



John Ryan

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Marje Russ
Chair
New Zealand Auditing and Assurance Standards Board
Level 6
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Tēnā koe Marje

Proposed public interest entity amendments

Thank you for seeking comment on the consultation document “Public Interest Entity Amendments” dated March 2024 (the Consultation Document).

As you will be aware, I am responsible for auditing all public sector entities in New Zealand, including public benefit entities and for-profit entities. My Office, together with the auditors I appoint to act on my behalf, provide the New Zealand Parliament and the public with independent assurance that public sector entities are operating and accounting for their performance as intended.

The Consultation Document raises an important question: Should the existing New Zealand definition of a “public interest entity” (PIE)¹ be extended to apply to circumstances beyond the audit independence considerations for which the definition was originally developed? In my opinion, your Board has not demonstrated that the extension of the New Zealand definition of a PIE to different circumstances satisfies the “compelling reason test” that is used to justify a modification of an international standard. This matter is discussed further in Attachment 1.

The Board’s proposals to require key audit matters in audit reports and engagement quality reviews for a substantial number of Tier 1 public organisations, will impose significant compliance costs on those organisations without demonstrable benefits to users. In my opinion, those additional compliance costs cannot be justified.

This places me in a difficult position as New Zealand’s public sector auditor because I have a statutory responsibility² to satisfy myself that the audit fees charged to public entities are reasonable. If your Board proceeded with proposals for which I could not justify the costs, I would need to consider

¹ The New Zealand definition of a “public interest entity” (PIE)¹ that currently applies to *PES 1: International Code of Ethics for Assurance Practitioners (including International Independence Standards) (New Zealand)* (PES 1)

² Section 42 of the Public Audit Act 2001

departing from the Board's standard and set my own standard, as I am permitted to do under the Public Audit Act 2001.

Attachment 2 responds to the Board's consultation questions.

If you have any questions, please contact Todd Beardsworth at todd.beardsworth@oag.parliament.nz

Nāku noa, nā

A handwritten signature in black ink, appearing to read 'JM Ryan', with a stylized flourish at the end.

John Ryan
Controller and Auditor-General

Attachment 1: Should the New Zealand definition of a “public interest entity” be applied universally to all standards issued by the New Zealand Auditing and Assurance Standards Board (NZAuASB) where a requirement refers to public interest entities?

We recognise that the NZAuASB sets ethical and professional, and auditing and assurance standards that converge with the international standards issued by the IAASB or the IESBA. Departures from international standards are permitted, but only if “compelling reasons” exist to justify a departure. The “compelling reason test” is contained in an External Reporting Board (XRB) document “NZAuASB Policy and Process for International Conformance and Harmonisation of Standards”.

In the context of the current “public interest entity” (PIE) proposals we reflect on the application of the compelling reason test in the context of PIEs.

The initial version of the International Code of Ethics (the international Code) was promulgated by the IESBA with an effective date of 1 January 2011. The Code was amended and issued for application in New Zealand (the New Zealand Code) by the New Zealand Institute of Chartered Accountants; that was responsible for issuing New Zealand’s ethical and auditing standards at that time.

When the XRB came into existence on 1 July 2011 one of the early tasks assigned to the NZAuASB was to satisfy itself that the New Zealand Code was fit-for-purpose in New Zealand. An aspect of this process was to ensure conformity with the international Code. At that time the NZAuASB reaffirmed the wider definition of a PIE (an entity that reports under Tier 1) that had been included in the New Zealand Code by the New Zealand Institute of Chartered Accountants was appropriate and in accordance with the “compelling reason test” that applied at that time.

The broader definition of a PIE was reaffirmed on the basis that:

- the change had been approved through proper “due process” and was supported by New Zealand stakeholders; and
- the public interest in New Zealand was better served by New Zealand auditors exhibiting a higher standard of auditor independence for a greater proportion of entities subject to audit when compared to the International Code.

What was not known at the time, was that the term PIE would be used in other standards and applied in circumstances unrelated to auditor independence. Applying the New Zealand definition of a PIE to circumstances unrelated to auditor independence risks the possibility of unintended consequences.

A forerunner of using the term PIE to new circumstances was in 2017 when new auditor rotation requirements were introduced. These requirements were in response to the familiarity threat to independence when an auditor had a long association with an entity subject to audit. The new rotation requirements were applied to PIEs, as defined in the New Zealand Code.

The auditor rotation requirements place a considerable strain on audit firms when assigning a small number of key audit partners across a firm’s audit portfolio. Concerns were raised at the time by

auditors because of the logistical problems that were created. Nonetheless, audit firms (through considerable effort and ingenuity) have found a way to comply with the auditor rotation requirements.

In 2024 the IAASB made the decision to use the term PIE, as defined by the IESBA, in the International Standards on Auditing (ISAs) in place of the term 'listed entities'. From an international ISA perspective this is appropriate and aligns with how we currently apply the equivalent ISA NZ requirements (i.e., reference to 'listed entities' in ISAs NZ requirements have been replaced with 'FMC reporting entities considered to have a higher level of public accountability').

The IAASB's decision will be a problem if it is applied verbatim in New Zealand. The appropriateness of the definition of a PIE in the New Zealand Code to other standards is being questioned. In our view, the NZAuASB's wider definition of a PIE is not responsive to the public interest or risk. As a consequence, the NZAuASB definition of a PIE scopes in many entities that are large, but in every other respect are of limited public interest and where risk is minimal. A direct consequence is that the requirements are inappropriately applied to a significant number of entities where the cost of the additional requirements is not accompanied by clearly demonstrable benefits in the public interest.

In addition, we note that some entities that possess the attributes of public interest and risk are not caught by the NZAuASB's wider definition of a PIE – for example, a small entity that is being prepared for sale to the public.

It is likely that the IAASB standards will continue to extend their application to PIEs in the future. This possibility increases the importance of the NZAuASB settling on an enduring solution to the current issue. Otherwise, the issue will continue to be debated each time the NZAuASB consults with stakeholders about adopting an international standard issued by the IAASB for application in New Zealand that places a requirement on the auditors of PIEs.

A possible solution is to continue to apply the 'PIE specific' independence provisions of the New Zealand Code to entities that apply Tier 1 financial reporting frameworks. However, the New Zealand Code should no longer refer to those entities as PIEs. If this was done, references to PIEs in the ISAs that are adopted for application in New Zealand could reflect a new New Zealand definition of a PIE that closely aligns to the IESBA definition. A possible new definition for PIEs is "FMC reporting entities considered to have a higher level of public accountability". This definition is already applied when specifying entities for which an engagement quality review is required (under PES 3) and when the auditor is required to include key audit matters in their audit report (under ISA (NZ) 701).

Attachment 2: Responses to questions for respondents

- 1** *Do you agree that the same definition of public interest entity should be used for the auditing and assurance standards and the professional and ethical standards? If not, please explain why not.*

We do not agree that the definition of a PIE, as currently specified for application under PES 1 should be applied to other professional and ethical standards, or to auditing and assurance standards.

We have been comfortable with this definition in the New Zealand Code because it was used for differential independence requirements. The Auditor-General applies a higher level of independence requirements than the New Zealand Code to all public sector entity audits.

In our view, a definition of a PIE that aligns to the IESBA definition should be applied to international standards issued by the IAASB when they are adopted in New Zealand.

- 2** *For each of the existing differential requirements, do you agree with the proposal to extend the application to public interest entities? If not, please explain why not and why in your view it is not in the public interest to do so.*

We note that the recent IAASB Exposure Draft³ on PIEs contains several observations of relevance to this question.

Paragraph 16 of the Explanatory Memorandum to the IAASB Exposure Draft states:

“The IAASB proposes that for the ISQMs and ISAs, the purpose of the differential requirements is to meet “the heightened expectations of stakeholders regarding *the audit engagement*” [Emphasis added by the IAASB]. The reference to “the heightened expectations of stakeholders regarding the audit engagement” implies (to us) a focus on public interest and risk. Such notions are not reflected in a PIE definition which includes entities that apply Tier 1 financial reporting frameworks (particularly for not-for-profit entities, and public sector entities). Tier 1 financial reporting frameworks are applied by entities based on the size of their expenditure. Public interest and risk are not necessarily directly related to financial size of an entity.

Paragraph 31 of the Explanatory Memorandum to the IAASB Exposure Draft states:

“In addition, the IESBA formed the view that establishing an overarching objective and expanding the PIE categories in the IESBA Code should bring some level of global consistency to the types of entities that should be treated as PIEs (i.e., a global baseline)”. In our view, this statement indicates that the NZAuASB needs to understand the purpose of

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Proposed Narrow Scope Amendments to:

- International Standards on Quality Management;
- International Standards on Auditing; and
- International Standard on Review Engagements 2400 (Revised), *Engagements to Review Historical Financial Statements* as a Result of the Revisions to the Definitions of Listed Entity and Public Interest Entity in the IESBA Code

a requirement and apply a definition of a PIE that closely equates to the international definition, unless there is a compelling reason not to do so in the New Zealand context.

The proposals are a blunt and expensive tool to enhance audit quality. It is unclear that audit quality will be enhanced beyond the current risk-based approach to EQRs and KAMs.

a) Mandatory engagement quality review.

We do not agree that the definition of a PIE, as currently specified for application under PES 1, should be applied to other professional and ethical standards, or to auditing and assurance standards. As discussed in Attachment 1 the existing definition of a PIE is not responsive to the public interest or risk.

The Auditor-General's auditing standards already extend engagement quality reviews beyond the minimum requirements of PES 3. The Auditor-General's criteria for engagement quality review reflect public interest and risk⁴.

The Auditor-General addresses risks related to audit quality in other ways, including:

- the Auditor-General applies AG PES 3 to his audit service providers in addition to their compliance with PES 3;
- the Auditor-General requires appointed auditors to submit modified audit reports to his Opinions Review Committee to consider the appropriateness of the modification under the circumstances and the quality of the audit report before it is issued; and
- the Auditor-General has identified a small number of entities where increased involvement by his leadership team is required.

b) Required communications with those charged with governance about the firm's system of quality management.

We do not agree that the definition of a PIE, as currently specified for application under PES 1, should be applied to other professional and ethical standards, or to auditing and assurance standards. As discussed in Attachment 1 the existing definition of a PIE is not responsive to the public interest or risk.

c) Communications about auditor independence.

Higher independence requirements are applied to Tier 1 entities under PES 1. It follows, as a matter of principle, that communications about auditor independence should align to Tier 1 entities. However, we do not consider Tier 1 entities are PIEs for the reasons given in Attachment 1..

All audit reports issued by the Auditor-General and on his behalf describe compliance with ethical requirements, including independence in a separate paragraph.

⁴ The Auditor-General's criteria for requiring an EQR is available in AG PES 3.

d) Communicating key audit matters in the auditor’s report.

We do not agree that the definition of a PIE, as currently specified for application under PES 1, should be applied to other professional and ethical standards, or to auditing and assurance standards. As discussed in Attachment 1 the existing definition of a PIE is not responsive to the public interest or risk.

Following the IAASB’s post-implementation review of key audit matters (KAMs), the IAASB noted (in a June 2021 feedback statement) there was a “lack of broad support to extend the communication of KAM beyond PIEs as costs were considered to exceed benefits for entities other than PIEs”.

This is important feedback because it provides a strong evidential basis for not extending KAMs reporting beyond PIEs, as defined in the IESBA standards. This finding also aligns with our own experience in reporting KAMs.

The Auditor-General currently includes KAMs in the audit reports of a few entities in addition to the public sector entities that are also FMC reporting entities. The primary examples of this are the audit reports for the Financial Statements of the Government and for Health New Zealand.

It is not feasible to include KAMs for all public sector entities that apply Tier 1 financial reporting frameworks.

e) Name of the engagement partner.

In our opinion, the engagement partner should be named in the audit report for every audit. This is current practice for audit reports issued by or on behalf of the Auditor-General.

3 Do you agree that the benefits of the proposals outweigh the expected costs? If not, why not?

If the NZAuASB intends to extend the definition of PIEs in PES 1 (entities where Tier 1 reporting is mandatory) to other standards this will impose significant compliance costs on those organisations without producing any demonstrable benefits to users. Those additional compliance costs cannot be justified; particularly when the definition of a PIE in PES 1 is not responsive to public interest or risk.

In the public sector there are approximately 295 entities that apply Tier 1 financial reporting frameworks due to their size. The NZAuASB proposals will result in⁵:

- An additional 95 entities being subject to engagement quality review (bearing in mind that these entities have already been assessed against the AG PES 3 criteria as not requiring an EQR); and

⁵ Details of these entities are available to the XRB on request.

- An additional 280 entities where auditors will need to include KAMs in the audit report.

The proposed requirements will place a substantial burden on already scarce audit resources. We already manage that resource with the public interest and risk as critical drivers. A PIE definition that does not reflect public interest or risk is not helpful in assisting auditors to assign audit resources to where they are most needed.

The proposals will require additional training for audit service providers who currently do not have experience in writing KAMs. They will also increase demand on our processes to mitigate risks for audit reports, other than standard audit reports.

4 Are there any other significant public interest matters that you wish to raise?

It is likely that the IAASB will continue to extend the application to PIEs to other standards in the future. We urge the NZAuASB to develop an enduring solution to this issue. Otherwise, the issue will continue to be debated each time the NZAuASB consults with stakeholders about adopting an international standard issued by the IAASB for application in New Zealand that places a requirement on the auditors of PIEs.