ISA 540 (Revised) Post-Implementation Survey

Response ID:365 Data

3. Section II: About the Respondent

1. Please provide the following information about your organization (if applicable) and other contact information:

Organization (or leave blank if you are completing the survey in your personal capacity) : External Reporting Board
Name(s) of contact(s) for this submission : Misha Pieters
Job title or role : Director - Auditing and Assurance
E-mail address(es) of contact(s) : misha.pieters@xrb.govt.nz

2. Please select from the following options the stakeholder group to which you or your organization belongs:

Jurisdictional Standard Setter (JSS) or Other Standard Setter

3. Please select from the following options the geographical region that best matches you or your organization:

Asia Pacific

4. Did you undertake outreach activities with other stakeholders outside your organization to inform your responses to this survey?

Yes

4A. Please provide further information about your outreach activities, including:

The manner in which the outreach was undertaken. : One on one discussions were held to solicit views.
The nature and number (or estimate thereof) of stakeholders with whom you engaged. : We engaged with auditors, representatives from professional bodies, regulators and academics.

5. You are welcome to provide any additional information you believe may be relevant to clarify the context in which you are completing the survey, or the circumstances or experiences that have informed your views or perspectives (or you can choose to leave this question blank).

There are multiple contributing factors impacting the audit of accounting estimates. Our observations below are therefore not only linked to the revision of ISA 540 (Revised).
Accounting estimates can be complex and are frequently the most challenging part of the audit. The preparation of these estimates is often challenging. Some estimates are becoming less precise and the disclosure and transparency of the methods and assumptions used becomes more important. Enhancing accounting estimates will require coordination across the financial reporting and assurance ecosystem. Lessons from sustainability assurance engagements where reporting is highly uncertain will increasingly flow through to auditing accounting estimates. Challenges identified will not be able to be solved by the IAASB alone but will require collaboration with others.
Overall, we found the targeted questions in the survey were narrowly scoped, and focussed on whether the revisions met a purpose established many years ago. We consider it is timely and relevant to explore whether ISA 540 (Revised) is fit for purpose in a rapidly evolving business context. We encourage the IAASB to consider more open-ended questions when undertaking post-implementation reviews in future.

4. Section III: Overall Questions

6. Please provide overall views about whether ISA 540 (Revised) has achieved its intended purpose and the objectives of the IAASB in developing the revised standard.

AUDIT FOCUS HAS IMPROVED, BUT PRACTICAL CHALLENGES REMAIN
There has been improved audit focus related to accounting estimates. In particular, auditors appear to place greater emphasis on risk assessment, documentation, and the application of professional scepticism. We also heard that adoption of the revised ISA (NZ) 540 has been relatively smooth.

However, recurring inspection findings and increasing complexity indicate that challenges remain particularly in regards to documentation.

The Financial Markets Authority (FMA), the audit regulator of Financial Market Conduct entities in New Zealand, continues to highlight the audit of accounting estimates as an area for continuous improvement. Recurring findings relate to documentation and the sufficiency of audit evidence, the need to assess the integrity of the significant assumptions and to test data used in complex models. There are also ongoing findings related to using an auditor's expert to audit an estimate.

It is not clear whether these challenges arise from the standard itself or from implementation in practice, or a combination of both, nor whether challenges will be better addressed through case studies.

We also note that complexity continues to increase. Accordingly, our response focusses on whether the standard remains fit for purpose in the current context and highlights ongoing challenges in practice, rather than only on whether the revision met the objectives of the project that were established years ago.

7. Are you aware of the non-authoritative guidance and support tools developed to support the implementation of ISA 540 (Revised)?

Yes

7A. Do you agree that the non-authoritative guidance and support tools developed to support the implementation of ISA 540 (Revised) are useful?

3 – Agree

Comments: STAKEHOLDERS VALUE EXISTING GUIDANCE, BUT WANT MORE PRACTICAL CASE STUDIES Existing non-authoritative guidance was viewed positively by those familiar with it. Those less familiar or who were not aware, cited the time frames since it was issued or the lack of prominence on websites. Given limited resources, we recommend the IAASB re-promote or recycle the relevant parts of the existing guidance so they remain visible to stakeholders. A recurring theme from our outreach was the need for practical case studies, particularly for "complex" estimates that are commonly encountered in practice. Suggestions we heard included a worked example of a valuation. These worked case studies would supplement and complement the examples in the extant guidance that are more straightforward and simpler.

5. Section IV: Perceived Benefits from ISA 540 (Revised)

8. For each perceived benefit, indicate the extent to which you agree that ISA 540 (Revised) has led to benefits or improvements.

	4 – Strongly Agree	3 – Agree	2 – Disagree	1 – Strongly Disagree	0 – No Response
(a) Enhanced exercise of professional skepticism when auditing accounting estimates.		X			
(b) Greater consideration of the skills and competencies of the engagement team, including the need to involve specialists or experts.			X		
(c) Greater attention to understanding management's process for making estimates, including the selection of methods, assumptions and data (and the consistency of selection between periods).		X			
(d) Better or more focused assessments of the risks of material misstatements for accounting estimates.		X			
(e) More focus on understanding and testing controls related to accounting estimates.		X			
(f) Increased auditor attention to disclosures related to accounting estimates, including disclosures about estimation uncertainty.		X			
(g) Enhanced interactions and communications between the auditor and management and those charged with governance related to the audit of accounting estimates.		X			
(h) Enhanced quality of financial reporting related to accounting estimates.		X			

9. Are there any additional benefits or positive outcomes arising from the implementation of ISA 540 (Revised) that you would like to highlight?

Yes

Please specify:

ISA 540 MAY HAVE IMPROVED AWARENESS AND REPORTING QUALITY
Several factors have contributed to improvements in reporting and auditing management's estimates and related disclosures. As a result, these benefits cannot be attributed solely to ISA 540 (Revised).
We have heard that increased audit focus on accounting estimates may have improved the quality of financial reporting in this area.
We have also observed better awareness and identification of accounting estimates that fall within the scope of ISA 540 (Revised).
Auditors may be placing more focus on understanding controls over management's estimates, often through walkthrough procedures. However, this has not necessarily led to more reliance on controls or less substantive testing being performed for accounting estimates. This is mainly because many entities do not have controls that are strong enough to support testing of operating effectiveness of controls.

6. Section V: Potential Issues or Challenges Relating to ISA 540 (Revised)

10. ISA 540 (Revised) was designed to be capable of being applied to all accounting estimates, and for the nature, timing and extent of the risk assessment and further audit procedures to be varied in relation to the estimation uncertainty and the assessment of the risks of material misstatement. Indicate the extent to which you have observed or are aware of any issues or challenges related to scalability and proportionality.

4 – Significant Issues or Challenges

11. Briefly describe these or any other issues or challenges you observed related to scalability and proportionality.

SCALABILITY CHALLENGES
We have heard mixed views on scalability. Some stakeholders noted that the standard appropriately highlights scalability and works in practice.

ISA 540 (Revised) was informed by matters impacting large and complex entities, for example the expected credit loss accounting standard. Many smaller entities do not have estimates of that nature.
Many found scalability and proportionality to be a key challenge. These concerns related to scaling the requirements to:
• smaller entities with simple estimates
• less complex estimates for larger entities
• an estimate that is multiples of materiality for which any misstatement is more likely to be material versus an estimate that is very close to the materiality threshold.
Practitioners from small practices commented that they apply the same approach regardless of the complexity of the estimate and have asked for additional case studies to be provided illustrating the application of principles in real-life scenarios.
There are challenges in applying risk assessment at the assertion level for estimates when the spectrum of risk differs at a more granular level. For example, in a discounted cash flow model, the level of risk may be assessed to be different for the cash flows and the discount rate. However, both the cash flows and discount rate may impact the same assertions.
Stakeholders highlighted the challenge of applying the requirements over the methods, assumptions and data that may impact the same assertion, but for which the inputs have very different risk profiles.

12. In your view, are the issues or challenges due to a lack of clarity or insufficiency of the requirements or application material in the standard?

Yes

13. What specific suggestions do you have for how the IAASB can best address the issues or challenges you have identified (e.g., standard-setting, non-authoritative guidance, or other actions)?

THE STANDARD SHOULD CLARIFY HOW RISK CAN BE ASSESSED AT A MORE GRANULAR LEVEL
We recommend the standard clarifies that, although risk assessment is performed at the assertion level, the auditor may assess risks in methods, assumptions and data at a more granular level to enable the audit to be risk-based and proportionate to the real risks. For example, risk related to one assertion may be higher in only two of five assumptions in a model. Drilling down to this level may be necessary to understand what is driving the risk and to design appropriate responses to address this risk.
PRACTICAL EXAMPLES WOULD HELP AUDITORS APPLY A PROPORTIONATE, RISK-BASED APPROACH
In addition, we recommend practical case studies be developed that provide practical examples of complex estimates and how the approach can be scaled and proportionate to the risk identified. This could include examples of estimates with differing risk profiles or examples across large and less complex entities.

7. Section V: Potential Issues or Challenges Relating to ISA 540 (Revised) (continued)

14. Indicate the extent to which you have observed or are aware of the following issues or challenges relating to ISA 540 (Revised) with respect the auditor exercising professional skepticism when auditing accounting estimates and related disclosures.

	4 – Significant Issues or Challenges	3 – Moderate Issues or Challenges	2 – Minor Issues or Challenges	1 – No Issues or Challenges	0 – No Response
(a) Appropriately challenging management's judgments used in making accounting estimates, particularly when they involve complex or subjective inputs.		X			
(b) Identifying and appropriately responding to potential indicators of management bias in the development of accounting estimates.			X		
(c) Appropriately considering all relevant audit evidence obtained, whether corroborative or contradictory.			X		

15. Briefly describe these or any other issues or challenges you observed related to exercising professional skepticism.

Stakeholders queried whether professional scepticism can be meaningfully strengthened through the standard, or whether it mainly develops through training, experience and an enquiring mindset.

Regulators have identified improvement in how auditors challenge management and management's experts. However, they also continue to note weaknesses in documenting judgements and obtaining sufficient appropriate audit evidence, particularly when an auditor uses an expert.

We heard that enhanced risk assessment procedures may have strengthened auditors' ability to identify potential indicators of management bias at a detailed level. This has increased the importance of applying the stand-back requirements appropriately to make an overall assessment.

We heard that auditors are generally obtaining both corroborative and contradictory evidence. However, contradictory evidence can be difficult to find, particularly where no active market exists. There was general agreement that additional emphasis on the requirement to take into account all relevant evidence obtained, whether corroborative or contradictory, is particularly helpful relevant in volatile environments.

16. In your view, are the observed issues or challenges due to a lack of clarity or insufficiency of the requirements or application material in the standard?

No

17. What specific suggestions do you have for how the IAASB can best address the issues or challenges you have identified (e.g., standard-setting, non-authoritative guidance, or other actions)?

We do not consider that further standard setting is the best way to enhance professional scepticism.

If further non-authoritative material is developed, such case studies may:

• demonstrate the benefits of assessing corroborative and contradictory evidence particularly when the client is operating in a volatile environment.

• include a practical prompt of what the auditor may consider when a client only obtains valuations every other year and there has been a significant change in economic conditions between valuations.

8. Section V: Potential Issues or Challenges Relating to ISA 540 (Revised) (continued)

18. Indicate the extent to which you have observed the following issues or challenges in applying ISA 540 (Revised) with respect to *risk assessment procedures and identifying and assessing the risks of material misstatement related to accounting estimates*.

	4 – Significant Issues or Challenges	3 – Moderate Issues or Challenges	2 – Minor Issues or Challenges	1 – No Issues or Challenges	0 – No Response
(a) The consideration of inherent risk factors and the interrelationship between them in identifying and assessing risks of material misstatement related to accounting estimates.			X		
(b) How the understanding of the entity and its environment, and the entity's internal control for accounting estimates, relates to the understanding required by ISA 315 (Revised 2019) (i.e., whether it is clear that the requirements in paragraph 13 of ISA 540 (Revised) relate specifically to accounting estimates and build on the broader requirements in ISA 315 (Revised 2019)).		X			
(c) Reviewing the outcome of previous accounting estimates or, where applicable, their subsequent re-estimation (i.e., the retrospective review of accounting estimates).		X			
(d) Understanding management's process for making accounting estimates, including how management identifies and selects relevant methods, assumptions and data, and how management understands and addresses estimation uncertainty.			X		
(e) The separate assessments of inherent and control risk relating to an accounting estimate.			X		
(f) Whether any of the assessed risks of material misstatement are significant risks.			X		

18A. Provide additional input, if any, about any issues or challenges regarding the interaction of ISA 540 (Revised) with ISA 315 (Revised 2019) in relation to risk assessment procedures and the identification and assessment of risks of material misstatement for accounting estimates.

The linkage between ISA 570 and ISA 315 is not clear. ISA 315 is risk based but ISA 570 requires specific audit procedures. This means that the work performed in line with ISA 570 may not be representative of the assessed risk. This is a key challenge for proportionality.

We heard that some stakeholders consider that regulatory findings persist relating to accounting estimates where the auditor does not sufficiently document their understanding of the client's business as this is core to applying a proportionate, risk-based audit of the entity's accounting estimates.

We also heard that auditors face challenges when entities do not have appropriate controls in place for accounting estimates. This has been highlighted in relation to the use of management's expert where the entity's management has limited understanding of the estimate and there are inadequate controls in place.

18B. Indicate the extent to which you agree with the following statements with respect to *reviewing the outcome of previous accounting estimates or, where applicable, their subsequent re-estimation.*

	4 – Strongly Agree	3 – Agree	2 – Disagree	1 – Strongly Disagree	0 – No Response
(a) The retrospective review process is difficult due to changes in economic conditions or assumptions that make prior-period estimates less comparable.		X			
(b) The time and effort required to perform a retrospective review outweigh the perceived benefits for audit risk assessment.		X			

19. Briefly describe these or any other issues or challenges you observed related to risk assessment procedures and whether such issues or challenges relate primarily to estimates that have a high degree of estimation uncertainty or complexity.

Some stakeholders emphasised the importance and value of retrospective reviews of estimates.
Others however reported the following challenges:
• Difficulty in certain circumstances to test the outcome of a previous estimate.
• That the time and effort to perform a retrospective review is significant and question the confidence it provides in some circumstances.
Some stakeholders questioned the benefit of performing a retrospective review when the estimate continues into the current period and is subject to other audit procedures.

20. In your view, are the observed issues or challenges due to a lack of clarity or insufficiency of the requirements or application material in the standard?

Difficult to Determine

21. What specific suggestions do you have for how the IAASB can best address the issues or challenges you have identified (e.g., standard-setting, non-authoritative guidance, or other actions)?

We recommend that the IAASB work with practitioners and regulators to identify examples where retrospective reviews of an estimate provide high quality audit evidence and where the benefit outweighs the cost. Such discussion could enable clear communication of when and how retrospective reviews promote audit quality.

9. Section V: Potential Issues or Challenges Relating to ISA 540 (Revised) (continued)

22. Indicate the extent to which you have observed the following issues or challenges in applying ISA 540 (Revised) with respect to *responding to the assessed risks of material misstatement*

	4 – Significant Issues or Challenges	3 – Moderate Issues or Challenges	2 – Minor Issues or Challenges	1 – No Issues or Challenges	0 – No Response
Responses to the Assessed Risks of Material Misstatement (a) Determining the most appropriate response(s) to the assessed risks of material misstatement at the assertion	X				
(b) Determining whether to test the operating effectiveness of controls related to an accounting estimate.			X		
(c) Appropriately applying the testing approach of obtaining audit evidence about events occurring up to the date of the auditor's report, either alone or with another testing approach(es).			X		
(d) Testing how management made the accounting estimate.	X				
(e) Developing an auditor's point estimate or range.	X				
Overall Evaluation (f) Determining whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.		X			
(g) Evaluating identified misstatements related to accounting estimates, including when the audit evidence supports a point estimate that differs from management's point estimate or a range that does not include management's point estimate, or when the auditor's range is wide (in some cases, multiples of materiality for the financial statements as a whole).		X			

22A. Indicate the extent to which you have observed the following issues or challenges in applying ISA 540 (Revised) with respect to *testing how management made the accounting estimates.*

	4 – Significant Issues or Challenges	3 – Moderate Issues or Challenges	2 – Minor Issues or Challenges	1 – No Issues or Challenges	0 – No Response
(a) Testing management's selection of the method, significant assumptions, and data used, including whether management's judgments give rise to indicators of possible management bias.		X			
(b) Understanding management's application of the method involving complex modelling and testing complex models, including the integrity and completeness of the data used.	X				
(c) Whether management has taken appropriate steps to understand and address estimation uncertainty, including the selection of an appropriate point estimate and developing related disclosures about estimation uncertainty.		X			

22B. Indicate the extent to which you have observed the following issues or challenges in applying ISA 540 (Revised) with respect to *developing a point estimate or range*.

	4 – Significant Issues or Challenges	3 – Moderate Issues or Challenges	2 – Minor Issues or Challenges	1 – No Issues or Challenges	0 – No Response
(a) Determining when it may be appropriate to develop an auditor's point estimate or range.			X		
(b) Determining that the auditor's range includes only amounts that are supported by sufficient appropriate audit evidence and have been evaluated to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework.				X	
(c) Maintaining objectivity and independence, for example, when material adjustments are made to management's point estimate based on the auditor's point estimate developed using a model or assumptions that were different from management's models and assumptions.		X			

23. Briefly describe these or any other issues or challenges you observed related to responding to risks of material misstatement and whether such issues or challenges relate primarily to estimates that have a high degree of estimation uncertainty or complexity.

Determining the most appropriate response to assessed risk
We have heard that concerns that the documentation of the distinction between testing approaches described in paragraph 18 often becomes blurred (i.e. more than one method is used to test management's estimate). While the standard acknowledges the possibility in paragraph A81, it does not address the practical challenges that arise.
For example, the auditor may plan to test how management made the accounting estimate (18 (b)) but may become aware of weaknesses in management's approach while performing this testing. Due to the weaknesses identified, the auditor may then develop a "challenger" estimate.
This "challenger" estimate may include elements of an auditor's point estimate. When this occurs, the documentation may become less clear as to whether this still constitutes testing of whether management's estimate is reasonable, or whether this moves into developing an auditor's point estimate or range.
The regulator highlighted that auditors may document that they are using a testing approach, but the evidence on file supports a different method. Ensuring this consistency of documentation across the audit file is a key challenge.

Testing how management made the estimate
Auditors may be uncertain about which parts of management's estimate to test and how to document the professional judgement applied in making that determination.
Challenges also arise when auditors cannot access all parts of an estimate. For example, if management uses an expert and parts of the model are protected as proprietary, auditors may not have sufficient access to review them fully. This can make it difficult to determine what constitutes sufficient appropriate audit evidence for those protected elements and may blur the distinction between testing approaches.
With the increased use of technology, additional risks identified with regard to black box" models are expected to become more common.
Auditors also reported challenges in deciding when to involve an expert to assess the reasonableness of management's estimate. Where management has used an expert, auditors may also find it difficult to source an auditor's expert with the necessary skills in smaller markets such as the New Zealand market.
Developing an auditor's point estimate or range
Developing a point estimate is often challenging and costly and is therefore uncommon in practice.
We heard challenges:
• around the level of precision required when an auditor develops a point estimate or range. This is particularly when evaluating misstatements where there is a high level of uncertainty and the estimate is complex
• about a lack of clarity about what steps to take to resolve differences between an auditor's estimate and management's estimate.

• related to independence in circumstances when there is a difference and a client adjusts their accounting estimate to reflect the auditor's point estimate.

24. In your view, are the observed issues or challenges due to a lack of clarity or insufficiency of the requirements or application material in the standard?

Yes

25. What specific suggestions do you have for how the IAASB can best address the issues or challenges you have identified (e.g., standard-setting, non-authoritative guidance, or other actions)?

We have heard that practitioners find the examples provided in the standard too simple. We encourage the use of more realistic case studies, based on more complex estimates encountered in practice.
We have heard challenges when management makes material adjustments to their estimate based on an auditor's point estimate. We would encourage application material to address this situation, outlining when necessary and providing practical examples.
We also encourage further guidance on how the precision of an auditor's point estimate or range affects the persuasiveness of audit evidence, particularly where estimation uncertainty is high and when evaluating misstatements.
Further clarity is also needed on the steps an auditor should take when the auditor's estimate differs from management's estimate.
It would be helpful to explain how to consider a material misstatement and whether, and in what circumstances, the matter should be communicated to those charged with governance or whether a scope limitation may need to be considered.
Emerging technology may provide opportunity to enhance documentation to ensure consistency across the audit file.

10. Section V: Potential Issues or Challenges Relating to ISA 540 (Revised) (continued)

26. Indicate the extent to which you have observed the following issues or challenges in applying ISA 540 (Revised) with respect to *communication, specialized skills or knowledge, including using the work of an auditor's expert, and documentation*.

	4 – Significant Issues or Challenges	3 – Moderate Issues or Challenges	2 – Minor Issues or Challenges	1 – No Issues or Challenges	0 – No Response
Communication (a) Determining the matters, if any, to communicate related to accounting estimates, (including about significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control).			X		
Specialized Skills or Knowledge, Including Using the Work of an Auditor's Expert (b) Determining when it is appropriate to involve an auditor's expert(s) (an internal or external expert) and using the work of an auditor's expert(s) in auditing an accounting estimate(s).	X				
Documentation (c) Preparing appropriate audit documentation in accordance with the requirements in paragraph 39 of ISA 540 (Revised).			X		

27. Briefly describe these or any other issues or challenges you encountered or observed related to communications, specialized skills or knowledge (including using the work of an auditor's expert) and documentation.

AUDITORS FACE PRACTICAL CHALLENGES WHEN USING EXPERTS
We identified three main challenges in using an auditor's expert.
• Auditors can find it difficult to determine when an expert is needed. For example, when management uses a valuation expert, it may be unclear whether the auditor's prior experience is sufficient or whether an auditor's expert is also needed. Paragraph A62

recognises valuation skills as an example of expertise the auditor may not possess.

• Auditors may face difficulty selecting an appropriate auditor's expert, particularly where there is divergence in practice or where different methodologies may be acceptable.

• Lack of clarity on the scope of work expected by an auditor's expert versus the audit team, for example experts often do not test the reliability of the underlying data so it is important that this is covered by the auditor.

28. In your view, are the observed issues or challenges due to a lack of clarity or insufficiency of the requirements or application material in the standard?

No

29. What specific suggestions do you have for how the IAASB can best address the issues or challenges you have identified (e.g., standard-setting, non-authoritative guidance, or other actions)?

It may be beneficial to include a practical example in a case study to clarify the scope of work expected by an auditor's expert versus the work to be completed by the audit team. This may be more related to the application of ISA 620.

We would encourage further non-authoritative guidance related to paragraphs A61 - A63 in determining the appropriate expert to engage particularly when there is a divergence in practice or areas known to be subject to differing interpretation.