

Audit Quality – Monitoring Report

1 July 2015 – 30 June 2016



Purpose of this report

Under the Auditor Regulation Act 2011 (the Act) we must carry out a quality review of the systems, policies and procedures of registered audit firms and licensed auditors at least once every four years.

We are also required to prepare a report each year on the quality reviews we completed in the preceding financial year. This report summarises our findings from quality reviews carried out between 1 July 2015 and 30 June 2016.

Our quality reviews of audit firms help improve audit quality standards and ensure that audit opinions are reliable. These reviews also help us achieve our strategic goal of ensuring that investors have access to resources which help them make better informed financial decisions.

In this year's report, we also draw attention to our expectations of directors and auditors of financial statements and the key focus areas which our stakeholders need to be aware of.

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This report is for:

- Accredited bodies
- Company directors
- Investors
- Auditors
- Issuers
- Chartered accountants



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Key trends

2016 Market snapshot¹

 **146**
domestic licensed auditors

 **24**
domestic registered firms

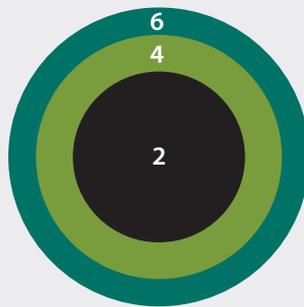
 **186**
NZX listed companies

 **1700**
FMC audits

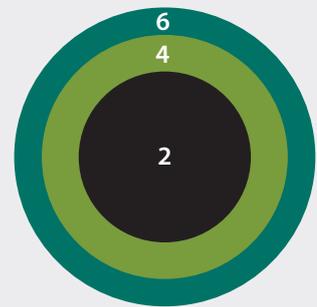
¹ As at 30 June 2016

Breakdown of reviewed firms 2013-2016

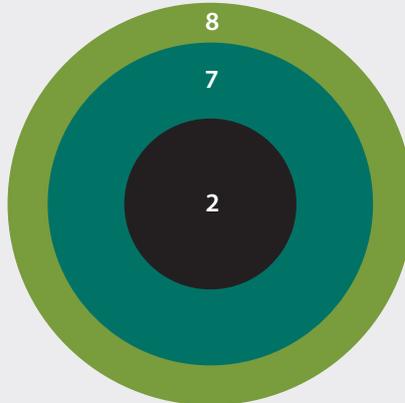
2015/2016



2014/2015



2013/2014



- Large national firms
- Other national and network firms*
- Smaller firms**

* Includes registered audit firms with multiple offices across New Zealand and audit firms that have separate registered firms but operate under one brand name and have less than 10 auditors.

** Firms with fewer than 4 licensed auditors.

Audit quality reviews 2015/16

 **12**
registered audit firms

 **30**
audit files, including 13 listed companies and 17 other companies

Audit quality reviews 2014/15

 **12**
registered audit firms

 **38**
audit files, including 13 listed companies and 25 other companies

Audit quality reviews 2013/14

 **17**
registered audit firms

 **56**
audit files, including 14 listed companies and 42 other companies

Executive summary

We acknowledge there has been noticeable improvement in audit quality since we first reviewed audit firms in 2013. Most audit firms have integrated the findings from our previous reviews into their working practices.

However, we saw a lack of consistent application of some changes to policies and procedures, as changes were not always visible or effective in some of the audit files we reviewed.

New Zealand audit firms are performing at a level consistent with international counterparts and our findings are consistent with the Survey of Inspection Findings by the International Forum of Independent Audit Regulators (IFIAR) in 2015.

Targeted approach

Last July marked the start of a new three yearly cycle of audit quality reviews. Between 1 July 2015 and 30 June 2016 we reviewed 12 audit firms (all of which we have reviewed previously) and 30 audit files.

We use a risk-based targeted approach to select audit files for review. This means we tend to review more complex businesses where investors are relying more heavily on a quality audit to ensure the organisation's financial position is appropriately disclosed in its financial statements.

Another factor which influences our selection of individual audit files is a weighting towards businesses that are known to have breached material laws or regulations.

As a result, the audits we review in any one year do not represent the audit environment as a whole.

As such, it would be misleading to focus solely on the percentage of audit files reviewed that need improvement, or to compare the results directly from one year to the next.

For more information about our audit file ratings, see Appendix 1 on page 17.

Progress made

In previous reviews we asked audit firms to outline a plan for how they will action our findings. This year we measured each firm's progress against their previous action plan.

We understand that it may take time for firms to fully implement the necessary changes into their policies and procedures. We expect it may take up to two audit review cycles before we see the changes made becoming fully effective.

We looked at whether the firms reviewed made improvements in the areas that we have highlighted as needing improvement during the first review cycle. See the diagram on the right for how they did.



- **Fully addressed our findings**
Firms have implemented effective systems and procedures since our previous review. **(17%)**
- **Improvement shown**
Firms implemented changes based on our findings, but improvements are not fully effective across all reviewed files. **(62%)**
- **No improvements found**
The planned system improvements to address our findings were not implemented or were ineffective. **(21%)**

Key improvement areas

The improvement areas we want auditors to focus on include:

- Internal review of audit quality.
- Independence (especially when providing non-assurance services).
- Use and documentation of professional scepticism.
- Greater focus on audit evidence and detailed documentation.
- Responsibilities relating to fraud.

Key findings

- Three sets of financial statements reviewed required additional work by the auditor to remediate our findings.
- One set of financial statements was restated in the subsequent year following additional work.

For more information see the 'Key findings' section on page 7.

Our expectations

We expect to see further improvements in overall audit quality once all auditors within a firm have embedded changes to their procedures, consistently, across the whole organisation.

We encourage audit firms to continue to take notice of this report's key findings, as well as their individual firm review, and then make effective changes to their own procedures.

Additionally, audit firms may find it useful to look at the reports of other global audit regulators.

See our 'Key takeaways for directors' section on page 5 of this report for directors' key responsibilities.

Disciplinary procedures

The Professional Conduct Committee (PCC) of the New Zealand Institute of Chartered Accountants (NZICA) concluded one complaint involving a licensed auditor this year. The complaint followed an FMA quality review and related to undisclosed alterations of the audit documentation immediately before a quality review visit, and breaches of independence requirements. The auditor was severely reprimanded, required to pay \$10,000, and the outcome of the procedure was recorded on the auditor's licence.

Two further complaints against licensed auditors are with the PCC at the date of publication of this report.

Auditor reporting

On 15 December 2016, a new standard for auditor reports will be introduced, covering New Zealand-listed companies with a reporting period ending on or after that date, and provides users of financial statements with previously unavailable additional audit information.

We may review early adopters of this new standard, where possible. After the first year, we will issue a report outlining the impact of the new standard, together with the External Reporting Board.

See the 'Early adopters of new auditing reporting section' on page 16 for more information.

International recognition

One of the objectives of the Auditor Regulation Act 2011 is to enhance the international recognition of New Zealand auditors and the international recognition of the New Zealand audit oversight framework. Such international recognition of standards and oversight contributes to investor confidence in our markets, domestically and internationally. International recognition provides investor confidence in New Zealand's capital markets.

In December 2014, we became a member of the International Forum of Independent Audit Regulators (IFIAR). Our membership of IFIAR gives us access to international knowledge on auditor regulation, and to influence the six largest international audit firms. It also enables us to use the experiences and methodologies of other regulators, and provides important training for our staff and reviewers.

In July this year, the European Commission recognised our audit oversight regime as equivalent to EU standards. This means New Zealand's systems of public oversight, quality assurance, investigation and penalties for auditors and audit firms are equivalent to EU standards. This allows NZ-regulated auditors to operate within the EU.

Both the European Union's recognition and the membership of IFIAR, show that New Zealand's framework of audit oversight meets high international standards.

Key takeaways for directors

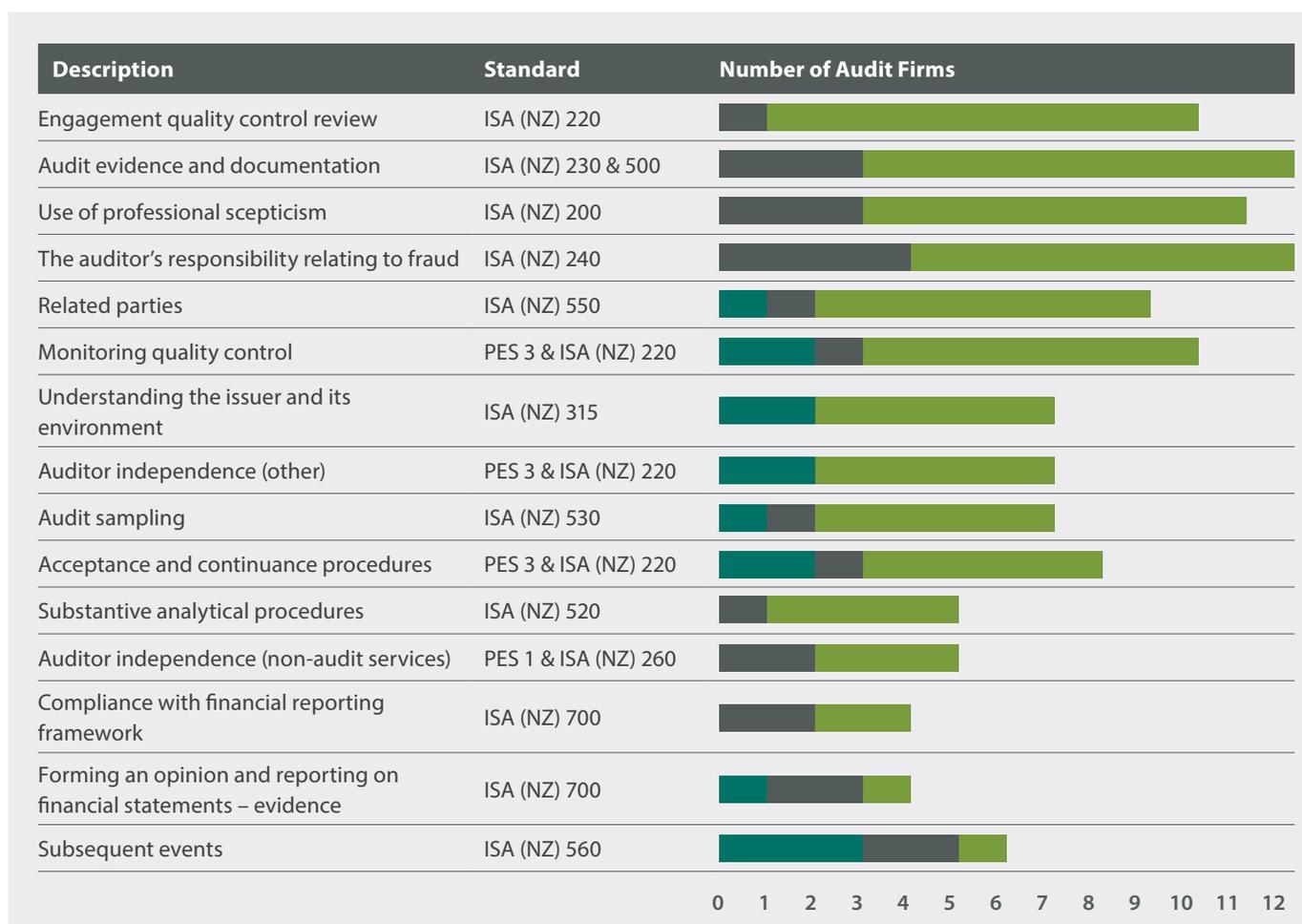
Focus area	What directors can do	Find out more here
Audit quality control	<ul style="list-style-type: none"> ● Engage with auditors and management. ● Ensure appropriate procedures are in place to facilitate audit quality. ● Ask how your contributions can improve audit quality. ● Discuss the audit firm's process for quality review, including external reviews by regulators. 	Page 7
Auditor independence	<ul style="list-style-type: none"> ● Ensure audit committees assess auditors' independence. ● Consider whether non-assurance services should be separated from audit services. ● Consider the independence in appearance. 	Page 8
Professional scepticism	<ul style="list-style-type: none"> ● Discuss the approach taken by auditors and management in areas of significant judgment. ● Discuss business challenges and risks with auditors. 	Page 10
Responsibilities relating to fraud	<ul style="list-style-type: none"> ● Discuss the potential risk of fraud with auditors. ● Put in place appropriate controls to limit the risk of fraud. 	Page 13
New style of auditor reporting	<ul style="list-style-type: none"> ● Engage early with your auditors about the new audit reporting. ● Encourage auditors to disclose useful information beyond the requirements of the standard. 	Page 16

Progress made

As mentioned in our Executive Summary, the audit firms detailed in this report have been reviewed previously. Following our first review, we asked firms to outline a plan showing how they would prevent any identified issues from reoccurring. This year, our reviews tested the effectiveness of these plans. We found up to 18 areas that required improvement following our first reviews of the firms.

We also found improvements in many areas. However, firms still have some work to do to ensure that the changes made to policies and procedures are consistently applied across all individual audit files. We understand that it will take time for firms to fully integrate these changes. We have highlighted key areas throughout this report to help auditors and directors turn their attention to where such improvements can be made. We strongly encourage both directors and audit committees to be active participants in the improvement of audit quality.

This table shows how firms did in the 15 most common areas requiring improvement.



Met the standard:

Yes

In these firms effective systems and procedures have been implemented following our review.

No

No improvements were found. In these firms the planned improvements to systems were ineffective or were not implemented.

Partly

In these firms changes were implemented based on our findings, however some improvements were not fully effective across all of the reviewed files.

Key findings

Audit quality control

We have seen definite improvements in audit quality since our previous reviews. There is greater compliance in many areas because of the plans firms have put in place. However, a high number of individual audit files still do not reach all minimum standards.

Improving the quality of audits depends on two important factors:

- how effective the firm's internal control procedures are, and
- the independent challenge on each engagement by the Engagement Quality Control Review (EQCR) partner.

Firms with robust internal reviews and appropriate investment in audit quality delivered higher standard audits than those without these systems in place.

Our assessments of firms' internal quality control programmes showed differences between large firms and those with only one to three licensed auditors. In some smaller audit firms, we found that the quality control procedures, and the monitoring of those procedures, did not exist or was ineffective.

Key observations about firms' internal monitoring:

- Internal audit quality reviews need to include an evaluation of firms' quality control systems.
- More clarity is needed around how firms address internal review findings to avoid future non-compliance.
- The outcomes of the review were not always discussed with audit staff, or the firms' board or management, resulting in issues not being addressed in subsequent audits.
- Unsatisfactory reviews often had no impact on the performance rating or remuneration of audit partners.²
- Where audit firms used external experts to assess complex accounting or audit matters, these experts were sometimes not used in a timely and effective manner.

² Professional and Ethical Standard 3 A5 (A)

EQCR partner

The EQCR partner also plays an important role in improving audit quality. Firms need to look critically at how effective their EQCR process is, and make sure that the EQCR has sufficient knowledge and experience to perform this role.

EQCR partners should critically review the key risk areas of the audit file and make sure the audit file contains strong audit evidence.

We have challenged firms where we found that their internal quality reviews did not address a significant number of the deficiencies found in our reviews.

A robust EQCR review can help to prevent non-compliance and reduce mistakes in financial statements. In some files we reviewed, EQCR partners did not detect the non-compliance we identified.

What directors can do

- Make sure your business has appropriate policies and procedures in place to address complex accounting issues or business transactions and seek independent advice when necessary. Do not rely solely on your auditor to address such issues.
- Ask auditors whether their audit file has been reviewed by the FMA or another regulator.
- Discuss with auditors lessons learnt from the audit review.
- Directors should ask their auditors how they could further contribute to audit quality.
- When appointing an auditor, directors and audit committees need to pay attention to audit quality and independence.
- Make sure that audit committee proposals contain information about external reviews by regulators and other factors such as relevant experience of audit staff and how senior members of the audit team will be used.
- Choose an audit firm based on quality of work, rather than solely on cost.

Our expectations

- Audit firms need to pro-actively review their internal measures of quality control.
- We encourage audit firms to continue to invest in their quality control functions, rather than rely solely on the audit reviews of regulators.
- We recommend that smaller audit firms with work to do in this area seek support from their international networks or other independent experts.
- Audit firms should also perform an independent self-assessment of the files that we identified in our review as needing significant improvement.
- Following an internal review, firms need to take action, not only to address the matters in their individual audit files, but also to avoid the same issues arising in other audit files.
- Audit firms do take action where licensed auditors have delivered poor quality audits, conversely, audit firms could look at rewarding staff who deliver high quality audits. This presents a missed opportunity for firms to encourage staff and partners to deliver high quality audits consistently.



Auditor independence

Auditors need to acknowledge the reliance that investors and their audit clients place upon the quality and independence of their work. The effective identification and assessment of threats to an auditor's independence, the application of appropriate safeguards, and the proper reporting of these to audit committees or directors, are all critical parts of an auditor's role.

In 2014, we issued two documents that have had a positive impact on highlighting the importance of independent disclosure of potential conflicts to the users of financial statements.³

Since publishing these documents, we have noticed better disclosure, especially in the area of disclosing the non-assurance services provided by auditors to listed companies.

This year, our reviews focused on compliance with the independence requirements for non-assurance services provided by auditors.

In large audit firms, we not only looked at independence across all the files selected for a full review, but we also selected an additional 10 files to review where the audit firm provided significant non-assurance services to the FMC reporting businesses, sometimes in excess of five times the audit fee.

The findings of these additional reviews are summarised in this section.

³ *The Disclosure of fees paid to auditors report and our updated Corporate Governance Handbook*

Compliance focus

Our reviews showed a high level of non-compliance with the Professional and Ethical Standards on specific issues.

Here are some key examples:

- Firm engagement letters included prohibited services, (although these services may not have been provided in practice) contrary to the standards, and were not picked up by the audit partner or audit committee chair.
- No evaluation of threats to a firm's independence and no appropriate safeguards in place to mitigate these threats.
- The proposed procedures to remediate a threat were not performed.
- Lack of independent assessment, as non-assurance services and audit work were performed by the same team.
- The appearance of independence was not appropriately considered in accepting non-assurance services. For example, where the auditor provided significant non-assurance services exceeding the audit fees many times, the audit file did not record any consideration of whether the appearance of independence could have been compromised.
- Non-assurance services were not disclosed appropriately in financial statements and the auditor did not report this.
- For all non-assurance services provided, potential threats to independence and how the threats would be dealt with, were not reported to the board.

Although some matters related to independence can involve a certain amount of subjectivity, our monitoring has identified a need for improvement in this area.

Some other jurisdictions have implemented stricter laws prohibiting non-assurance services or restricted services over a certain threshold. In New Zealand, there are also stricter independence rules for audits carried out under the Public Audit Act 2001.

What directors can do

- Ensure that audit committees assess auditors' independence objectively and don't rely solely on their auditor to confirm it.
- Agree on an internal policy for the approval of non-assurance services from their auditor. The policy should consider:
 - setting an appropriate threshold for non-assurance services at a level that in the directors' opinion doesn't impact the appearance of independence
 - the nature of services being provided and their impact on auditor independence
 - when it is appropriate to get another firm to carry out non-assurance services
- Ask your auditors for a detailed assessment of identified threats from non-assurance services and how the firm will tackle this, especially in complex areas.

Our expectations

We expect audit firms to improve their assessment of independence threats, look at the safeguards they have in place to mitigate these threats, and actively review the audit work they perform to ensure that mitigation was successful.

We also expect audit firms to place more emphasis on the conceptual principles of independence, and not just consider each non-assurance service in isolation. Auditors need to clearly communicate to directors the impact of non-assurance services at the start and completion of each relevant audit. Due to the significance of independence issues, there needs to be a review by both the engagement partner and the EQCR partner.

Not complying with the independence requirements of the professional standards is a serious breach of the Act.

Last year, we referred one auditor to their disciplinary body for a breach of independence requirements (among other non-compliance issues).

We expect all auditors to address the examples of non-compliance detailed on this page. We may refer more auditors to their disciplinary bodies if we continue to see non-compliance in this area.

Professional scepticism

A good quality audit includes an appropriate degree of professional scepticism. The appropriate relationship between the auditor, management and directors is crucial to maintaining robust levels of professional scepticism.

New Zealand is not unique in its need to address this area of professional judgment and scepticism in audits. It is an on-going concern among audit regulators internationally. We highlighted a number of FMC audit files in our reviews this year that needed to improve professional scepticism.

We are particularly concerned that insufficient scepticism is applied where significant judgment is required by both the preparer of financial statements and the auditor.

We also expect auditors to be particularly alert when businesses are under significant financial pressure, such as fast-growing businesses or those performing below expectations.

Professional scepticism is affected by certain conditions and pressures that may arise or change during an audit. Decisions made during the planning and performance stage of the audit, such as the level of skill and expertise needed, audit evidence and the audit work to be conducted, often change once the audit is underway.

Auditors must evaluate what management tells them against their own knowledge of a client's business, and their knowledge of the broader business environment, to gain a full picture.

This allows auditors to evaluate management's views in the context of both internal and external evidence and to form an independent view, which may be different.

Key examples

Our reviews revealed the following examples where the auditor did not apply professional scepticism, or did not record the necessary challenge:

- Management assumptions weren't questioned or tested, such as identifying the appropriate cash generating units, significant growth assumptions and unrealistic budgets.
- No testing against external data inputs into the asset valuation for reasonableness.
- Where a business did not provide sufficient evidence regarding the going concern assumptions, the auditor did not critically assess the disclosure in the financial statements, and the impact on the audit opinion.
- Accepting changes in accounting treatments without documenting consideration of how the business complied with the new treatment or if the treatment complied with International Financial Reporting Standards (NZ IFRS).
- Obtaining third-party confirmations that contradicted disclosure in the financial statements and were not supported by other audit evidence, such as underlying contracts.

- Relying on schedules of stock by expiry dates, inventory pricing and actual sale prices provided by a client, without testing the accuracy of this data for the purpose of testing net realisable inventory value.
- No critical assessment of the disclosure in the financial statements, and the impact on the audit opinion.
- Placing undue reliance on IT-generated reports, such as valuation reports, without testing data reliability.
- Not considering fraud risk (including financial reporting fraud) and management override in the audit.

What directors can do

- Challenge auditors understanding of the business and its risks.
- Make sure auditors understand the relevant laws and regulations that apply to the business.
- Ask auditors to explain any contentious issues and issues requiring significant judgment that were resolved by management and the auditor.
- Find out how the auditor questioned management and understand why the auditor took this approach.
- If the auditor and management had a different view, understand how they resolved their differences.
- Cultivate open dialogue where the auditor can discuss challenges with the audit committee as well as management during the audit.

Our expectations

We would like to see engagement partners take more of a lead at both the planning and issues resolution stages of audits. This is the best way to improve the level of scepticism in audits. Audit teams with less experience should be supported by experienced managers, engagement partners and EQCR partners.

There should also be a robust review of the work performed by audit staff. Firms need to analyse the findings of their own internal quality reviews and reviews by regulators, to improve overall audit staff training.

We also expect EQCR partners to critically assess the quality and sufficiency of the audit evidence obtained by the audit team in key areas of the audit.

If businesses provide insufficient evidence in areas of key judgment, the auditor should evaluate whether they are able to obtain other sufficient and appropriate audit evidence to mitigate the risks. Where the auditor cannot obtain sufficient appropriate audit evidence, we expect to see documentation in the audit file explaining how this has affected the audit opinion.



Audit evidence and documentation

Since our first audit quality monitoring report in 2013, we have seen significant improvement in audit documentation. This means we have shifted our focus to the execution of the actual audit procedures, which are audit fundamentals, but also support important areas of the audit.

There is still room for improvement in some areas. We found examples of wrongly executed or designed audit procedures where the appropriate audit evidence was either not obtained or where insufficient audit evidence was obtained in key areas of audits.

Key examples are:

- Audit teams performed targeted testing of a small part of the population, and relied on this testing for the entire population without further evidence.
- No bank confirmations obtained for cash balances, or no assessment of the terms and conditions of cash balances held outside usual banking relationships.
- Reliance on a test of controls when these tests did not cover the appropriate period (e.g. covered less than nine months of the year).
- Procedures performed to assess the accuracy of inventory costing were either inappropriately designed, executed, or both.
- The four-step model⁴ for performing substantive analytics was not followed.
- Audit procedures were designed to address key risk areas of the audit file, but those procedures were not carried out in the audit.
- Wrong sample size and approach taken (a test of detail carried out, instead of a test of control).

Our expectations

Adequate training and supervision of audit staff is essential to achieving consistently high quality audits.

Senior audit team members must make sure that audit procedures are appropriately designed and executed. If important parts of an audit are performed by more junior staff, the firm must check those staff have appropriate training and expertise to perform their tasks. Their work must be supervised and reviewed by an experienced manager. Senior staff and engagement partners need to allocate the appropriate time to perform these reviews.

We also expect the EQCR partner to identify whether insufficient or inappropriate audit evidence was obtained in the key risk areas.

⁴ See Glossary on page 21 for a description of the four-step model.

Responsibilities relating to fraud

Auditors provide assurance that the financial statements, taken as a whole, are free from material misstatement caused by fraud or error. In each audit, auditors must assess the risk of fraud due to management override and should also consider the possibility of fraud in revenue recognition.

For many companies, revenue is one of the largest items in their financial statements, and is an important driver of their operating results. This is why auditing revenue is often a key area of focus in our quality reviews.

Although all of the auditors reviewed had procedures in place to address the risk of fraud and management override, we still found some areas of non-compliance.

For example, in some cases there was insufficient audit evidence obtained to issue the audit opinion, and revenue issues were often the main contributor to this conclusion.

Areas of improvement

Auditors can improve the quality and effectiveness of procedures by:

- Having meaningful discussions with all management to assess any fraud risk factors.
- Discussing the risks of possible fraud, as well as known fraud.
- Improving the use of professional scepticism when rebutting the presumption of fraud.
- Assessing the accounting treatment regarding revenue to ensure the chosen treatment meets the standards and is correctly applied.

- Executing the procedures laid out in their plans.
- Ensuring that journal testing is carried out in a way that it addresses any fraud risks.
- Ensuring supporting documentation about data completeness and how journal entries were selected and tested is included where computer-assisted audit techniques are used.
- Performing appropriate audit procedures to ensure IT-generated reports are reliable.
- Considering all audit evidence and reaching an overall conclusion about the risks of material misstatement due to fraud.

What directors can do

- Discuss audit plans and any risks of fraud with auditors.
- Make sure audit committees have appropriate controls in place to limit the risk of material misstatement in the financial statements due to fraud.
- Ask management what effective controls are in place to limit fraudulent misstatement.
- Question auditors about the audit procedures performed in response to the risk of management override.
- Ask auditors to explain their approach to testing journals and any computer-assisted audit techniques (CAATs) that were used.

Our expectations

We expect auditors to identify the risks of fraud when they plan and carry out an audit, and have audit procedures in place which address these risks appropriately. Fraud risk discussions should be led by the engagement partner and need to carry on throughout the entire audit.

Directors and audit committees have an important role to play around improving the quality of audits and fraud assessment.

Other improvement areas

Although we've seen significant improvement, we continue to see non-compliance with specific auditing standards in some of the individual audit files reviewed.

Outlined below are the additional areas where we want to see further improvement.

Audit sampling

- Audit teams selected the wrong sample size. Where the auditor performed a test of detail, the audit team selected a lower sample size in accordance with their controls testing methodology.
- Judgemental sample sizes were selected, without explanation as to how this sample size was determined and how the sample size reduced sampling risk to an acceptable level.
- Targeted testing was used to represent the entire population.
- Auditors did not investigate appropriately the nature and cause of any identified deviations or misstatements in test results.

Compliance with the financial reporting framework

- Smaller audit firms showed instances where the firm did not identify the business' non-compliance with accounting standards.
- The areas of business acquisitions and employee benefit schemes were an issue.
- Smaller audit firms showed mistakes in audit opinions. For example, emphasis of matter paragraphs did not contain the prescribed wording of the standard, which may be confusing to investors.

- Where an auditor's opinion was modified, the reasons were not always clearly stated in the audit opinion.

Materiality

- Audit firm's materiality assessments for 'for-profit' businesses did not always consider the net profit before tax as a materiality basis. In these cases, materiality always significantly exceeded the benchmark for profit before tax used by audit firms.
- Files lacked documentation about the professional judgment an auditor used when selecting the appropriate materiality benchmark.
- Some smaller audit firms used dual materiality for balance sheet and comprehensive income, which is contrary to the standard.

Related-party transactions

- Auditors had not addressed both the completeness and accuracy of the related-party transactions in some files.
- Files lacked audit evidence to support disclosures where financial statements showed that related-party transactions were at arm's length.

Substantive analytical procedures

- Audit comfort that was meant to be obtained from the analytical procedures was not clear.
- Auditors set imprecise expectations allowing for errors that exceeded the materiality, making it unclear how these analytical procedures contributed to the overall audit evidence.

- Differences found between the recorded amounts and the expected threshold weren't supported by further audit evidence.
- Auditors used IT-generated reports for analytical procedures without checking their reliability.

Understanding the issuer and its environment

- Risk assessments were not clearly documented, or it was unclear how the audit procedures addressed these risks.
- No understanding of the control environment obtained.
- The risks of material misstatement on an assertion level weren't assessed, making it unclear whether the auditor had gained sufficient audit evidence.

Our expectations

We want auditors to make sure their procedures are designed and executed appropriately. When work is carried out by junior audit staff, the firm must make sure that all staff have appropriate training to perform their assigned tasks, and their work is appropriately supervised and reviewed by a more experienced staff member.

In their annual audit training, firms need to continue to pay attention to the areas highlighted above to analyse why their teams may sometimes fail to comply with the audit methodology of the firm.

Future focus

Our quality review programme over the 2016-2017 period will continue to focus on the risks that FMC reporting businesses pose to investors, building on the results of our previous quality reviews.

Our reviews focus on the successful implementation of the plan which we ask audit firms to provide us with, together with their on-going compliance with the Assurance Standards. As documentation of audit files improves, we have an opportunity to review certain areas in more depth.

If a review is unsatisfactory, we have a range of tools to help firms improve. These include:

- an auditor is required to perform additional work to address our findings
- a business is required to restate the financial statements, if we find misstatements
- having a follow-up review within 12 to 18 months of the previous review to ensure that the firm has taken appropriate action to address our findings
- issuing directions to remediate any findings
- referring complaints to the licensed auditor's professional body to be dealt with under its disciplinary procedures.

For more information see our *Auditor Regulation and Oversight Plan 2016-19* on our key focus areas and how we conduct our reviews.

Changes to our reviews

When the auditor oversight regime began in 2012, we contracted NZICA, as an accredited body, to perform audit quality reviews on our behalf, as we did not have the expertise and resources.

We decided not to renew our contract with NZICA last year. From 2016 our staff and contractors completed these reviews in-house.

This approach aligns with international audit regulators and is no reflection on NZICA's performance. Our review approach remains the same and we do not anticipate any significant differences to the style of this year's reviews.

We also continue to expand our relationships with other regulators such as the Australian Securities and Investment Commission and may arrange secondments with them to assist us with the completion of our reviews.

Auditor General

In July 2016, we entered into a Memorandum of Understanding (MOU) with the Auditor General. Under the MOU, the Auditor General has agreed that we can undertake audit quality reviews of FMC audits that private audit firms carry out on its behalf. The Auditor General has also invited us to undertake quality reviews of the FMC audits that Audit New Zealand carry out on its behalf.



Early adopters of new auditor reporting

New style of reporting

The new requirements for audit reports come into effect on 15 December 2016. These new requirements will bring New Zealand auditors in line with a number of other countries which have already adopted these International Auditing Standards.

The new report will look significantly different from most existing auditor reports. In the past, the auditor's report provided a short statement on the overall conclusion of the audit. Under the new requirements the auditor, who will be named, has to provide insights about the most important areas of the audit ('Key Audit Matters'), outline the reasons why these areas are most significant, and the work done to address them.

July 2015 to June 2016 reporting year

At the date of publication, a number of listed companies, audited by the large audit firms, have issued an audit report using the new format. We recommend directors and investors look at these reports.⁵

The majority of these new reports included reporting of materiality (the precision to which the auditor has performed their work) and additional conclusions provided by these auditors related to the work performed on each key audit matter.

These disclosures follow the approach of UK audit opinions which introduced a similar audit standard two years ago.

Although not required by the New Zealand standard, we support the provision of this additional useful information.

We are pleased to see that these companies and audit firms have provided this information earlier than required, and are also providing additional useful information for investors that goes beyond the minimum requirements.

We encourage other audit firms and listed businesses to follow suit and go beyond the minimum requirements of the standard, whilst also maintaining a clear, concise and effective report that speaks to the full range of users of the financial statements.

Our approach to new reports

As each business is different and auditors will apply their individual judgement to their reports, we expect to see reporting that is specific to individual businesses.

In our review of audit files we will look at the process followed by the audit firm to determine the key audit matters, and whether the audit work performed fairly reflects the disclosure in their audit report.

We encourage audit committees and directors to engage early with their auditors on the auditor report for their financial statements.

Although the new requirement is initially aimed at listed businesses⁶, our expectation is that unlisted significant banks and large insurance companies will follow the lead of their peers overseas.

See our *Auditor Regulation and Oversight Plan 2016-2019* for further details of how we intend to focus on the new style of auditor's report.

⁵ CA ANZ has issued a report 'Enhanced Auditor Reporting – One Year On', which included all listed entities in Australia and New Zealand that have the new reporting.

⁶ The requirement is only for listed entities, with other FMC reporting entities following for periods ending on or after 31 December 2018.

Appendix 1 – Quality review framework

Requirement

We are required by law to perform an audit quality review of every registered audit firm at least once every four years.

To remain internationally aligned, we aim to keep our review cycle consistent with the European Union's three-year cycle. For large audit firms, we split our review work into two visits about 18 months apart.

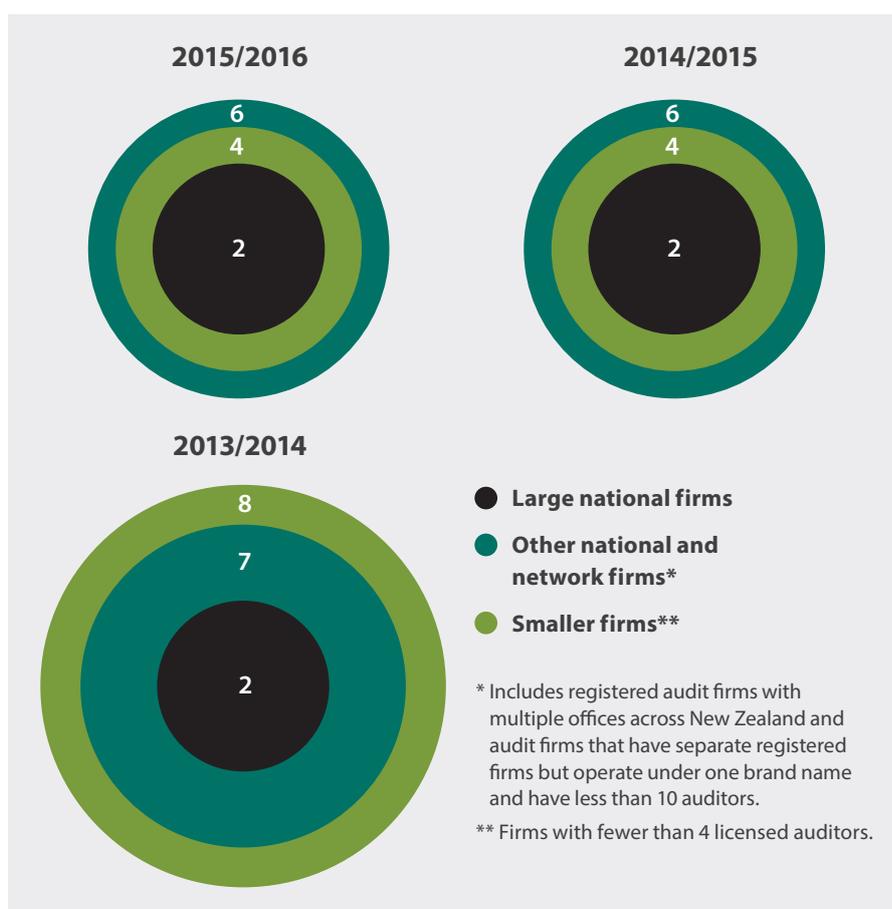
We are directly responsible for audit reviews, although initially we delegated this responsibility to the New Zealand Institute of Chartered Accountants (NZICA); in July 2016 we brought these reviews in-house. However all reviews referred to in this report were conducted by NZICA.

To ensure the high quality of the NZICA reviews we:

- Approved the schedule of firms and licensed auditors that were reviewed.
- Approved the review methodology.
- Selected which audit files were reviewed using our risk-based framework.
- Were involved in review decision-making.
- Issued the final review reports to firms.
- Actively took part in the majority of reviews.

We included both scheduled reviews and reviews of audit firms that required significant improvements.

Breakdown of reviewed firms 2013-2016



Quality review methodology

The purpose of an audit quality review is to make sure that the systems, policies and procedures of audit firms comply with the Auditing and Assurance Standards and other relevant legislation. Audit firms must also carry out FMC audits with reasonable care, diligence and skill.

We assess an audit firm's compliance with the standards and the requirements of the Act by:

- looking at the firm's overall quality control systems to perform compliant FMC audits
- reviewing a selection of individual FMC audit engagement files to measure quality control to see if a file complies with the above systems and the Auditing and Assurance Standards.

All of our reviews undergo a robust moderation process. Each of our audit quality review assessment reports are peer reviewed by another reviewer, not involved in the initial review. Our final report then goes to the Audit Regulatory Advisory Group (ARAG) of NZICA for consideration. In our new structure this role will be performed by our Audit Oversight Committee (AOC).

Both ARAG and AOC provide an independent forum to review the consistency and fairness of all quality review reports. AOC and ARAG, largely, are made up of the same members. The two committees comprise a diverse group of professionals including ex-auditors, company directors, and others with relevant experience who are independent of the audit profession.

Audit firms must have systems, policies and procedures (a quality control system) in place to provide a robust framework to underpin FMC audits.

The requirement of a quality control system is set out in the Professional and Ethical Standards and Auditing Standards.

Our assessment of an audit firm's quality control system focuses on whether:

- the system complies with the relevant standards
- the system's policies and procedures are followed
- the system contributes to high quality FMC audits.

We also evaluate how effective the firm's internal monitoring of the audit quality control system is. Another important aspect of quality control is performing an engagement quality control review (EQCR) on each FMC audit file.

The EQCR is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team has made and the conclusions reached in the auditor's report.

We have issued additional requirements⁷ related to this EQCR, as we see this as a key part of the audit process.

We expect the EQCR to be suitably qualified, with relevant appropriate experience required to give an objective evaluation. They should also be involved in key decision-making to make sure the audit has an efficient process.

Individual file reviews

We carry out individual file reviews to make sure that the auditor has complied with auditing and assurance standards. The file review also checks if the licensed auditor has exercised reasonable care, diligence and skill in carrying out FMC audits.

Key attributes of audit quality are:

- an independent audit carried out by a licensed auditor
- appropriate levels of professional scepticism applied by the auditor
- reliable audit opinion issued
- enough appropriate audit evidence obtained
- auditing and assurance standards followed.

File selection and ratings for individual audit files

When we review FMC audit files, we take into account:

- businesses of significant public interest based on the value of securities issued to the public, (such as KiwiSaver schemes, banks, insurance companies and businesses listed on the NZX)
- businesses and industries that are more vulnerable to risks from existing and emerging market conditions, such as newly listed businesses, or businesses with significant growth
- other businesses of higher risk such as finance companies or businesses with non-compliance issues such as qualified audit reports or non-compliance with laws and regulations
- a cross-section of different licensed auditors in each registered firm.

If our review found a file did not meet the required standards, it is more likely that we would review that auditor again in future.

⁷ Paragraph 8(1)(f) of the Auditor Regulation Act (Prescribed Minimum Standards and Conditions for Licensed Auditors and Registered Audit Firms) Notice 2012 requires that, "key decisions and judgements involved in an FMC audit must be subject to engagement quality control review by another licensed auditor".

Our selection process

The number of files we select for each audit firm takes into account the number of licensed auditors at the firm, the number of FMC audits and the results of the firm's previous review.

When we complete a review, we give each individual file a rating. The reviewer gives the file a proposed rating and is moderated by ARAG (or in future by AOC).

There are three categories of rating:

1. Good, or good with limited improvements required

The findings in the file relate to improving some documentation or minor non-compliance with the auditing standards. The reviewer is satisfied that all audit procedures have been performed, around key risk areas and sufficient audit evidence was obtained.

2. Compliant, but improvements needed

Our review identified a number of areas in the file where the audit wasn't performed in accordance with the audit standards. However, overall the reviewer found there was sufficient and appropriate audit evidence obtained in the key risk areas.

3. Significant improvements required

The file showed several areas where the audit wasn't performed in accordance with the standards. The reviewer found insufficient or appropriate audit evidence obtained in at least one key risk area of the audit, or the review of the audit file showed a material misstatement that required restatement of the financial statements and/or the audit opinion.

Here is a summary of the ratings from this year's reviews

Listed businesses

Year	Good	Compliant	Significant improvements
2016	–	6	7
2015	5	6	2
2014	1	9	4
2013	2	2	3

Other FMC reporting businesses

Year	Good	Compliant	Significant improvements
2016	–	9	8
2015	2	8	15
2014	2	24	16
2013	3	7	16

Background to our rating criteria

Our reviews do not assess whether the audited information was reported correctly. Where an audit required significant improvements, it does not necessarily mean that the audit opinion issued was inappropriate, that the financial statements were inaccurately prepared or did not show a true and fair view. Equally, where we rated an audit as good or compliant this doesn't imply that the financial statements did not contain any inaccuracy or misrepresentation.

Our reviews cover different audit firms each year and files are not selected randomly. Due to this targeted approach, the audit files inspected do not represent the market as a whole. The summary of our inspection results needs to be interpreted cautiously, as results in any one year are not comparable directly with previous years.

Appendix 2 – Market data

	30 June 2016	30 June 2015	30 June 2014
Domestic licensed auditors	146	150	141
Domestic registered firms	24 ⁸	29 ⁹	30
NZX listed companies	186	162	147
FMC audits	1,500	1,700	1,700

	30 June 2016	30 June 2015	30 June 2014
New licences issued to domestic auditors	8	10	8
Licences cancelled from domestic auditors	12	1	17
Registrations cancelled or registrations expired from domestic auditors ¹⁰	4	0	11
Firms reviewed	12	12	17
Audit files reviewed	30	38	56

⁸ This includes five firms that have separate firm registrations, but operate under one brand name.

⁹ This includes nine firms that have separate firm registrations, but operate under two brand names.

¹⁰ A number of audit firms merged during the 2015-2016 financial year which resulted in the cancellation of licences.

Glossary

Accounting standards/NZIFRS	The New Zealand equivalent of International Financial Reporting Standard issued by the External Reporting Board
Act	Auditor Regulation Act 2011
AROC	Audit Regulatory Advisory Group
AOC	Audit Oversight Committee
Audit firm	Registered audit firm as defined by the Act
Auditing and assurance standards	The auditing and assurance standards issued by the External Reporting Board
Auditing standards	International Standard on Auditing (New Zealand) to be applied in conducting audits of historical financial information issued by the External Reporting Board
Auditor	Licensed auditor as defined by the Act
EQCR	Engagement Quality Control Review. This is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team has made and the conclusions it has reached in formulating the auditor's report
EQCR partner	Licensed auditor who performs the EQCR. This may be a licensed auditor who is not a partner in the audit firm
FMA	Financial Markets Authority
Going concern	Under the going concern assumption, a business is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless those charged with governance either plans to liquidate their business, cease operations, or has no other alternative but to stop doing business
ISA (NZ)	International Standard on Auditing (New Zealand)
FMC reporting entity	Has the same meaning as in section 6 of the Auditor Regulation Act 2011
FMC audit	Has the same meaning as in section 6 of the Auditor Regulation Act 2011
Four-step model	When designing and performing substantive analytical procedures the auditor shall: <ul style="list-style-type: none"> ● Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions. ● Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation. ● Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. ● Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

NZICA	New Zealand Institute of Chartered Accountants
Professional scepticism	An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
PES	Professional and Ethical Standard
Non-assurance service	Any engagement provide by the audit firm that doesn't meet the following definition <i>“an engagement in which an assurance practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria”</i>
Quality review	Means a review of an audit firm defined in the <i>Auditor Regulation Act 2011</i>
Revenue recognition	Incorporating the gross inflow of economic benefits (cash, receivables, and other assets) arising from the ordinary operating activities of a business (such as sales of goods, sales of services, interest, royalties, and dividends) in the income statement when it meets the following criteria: <ul style="list-style-type: none"> ● it is probable that any future economic benefit associated with the item of revenue will flow to the business ● the amount of revenue can be measured with reliability.

