

June 2017

Auditor regulation and oversight plan, 2017-2020

This report is for:

- Auditors
- People who prepare financial statements
 - Directors of FMC reporting entities.

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Executive summary

Our role

Our main statutory objective is to promote and encourage the development of fair, efficient and transparent financial markets. Our *Strategic Risk Outlook 2017* outlines what we believe are the current and main drivers of risk to fair, efficient and transparent financial markets. Based on the drivers of risk identified, we have seven strategic priorities that will guide our activities over the next three years. Two of these priorities are particularly relevant to auditors' work.

They are:

- Investor decision-making — we want to see capable, confident and well-informed investors.
- Frontline regulators — we want to see frontline regulators who contribute to well-regulated financial markets.

Audited financial statements are a key resource which investors rely on. Their confidence in the financial statements is dependent on the perceived quality of the audits. Auditor regulation and oversight helps to ensure the businesses we regulate (known as FMC reporting entities) have access to competent auditors, and these audits (known as FMC audits) are of a high standard.

To achieve this, we:

- Review audit quality to ensure they meet the Auditing and Assurance Standards.
- Monitor accredited bodies to ensure they are effective frontline regulators of auditors.

What we intend to do

Over the next three years to 30 June 2020, we will focus on three main areas:

- **Improving audit quality** — we aim to perform audit quality reviews of registered audit firms once every three years. We will also ensure our key stakeholders, including audit firms, are informed about developments in audit quality, and what can be improved. There has been no significant change in our current review's focus compared with previous years. Our reviews are aligned with what audit regulators are doing internationally.
- **Monitoring changes in the new standards for auditor reporting** — the new standard for auditors' reports came into effect for all New Zealand-listed issuers with reporting dates ending on and after 15 December 2016. We have already seen some auditors and reporting entities adopt this standard early. In our upcoming review cycle, we will pay specific attention to implementation of the new standard.
- **Monitoring accredited bodies** — we are required to monitor the accredited bodies and their regulatory role.

The purpose of auditor regulation

Investor confidence is key to successful financial markets. This confidence depends on investors having access to credible and reliable financial information. Audits of FMC reporting entities' financial statements aim to enhance investor confidence. The audits ensure these statements comply with financial reporting standards and give a true and fair view of the financial position of the business.

Auditor regulation supports the quality, expertise and integrity of audits done by FMC reporting entities. By maintaining high auditing standards we aim to:

- Increase investors' confidence in the quality of the audited financial statements of FMC reporting entities.
- Give wider recognition to the professional status of New Zealand auditors in overseas jurisdictions.

Increasing investor confidence

The Auditor Regulation Act 2011 (the Act) regulates auditors' performance of financial statement audits of FMC reporting entities. The Act recognises this is a specialist job that cannot necessarily be performed by any qualified accountant.

Both the FMA and accredited bodies, who act as frontline regulators of auditors, play an important role in carrying out the responsibilities of the Act. An overview of these responsibilities is set out in the Appendix.

One of the tools we use to monitor the quality of audits is performing audit quality reviews on registered audit firms. We explain our review process in the next section. We also explain our other activities, including how we work with accredited bodies.

Recognition of New Zealand auditors overseas

Another objective of the Act is to enhance the international recognition of New Zealand auditors. This is important as it gives overseas investors confidence that New Zealand's capital markets have similar oversight to other capital markets.

In July 2016, the European Union (EU) recognised New Zealand's oversight regime. This means New Zealand auditors can continue to audit the financial statements of businesses listed in the EU markets. The European recognition also confirms New Zealand's regulatory structure is robust, and gives investors confidence that New Zealand auditors meet international standards. The recognition means we are now able to share information with the EU audit oversight authorities, and can rely on each other's work on the supervision of auditors and audit firms.

In December 2014, we joined the International Forum of Independent Audit Regulators (IFIAR). Our membership of this organisation gives us access to international knowledge on auditor regulation, and increased influence with the largest six international audit firms. On 4 April 2017, we signed - with 21 other IFIAR members - IFIAR's Multilateral Memorandum of Understanding (MMOU). This MMOU facilitates better information exchange. It improves cooperation among members and contributes to more effective regulation of audit firms.

Our IFIAR membership allows us to learn from the experiences and methodologies of other regulators, and provides important training for our staff and reviewers. We are also included in several taskforce groups within IFIAR, such as the taskforce for smaller regulators, which helps us improve as a regulator.

Improving audit quality

Our audits of FMC reporting entities' financial statements aim to increase investor confidence. One way we ensure these audits are done well is by reviewing audits performed by registered audit firms. We explain the results to each firm so they understand any issues identified and can improve their higher-risk audits.

How we review audit quality

The Act requires us to perform an audit quality review of each registered audit firm at least once every four years. However, we will aim to keep our review cycle consistent with the EU's three-year cycle, to stay aligned internationally. The frequency of our inspections varies. We inspect larger firms every 18 months, while other firms are generally inspected once every three years. FMA staff and contractors -including staff from other overseas audit oversight bodies- carry out these reviews.

We review the systems, policies and procedures audit firms have to comply with the Act's requirements, and what's required by the Auditing and Assurance Standards. Audit firms must also use reasonable care, diligence and skill in carrying out FMC audits. We test this by reviewing individual audit files.

Our audit quality review process is outlined below.

Planning

- We produce an annual schedule of the audit firms we will review.
- We communicate early with the relevant audit firm to agree on suitable review dates.
- We select files to inspect, based on the risk the audited business poses to investors. These businesses may include listed companies, financial institutions and large investment schemes. Audit files are checked for compliance with a wide range of Auditing and Assurance Standards.
- We select the key focus areas for reviewers for their audit file reviews.

Onsite visit to audit firms

- The reviewers perform the onsite review in line with our standard methodology and procedures which include the minimum requirements of section 68 of the Act covering audit quality reviews. The reviews aim to follow international best practice.
- The findings of the individual file reviewed are discussed with the team that performed the audit. The team can provide further evidence and explanations, when necessary.
- After an onsite visit, the reviewers communicate their key findings to the team in charge of audit quality at the audit firm.

Reporting

- We provide the audit firm with a draft report of our findings. The firm has the opportunity to comment and provide us with further evidence about how they complied with the Auditing and Assurance Standards.
- Following the audit firm's comments, we prepare a final draft quality review report which is provided to our Audit Oversight Committee (AOC). The AOC gives an independent review of the consistency and fairness of all quality review reports. It is made up of a diverse group of professionals, including ex-auditors, partners, company directors, and others with relevant experience.
- We provide the audit firm with a final report which contains our findings and recommendations for remediation.
- We require audit firms to provide details of how they will mitigate the key findings identified in the final report. We may give further directions to the audit firm if its response is insufficient.

Are you interested in becoming a reviewer?

We would like to hear from auditors with more than 10 years of significant audit experience who have recently left the audit industry and are interested in becoming a reviewer for the FMA. For more information, please contact [Jacco Moison](#).

Areas of focus

During our audit quality reviews, we assess:

- the audit firms' internal quality control, and
- the quality of individual audit files.

We decide what our focus areas will be at the start of a three-year audit cycle. We are currently in the second year of the second three year cycle. We have selected the following focus areas based on issues identified by international audit regulators and our own findings from most-recent reviews¹.

The new audit report

As this is the first year these reports will undergo an audit quality review, auditors might be required to clarify the description of what they have done to address the risks assessed.

When we review the new auditor reporting, our focus will be on:

- the process the audit firms followed to determine key audit matters
- the quality of information in the audit report
- whether the audit work establishing key audit matters is appropriate.

We will work with audit firms to help them provide clearer and better audit reports that give investors and other users of financial statements the most relevant information.

Auditor independence

An important part of an auditor's role is to act in the interests of investors, as well as the client. Auditors also need to effectively identify and assess any threats to their independence. They must apply appropriate safeguards to protect their independence, and report these properly to audit committees or directors.

In our reviews, we will focus on audit firms that provide significant non-audit services to the FMC reporting entities they audit. We will review whether they have appropriately identified threats to their independence, whether those threats were addressed sufficiently by the controls put in place; and the audit work performed. We will also verify whether all aspects of the non-audit services were reported to the board of directors, and are appropriately disclosed in the financial statements and the audit.

Audit quality control systems and supervision

We will focus on the adequacy and effectiveness of the audit firm's own control policies and procedures, especially where our reviews show findings which the firm's own quality review procedures did not pick up.

The engagement quality control review (EQCR) partner plays an important role in an audit firm's audit quality. We expect the EQCR partner to be involved in the key areas of risk in the audit file. We also expect the EQCR to be performed during the planning, execution and final audit procedures. This is to ensure the audit team has sufficient

¹ See our [Audit Quality Review Report 2016](#)

time to address any comments made by the EQCR partner. We will review whether the EQCR partner's involvement is clearly documented on each audit file.

Professional scepticism

We expect an appropriate level of professional scepticism to be maintained during every audit. In the audit documentation, we expect to see sufficient audit evidence to show that the engagement partners, the engagement quality control reviewers and staff, applied appropriate professional scepticism.

In particular, we will focus on whether there is sufficient documentation of professional scepticism in the following areas:

- Significant judgments on accounting estimates and fair value calculations.
- Reliability of data provided by management or directors.
- Management and directors' representations.
- Impairment calculations and recoverability of assets.
- Changes in accounting treatments, or use of unusual accounting treatments by the FMC reporting entities.

Audit evidence

We will review whether licensed auditors have appropriate audit evidence to determine whether the FMC reporting entities' financial statements had no material misstatements.

Our focus on audit evidence will concentrate on ensuring audit firms have obtained sufficient evidence in the following areas:

- A company's going concern.
- Revenue recognition, including the assumptions of fraud and management override.

Understanding the issuer and its environment

We expect auditors to have an adequate understanding of an FMC reporting entity's business model. This should be reflected in the auditor's risk assessment to ensure that all key risk areas are included in the audit strategy. The audit procedures should be backed by sufficient audit evidence covering all the key risks identified.

We will focus on whether:

- risks have been properly identified
- the review of the audit procedures have been properly executed
- there is sufficient evidence to back the procedures.

The auditor's responsibilities relating to fraud

One of the auditor's objectives is to identify and assess the risks of material misstatement of the financial statements because of fraud. We will review the auditors assessment of this risk, and see if they followed the procedures used to address it correctly. We will continue to review the areas of journal entries and other specific fraud procedures.

Use of an auditor's expert

If financial reports are complex or include matters requiring specialist knowledge, such as valuations of certain assets and liabilities, FMC reporting entities may use external or internal experts for advice. We expect auditors who rely on the work of other auditors or experts, to their competence and objectivity. Auditors should evaluate the quality of the experts work, their independence, their key assumptions, and the valuation methods used. In the absence of in-house expertise sufficient to challenge the work of a company's expert, we will review whether the auditor has engaged their own independent expert.

Audit fees and audit performance

We observe some audit fees have decreased or remained flat for several years. While we are keen to see companies get value for money from their audits, we would be concerned if the reduced fees result in inappropriate time pressures which affect the quality of the audit work. To assess whether sufficient audit work has been completed, we will focus on FMC audits with very low audit fees, or where the audit fees did not reflect the complex nature of the business.

Execution of audit procedures

In our reviews, we often look at significant account balances and transactions. These areas may not necessarily be identified as key risk areas by the audit team. We will focus on the execution of the audit procedures for these significant account balances and transactions.

Education and communication

Our audit quality reviews will, most likely, reveal breaches of auditing standards or identify areas for improvement. We will ensure our key stakeholders, including audit firms, are informed about any issues arising out of our audit quality reviews, and know about any key developments in audit quality.

Many stakeholders help play a role to improve the quality of FMC audits. Our communication about the audit oversight regime is designed to help these stakeholders contribute to the overall improvement in audit quality in New Zealand.

Our communication for the next three years will include:

- This auditor oversight plan which informs our stakeholders of key focus areas in the monitoring process. The Act requires us to update this plan annually on a rolling three-year basis.
- Quality review assessment reports for audit firms after an audit quality review. These reports contain the findings of reviews and our recommendations for remediation.
- Presentations at audit firms of what we found during their individual audit quality review, and how to improve their overall audit quality.
- Presentations to other stakeholders about the audit oversight regime, and how other businesses and professionals can contribute to audit quality.
- An ongoing dialogue with accredited bodies of our audit quality review findings and other trends in the audit industry. The aim is to improve the joint monitoring of licensed auditors and address education issues.
- Annual reports of audit quality reviews which summarise the findings done during the year. These reports include recommendations to both auditors and other stakeholders on how to improve audit quality. This enables auditors to willingly comply with our compliance expectations, the standards and legislative requirements.

We will work with the External Reporting Board (XRB) to identify improvement areas so these can be addressed by influencing international standards.

The role of accredited bodies

While we carry out some areas of the auditor oversight regime directly, accredited bodies also have important responsibilities as frontline regulators. We monitor how well they perform this role, and expect them to significantly contribute to achieving the Act's objectives.

The accreditation process

Professional bodies need the appropriate systems, policies and procedures in place to perform their regulatory functions. Our accreditation process evaluates how robust the professional bodies' procedures are, and indicates whether policies or processes need to be changed to meet standards.

Our website has details of the requirements, found in this document, [Policies and guidance for the assessment of applications to be an accredited body](#). Currently, there are two accredited bodies: the New Zealand Institute of Chartered Accountants (NZICA)² and CPA Australia.

Regulatory functions	How they work	How we monitor them
Licensing domestic auditors and registering domestic audit firms.	We have issued the prescribed minimum standards auditors that audit firms have to meet. Accredited bodies have to notify us about license and registration approvals and failures.	We review a sample of licences and registrations assessed by accredited bodies to confirm whether the applicants have met the minimum standards. We also provide recommendations to improve accredited bodies' systems and policies, if and when required.
Monitoring licensed auditors and registered audit firms.	We review the policies and procedures accredited bodies have in place for monitoring licensed auditors and registered audit firms. We can request information about their monitoring at any time.	We review the effectiveness of accredited bodies' monitoring procedures. We also provide recommendations to improve accredited bodies' systems and policies, if and when required.
Promoting and monitoring competence.	Licensed auditors must comply with the minimum standards we set for professional development and ongoing competence.	We review the availability of training provided by accredited bodies.

² NZICA amalgamated on 1 January 2015 to form the Chartered Accountants Australia and New Zealand, however NZICA continues to be the accredited body)

Taking action against misconduct.

We review accredited bodies' policies and procedures for dealing with misconduct of licensed auditors or registered audit firms. Accredited bodies must report any complaints received about licensed auditors or registered audit firms to us. We also have the power to start or take over investigations of misconduct and to take direct disciplinary action.

We review any complaints about a licensed auditor to see if accredited bodies' policies and procedures were followed. We also provide recommendations to improve accredited bodies' systems and policies, where necessary.

How we monitor accredited bodies

We review the adequacy and effectiveness of their regulatory systems to make sure these accredited bodies perform their frontline regulatory function effectively. We will liaise, on a regular basis, with accredited bodies about their reports or notifications and, where appropriate, share intelligence with them. We expect accredited bodies to use their full range of regulatory tools. We will work closely with accredited bodies to co-ordinate these tasks to ensure there are no gaps or possible duplication of work and that appropriate action is taken when an issue is identified.

The table below sets out the regulatory functions accredited bodies carry out, how they ensure these are appropriate and effective, and how we monitor them.

We will discuss with the relevant accredited bodies the outcomes of our ongoing monitoring, and report any weaknesses or areas for improvement we identify. We have the power to direct an accredited body to amend its systems and processes if deemed necessary. However, we expect any issues to be resolved through constructive dialogue, and followed up with remedial action, without the need to resort to formal direction.

At the end of each year, we report on our monitoring of each accredited body³. These reports provide information about how effective the accredited body's policies and processes are in each of the areas set out in the table above. The accredited body also needs to provide an annual report detailing its relevant systems and processes, and how it has performed its regulatory functions.

³ These reports can be found on our [website](#)

How we will measure our performance

Our *Statement of Intent 2017-2020* outlines how we will measure our performance against our objectives. The following measures, directly or indirectly, reflect the objectives of the auditor oversight regime.

Measure: Investors believe that frontline regulators contribute well-regulated New Zealand financial markets.

Explanation: We work closely with accredited bodies, in their capacity as frontline regulators, to ensure they have effective regulatory arrangements. We also ensure their regulatory efforts are focused on issues that licensed auditors and registered audit firms need to address.

Measure: The FMA stakeholders and consumers of New Zealand financial services believe that FMA's actions help raise standards of market conduct and integrity

Explanation: Through our audit quality reviews we monitor auditors' compliance with their legal obligations. Where we see technical non-compliance with the standards we make recommendations to help improve audit firms' systems and processes. Where we see serious non-compliance we may require auditors to perform additional audit work and may refer auditors to the disciplinary tribunal of their professional body. We survey investors and other stakeholders to understand whether we are perceived to be having an impact on market conduct and integrity.

Measure: Investors believe financial product information given to them helped them to make an informed decision.

Explanation: Audited financial information is an important part of financial product offer information. The new audit report will also help investors to make informed decisions about which companies to invest in. Over time, we expect to see an increase in the number of investors who find this information helpful. We will survey investors to understand if they did find it helpful to them.

The outcome of these performance measurements will be included in our annual report.

Appendix: Regulatory responsibilities

The table below gives an overview of the most significant auditor regulation activities, as set out in the *Auditor Regulation Act 2011*, and describes who performs them.

Activities	What accredited bodies do	What we do
Licensing of auditors and registration of audit firms.	License domestic auditors and register audit firms, based on the prescribed minimum standards set by us.	License overseas auditors and audit firms based on the minimum standards prescribed by us, or on the basis of the Trans-Tasman Mutual Recognition Agreement.
Monitoring of licensed auditors and registered audit firms.	Must have systems in place for ongoing monitoring of licensed auditors.	Conduct audit quality reviews of registered domestic audit firms. We also assess the quality control systems at the firm and review individual audit files. We perform other monitoring work following financial statement reviews, complaints and referrals.
Promoting and monitoring the competence of auditors	Provide appropriate training for licensed auditors, and ensure they continue to meet the ongoing competence requirements.	Provide information to licensed auditors, registered audit firms, accredited bodies, FMC reporting entities and other stakeholders about the regulatory regime. We also inform them of our findings and recommendations on how audit quality can be improved.
Investigations	Investigate any complaints about FMC audits from the public or us.	Refer any complaints about an FMC audit to the accredited body of the licensed auditor. If the accredited body decides not to investigate or does not investigate promptly, we may take over the investigation.
Taking action against misconduct	Must have appropriate systems, policies and procedures to deal with misconduct by licensed auditors or registered audit firms. Must also follow up on complaints referred by us.	If we identify misconduct through our audit quality reviews or other monitoring, we complain to the accredited body of the licensed auditor. If we investigate, we may take disciplinary action. We may also issue directions to licensed auditors and registered audit firms.