

1 August 2017

Matthew Waldron
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International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
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USA

Dear Matthew,

Proposed ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures (ED-540)

Thank you for the opportunity to comment on this Exposure Draft. We submit the feedback from the New Zealand Auditing and Assurance Standards Board (NZAuASB) to the specific questions raised in the Proposed ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, (ED-540) in the attachment.

The External Reporting Board (XRB) is a Crown Entity responsible for developing and issuing accounting and auditing and assurance standards in New Zealand. The XRB's outcome goal is to contribute to the creation of dynamic and trusted markets through the establishment of an accounting and assurance framework that engenders confidence in New Zealand financial reporting, assists entities to compete internationally and enhances entities' accountability to stakeholders. The NZAuASB has been delegated responsibility by the XRB for developing and issuing auditing and assurance standards, including ethical standards for assurance practitioners.

Overall comments

The NZAuASB is supportive of the intentions of the IAASB in its efforts to revise ISA 540. Such efforts are necessary to address this highly judgemental area and are timely in light of the recent changes in the accounting environment. However, we have a number of fundamental concerns with ED- 540 as currently drafted, as discussed in the paragraphs that follow and in our responses to the IAASB's specific questions.

ED-540's focus on Financial Instruments

A key driver in the proposed revision to ISA 540, as indicated by the IAASB's outreach with regulators and auditors, was the need to focus on the issues for audits of financial institutions arising from IFRS 9¹. The focus of ED-540 therefore is on auditing of complex accounting estimates. This complexity is reflected in the content and drafting style of the exposure draft. Many of our constituents noted ED-540 needed to be read several times before its application was understood. Such complexity of subject matter coupled with complexity of drafting is likely to confuse the reader and result in the key concepts not being clearly understood and applied.

¹ IFRS 9, *Financial Instruments*

Many of our constituents also noted that, throughout ED-540, the application material and examples focussed on issues for audits of financial institutions. In our view, ED-540 would be enhanced by considering audit issues particular to other sectors, for example, the public sector. An issue of concern to our public sector constituents is the valuation of assets, particularly those with estimation uncertainty, such as valuation of heritage assets and infrastructure assets.

The NZAuASB found the flowchart supplement to ED-540 to be very helpful in explaining the overall approach of the standard, and recommends that the IAASB consider incorporating such a flowchart in the introductory material to the standard.

Objectives-based vs Rules-based Standard

The NZAuASB fully supports the auditor's consideration of, and responses to, the extent to which the accounting estimate is subject to, or affected by, complexity, the need for the use of judgement by management, including the potential for management bias, and estimation uncertainty. However, the NZAuASB is concerned that paragraphs 17-19 are not sufficiently objectives-based and, accordingly, due to the granularity of the requirements, will drive a compliance mentality rather than auditors using their judgement in addressing the specific risks resulting from each of the factors.

Introduction of new concepts – low risk, not low risk

ED-540 requires the auditor to determine whether the assessed risk of material misstatement related to accounting estimates is "low" or "not low", which in turn drives the nature, timing and extent of the auditor's further audit procedures. The NZAuASB is concerned that the new concepts of "low" and "not low" have not been clearly defined, and that there is a disconnect with the assessment of risk based on the extant standards. We note that ISA 315 (Revised) requires the auditor to determine whether any of the risks of material misstatement are, in the auditor's judgement, significant risks². Further, the NZAuASB is concerned that only the simplest of accounting estimates will be assessed as "low" and accordingly, those accounting estimates that exhibit one of the characteristics of complexity, judgement or estimation uncertainty may be inappropriately assessed as "not low". This is of particular concern in the public sector where an entity may have a small number of high value items on its balance sheet, for example, heritage assets or infrastructure assets. Such an item is likely to be the most significant item on the balance sheet and therefore attract most audit attention. Because ED-540 sets the threshold for designing and performing additional audit procedures at a level where inherent risk is "not low" rather than "significant", and the required work effort along the spectrum of risk is not clear, this could lead to a significant increase in work effort which is disproportionate with the level of risk.

Unnecessary content

There are a number of sections within ED-540 that, in our view, contain unnecessary content. Either because they

- state the obvious;
- discuss fundamental concepts which in our view should be well understood by the auditor and are not specific to auditing accounting estimates; or
- repeat issues already addressed in the exposure draft.

The appendices to ED-540 are an example of content which in our view is unnecessary.

² ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement Through Understanding The Entity and Its Environment*, paragraph 27

This has the effect of making the standard longer than it needs to be (ED-540 includes 17 requirements and 211 application paragraphs). It also potentially detracts from the expectation that the auditor should be applying professional judgement to each engagement based on the auditor's knowledge and understanding of the entity subject to audit and its operating environment.

In addition, we consider that the role of the auditing standard is to guide the auditor. While we acknowledge that it is sometimes helpful to include information about the responsibilities of management and those charged with governance, in our view, such references should be limited to essential explanatory material.

Accordingly, the NZAuASB recommends that the IAASB carefully consider the relevance of each of the 211 application paragraphs to ED-540 with a view to determining whether the guidance is essential.

In formulating this response, the NZAuASB sought input from New Zealand constituents.

Should you have any queries concerning our submission please contact me at the address details provided below or Sylvia van Dyk (sylvia.vandyk@xrb.govt.nz).

Yours sincerely,

A handwritten signature in black ink, appearing to read "Robert Buchanan". The signature is fluid and cursive, with a long horizontal stroke at the end.

Robert Buchanan

Chairman

Email: robert@buchananlaw.co.nz

Submission of the New Zealand Auditing and Assurance Standards Board

Proposed ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures

I Schedule of Responses to the IAASB's Specific Questions

Overall Questions

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

The explanatory memorandum indicates that ISA 540 has been updated to focus on issues for audits of financial institutions arising from IFRS 9 which fundamentally change the way that banks and other entities account for their loan assets and other credit exposures. The NZAuASB acknowledges the inclusion of additional guidance relating to complex modelling, which we agree is needed. The NZAuASB, however, is concerned that the focus of ED-540 is heavily weighted towards complex accounting estimates found in the banking and insurance industries, and recommends that additional examples could be included in the guidance that reflect auditing issues relating to accounting estimates that are common in other sectors. Such an approach would provide a more balanced standard. As previously noted, a number of our constituents observed that ED-540 does not adequately address auditing issues relating to accounting estimates in the public sector.

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

Overall respondents indicated that professional scepticism has been appropriately reinforced within ED-540. However, feedback from practitioners indicated that some are concerned that the level of granularity in the requirements of ED-540, in particular paragraphs 17-19, may create a compliance mentality, rather than reinforce the notion of professional scepticism when auditing accounting estimates (see our response to question 4).

While the auditor does consider complexity, use of judgement and estimation uncertainty when auditing accounting estimates, each factor is not separately considered as appears in the case in ED-540. Rather, the factors are integrated and often overlap.

The NZAuASB is very supportive of including a stand-back provision in ED-540. One of the objectives of the IAASB's Clarity Project was to reduce duplication of material in the standards. Accordingly, with respect to the stand-back provision, the NZAuASB believes that the requirement in ED-540 should be incremental to the requirement in ISA 330. As such, we recommend that the requirement in paragraph 22 of ED-540 focus on the auditor's consideration of management bias and the auditor's evaluation of management's decisions relating to the accounting estimates. The requirements to evaluate whether the assessments of the risk of material misstatement at the assertion level remain appropriate and whether sufficient appropriate audit evidence has been obtained (as drafted in paragraphs 22(a) and 22(b)) are, in our view, already sufficiently addressed in ISA 330. Further, the NZAuASB considers that the stand-back provision should apply to the auditor's initial assessment of inherent risk for all accounting estimates, not just those that are initially identified as being "not low" risk. We believe that, in this regard, ED-540 needs to be clearer. The auditor's assessment of risk is the foundation on which the auditor determines the response to those assessed risks and the further audit procedures to be performed.

Focus on Risk Assessment and Responses

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

The NZAuASB is concerned that ED-540 is not sufficiently scalable with respect to auditing accounting estimates.

The NZAuASB is concerned with the requirement to assess risk of material misstatement related to accounting estimates as “low” or “not low” based on inherent risk. The concepts of “low” and “not low” have not been clearly defined and there is a disconnect with the assessment of risk based on the extant standards. Based on the examples provided in paragraph A72 only the simplest of accounting estimates will be assessed with inherent risk of “low”. In such circumstances, ED-540 is specific as to the further audit procedures to be performed.

For those accounting estimates for which the inherent risk is assessed as “not low” there is a broad range of different types of estimates, some of which will have a higher inherent risk than others. There is no category of inherent risk between “low” and “not low”. The granular requirements in paragraphs 17-19, however, apply to all estimates regardless of the level of inherent risk above “not low”. The concern of the NZAuASB is that the drafting of these requirements at such a granular level may reduce the application of professional judgement of the auditor and result in a compliance based approach to auditing the estimate. This is further discussed in response to question 4.

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?

Objectives-based vs rules-based requirements

The NZAuASB is concerned that paragraphs 17-19 are not sufficiently objectives-based. We agree that the auditor is required to consider complexity, use of judgement by management, and estimation uncertainty, and that these factors either individually or combined affect the risk assessment and the auditor’s response to the assessed risk.

Many of our respondents expressed concern that there is not sufficient flexibility within the requirements, and as drafted, these requirements, due to their granularity, will drive a compliance mentality rather than auditors using their judgement in addressing the specific risks resulting from each of the factors.

As drafted, the requirements apply to all estimates with an inherent risk assessed as “not low”. The auditor uses judgement to determine the extent of work effort required. In our view, the requirement is that the auditor obtain sufficient appropriate audit evidence. The matters under paragraphs 17-19 that the auditor is required to obtain sufficient appropriate audit evidence about are in our view application material to the requirement. For example, in paragraph 17, an objectives-based requirement would be that the auditor obtain sufficient appropriate audit evidence related to management’s use of a complex method (including complex modelling) or when management’s method otherwise involves the use of specialised skills or knowledge. The matters indicated in paragraphs (a) – (e) are the matters that auditor may consider in obtaining sufficient appropriate audit evidence.

The above approach allows the auditor to adjust the work effort based on the level of risk along the spectrum of “not low” risk to “significant” risk.

Developing an auditor’s point estimate or range

Paragraph 19(b) of ED-540 requires the auditor, to the extent possible, to develop an auditor’s point estimate or range when management has not appropriately understood and addressed estimation uncertainty. Participants at our roundtable discussions noted that it is generally not common practice for the auditor to develop a range. Rather, the auditor evaluates the models, data and assumptions used by management in determining their point estimate as required by extant ISA 540. Extant ISA 540 allows the auditor to determine the appropriate further audit procedures in responding to the assessed risk of material misstatement.³

The NZAuASB is concerned that the approach taken in ED-540, requiring the auditor to develop a point estimate or range, may be seen as confrontational, pitting the auditor against the preparer. In addition, ED-540 assumes a certain level of preparer sophistication. In the SME/SMP environment, in particular, the preparer may not have the sophistication necessary to understand and address estimation uncertainty. When this is the case, the requirement for the auditor to develop a point estimate or range may present an independence issue, resulting in the risk that the auditor is auditing his or her own work.

The NZAuASB believes that when, in the auditor’s judgement, management has not properly understood and addressed estimation uncertainty, the auditor firstly needs to request that management consider alternative assumptions or provide additional disclosures. If management is unable or refuses to do so, the auditor should then be required to consider the possibility of developing an auditor’s point estimate or range. If the auditor is unable to develop a point estimate or range, then the auditor needs to consider the impact on the audit and the auditor’s opinion.

- b) Do you support the requirement in ED-540 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?**

The NZAuASB supports the requirements in ED-540 for the auditor to take into account the extent to which the accounting estimate is subject to, or affected by, complexity, the need for the use of judgement, including the potential for management bias, and estimation uncertainty. Feedback from practitioners indicates that these factors are generally already being considered. Often these factors are integrated and overlap. In practice each factor is not necessarily considered discretely as appears contemplated by ED-540. Rather, the auditor may design and perform procedures that do not compartmentalise the factors in this way.

As discussed in the response to question 4(a), the NZAuASB has some concerns about the prescriptive nature of the requirements in paragraphs 17-19 to address these factors.

³ Paragraph 13 of extant ISA 540 requires the auditor to undertake one or more of the following, taking into account the nature of the accounting estimate:

- a) Determine whether events occurring up to the date of the auditor’s report provide audit evidence regarding the accounting estimate.
- b) Test how management made the accounting estimate and the data on which it is based.
- c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- d) Develop a point estimate or a range to evaluate management’s point estimate.

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?

As noted in the introductory comments, there are a number of sections within ED-540 that, in our view, contain unnecessary content. Either because they

- state the obvious;
- discuss fundamental concepts which in our view should be well understood by the auditor and are not specific to auditing accounting estimates; or
- repeat issues already addressed in the exposure draft.

This has the effect of making the standard longer than it needs to be (ED-540 includes 17 requirements and 211 application paragraphs). It also potentially detracts from the expectation that the auditor should be applying professional judgement to each engagement based on the auditor's knowledge and understanding of the entity subject to audit and its operating environment.

In addition, we consider that the role of the auditing standard is to guide the auditor. While the NZAuASB acknowledges that it is sometimes helpful to include information about the responsibilities of management and those charged with governance, in our view, such references should be limited to essential explanatory material.

Accordingly, the NZAuASB recommends that the IAASB carefully consider the relevance of each of the 211 application paragraphs to ED-540 with a view to determining whether the guidance is essential.

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?

As noted in the preceding comment, our constituents indicated that it is not common for the auditor to develop a range. From a practical perspective, we see very little difference in the proposals in ED-540 compared with extant ISA 540. ED-540 requires the auditor to only include in the range amounts that are supported by audit evidence and that the auditor has evaluated to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework. Extant ISA 540 requires the auditor to narrow the range by eliminating those outcomes from the extremities that are unlikely to occur and continuing to narrow the range, based on audit evidence, until the auditor concludes that all outcomes within the range are considered reasonable.

Paragraph A134 indicates that an auditor's range for an accounting estimate may be multiples of materiality and that in such circumstances, the auditor's evaluation of the reasonableness of the disclosures about estimation uncertainty becomes increasingly more important. The NZAuASB considers that additional application material to address the auditor's considerations when this is the case would be helpful.

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?

In our view, consistent determination of misstatements will continue to present a challenge, particularly for those misstatements that represent judgemental misstatements rather than factual misstatements. In relation to determining misstatements, ED-540 does not provide sufficient guidance on the auditor's assessment and evaluation of misstatements that arise as a result of a difference in judgement. As it

relates to estimates, for those misstatements identified as judgemental, the auditor may be less likely to request management to make an adjustment. Guidance that addresses the auditor's considerations in relation to judgemental misstatements would be helpful, for example, the auditor's considerations when determining whether to request management to adjust for a judgemental misstatement.

The requirement in paragraph 23 applies to disclosures as well as amounts recorded in the financial statements. However, applicable application material appears to be scattered throughout ED-540. For example, paragraphs A124-A125 discuss what the auditor may do when the auditor concludes that disclosure of estimation uncertainty is not reasonable in light of the circumstances and facts involved. In our view, this guidance would be more appropriately included in the discussion of misstatements. Similarly, paragraphs A135-A138 address disclosures related to accounting estimates. We consider that a robust discussion (within one section rather than in separate sections in the application material) of the auditor's considerations when determining the reasonableness of disclosures (in addition to those relating to estimation uncertainty) would significantly enhance the standard and lead to more consistent determination of misstatements related to disclosures

Conforming and Consequential Amendments

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?

The NZAuASB supports the inclusion of the proposed conforming and consequential amendments to ISA 500 with respect to external information sources.

Request for General Comments

8. (a) Translations

(b) Effective Date

The NZAuASB has no comment on potential translation issues.

The NZAuASB supports an effective date of approximately 18 months after approval of the final ISA with early application permitted and encouraged. We believe that 18 months allows sufficient time for national due process.

General Comments

- The NZAuASB found the flowchart supplement to ED-540 to be very helpful in explaining the overall approach of the standard, and recommends that the IAASB consider incorporating such a flowchart in the introductory material to the standard.
- The terms "significant assumptions" and "significant data" are key to understanding and appropriately applying ED-540. The NZAuASB notes that the meaning of significant assumptions and significant data is described in paragraph A35. However, such description is lost in the extensive application material. The NZAuASB believes that definitions of these terms would be helpful.
- Paragraph A1 – To illustrate the breadth of accounting estimates, the NZAuASB suggests adding the following additional examples provided by practitioners to paragraph A1:
 - Biological assets
 - Investment properties