of a valuer's report, received by management, or based on the information provided by an internal expert. Where

⁵ See paragraph 13 of ED-540.

this is the case, the most likely current approach would be to review the assumptions applied by management (or management's expert) and assess them for reasonableness. This approach is permitted in ED-540 under paragraph 15(a)(ii), but only applies to account areas where the inherent risk is assessed as low.

- 5.6 Since the trigger point under ED-540 is the assessment given to the inherent risk, land and building valuations are likely to require application of the further audit procedures referred to in paragraph 15(b). This could mean a considerable increase in work effort is required for many public sector entities.

An increased "self-review" threat to independence

- 5.7 Our observation from public sector audits is that often valuers' reports do not contain evidence of how estimation uncertainty has been addressed. Where that is the case, under paragraph 19(b) "*the auditor shall, to the extent possible, develop an auditor's point estimate or range*".
- 5.8 We are concerned that ED-540 may require auditors to perform work which could pose a "self-review" threat. In our view, it is not the auditor's role to develop a model or even a point estimate. This should remain the responsibility of management. Where auditors become aware of deficiencies in an entity's approach, this should be communicated to management and those charged with governance, but the auditor should stop short of actually calculating a figure.
- 5.9 The necessary level of work to develop an auditor's point estimate or range could be quite onerous and it is unclear whether the additional work is required in all circumstances or just when the auditor is concerned that an estimate might be materially misstated.
- 5.10 There is also a small risk that this could become a factor in the auditors' assessment of inherent risk and, as a result, inadvertently influence irrational behaviours (that is, lead to auditors inappropriately assessing an estimate as low risk).

An increased use of experts by auditors

- 5.11 Application guidance paragraph A69 provides examples of estimates that auditors should be capable of assessing. Paragraph A69 also suggests that other estimates (such as expected credit losses or insurance contract liabilities) would be likely to require auditors to apply specialised skills or knowledge from outside the audit team's collective "experience", implying that auditors are unlikely to be able to audit such figures themselves.
- 5.12 We believe that many auditors would have the skills and knowledge required in order to obtain sufficient appropriate audit evidence relating to many accounting estimates that fall between the two extremes cited in paragraph A69. In particular, there are a number of professional service firms that carry out a range of services. It would seem unusual for them to be able to carry out valuation services on a consultancy basis, but at the same time, not be considered capable of assessing similar estimates in an audit capacity.

- 5.13 We foresee a future where auditors are increasingly required to engage an independent auditor's expert to review and/or challenge an estimate that has been developed by an expert engaged by management. We question what added value this approach will provide for users of financial statements.
- 5.14 In our experience, a knowledgeable and experienced auditor often asks more probing questions and applies more professional scepticism than independent "experts" and also has a considerable amount of practical experience and knowledge that they are able to draw on.

6 Disclosure is not sufficiently emphasised

- 6.1 Accounting estimates, by their nature, cannot be sufficiently represented in financial statements only by a numerical amount. They must be accompanied by appropriate note disclosure. This disclosure should provide users with clear information about the uncertainties that surround the figure presented in the financial statements and the method used to determine the final figure.
- 6.2 The fair presentation of an accounting estimate requires a significant effort in quantifying the figure to be recognised together with appropriate disclosure. The auditor's role is to satisfy themselves that the combination of the figure recorded and the associated note disclosure is fairly presented.
- 6.3 In our view, ED-540 does not adequately emphasise the importance of appropriate disclosure around accounting estimates. Nor does ED-540 sufficiently clarify the auditor's role in assessing the adequacy of disclosures, in order to form an opinion on fair presentation.

APPENDIX: SPECIFIC QUESTIONS POSED BY THE IAASB ON ED-540

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

We have no specific comments to make on this matter.

2. Do the requirements and application material of ED-540 appropriately reinforce the application of professional scepticism when auditing accounting estimates?

There are some sections where the application of professional scepticism when auditing accounting estimates is reinforced. For example, paragraph A2 identifies some of the factors auditors should consider when assessing the reasonableness of accounting estimates. The section encourages auditors to consider the consistency of the data and assumptions applied by management in reaching its estimates. Although there is nothing in the extant ISA 540 that prevents auditors from considering this or other factors, the explicit inclusion of more factors can assist the auditor identifying areas where scepticism could be applied.

However, please also refer to our comments at section 2 in the main body of this submission. The Standard needs to focus on the application of principles, rather than procedures. We are concerned that too much focus on procedures may distract auditors from focusing on professional scepticism.

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

No, please refer to our comments at section 4 in the main body of this submission.

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?

No. Please refer to our comments in section 5 of the main submission above.

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 judgement by management and the potential for management bias, and estimation uncertainty?

Yes, we support this requirement, but these are all factors that auditors should already be considering under the existing standard. ED-540 makes the expectations more explicit, but it remains to be seen whether auditors will be any clearer in how they demonstrate that they have considered those factors.

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

We have no specific comments to make on this matter, although as noted in the main body of our submission, we believe that overall the standard (and accompanying guidance) is unnecessarily complex and is too long.

5. 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?

The requirement in paragraph 23 for the auditor to "stand back" is a useful requirement. However, we feel that it is a useful requirement that should be applied to all areas of the audit, not just auditing accounting estimates.

6. 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?

The guidance given is helpful in a limited number of instances, but might not work for all situations. In the public sector, for example, many accounting estimates cannot be based on (or influenced by) external information, because there is none.

We believe that more consideration should be applied to the identification of examples of external information sources (amendments to paragraph A33F in ISA 500). For example, it could also apply to information from national statistics organisations that provide information supporting the estimates that entities prepare, such as demographic indices used to estimate pension liabilities or construction indices used in valuations of infrastructure assets.

7. In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:

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

We have no specific comments to make on this matter.

b) Effective Date – Recognising 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.

We have no specific comments to make on this matter.