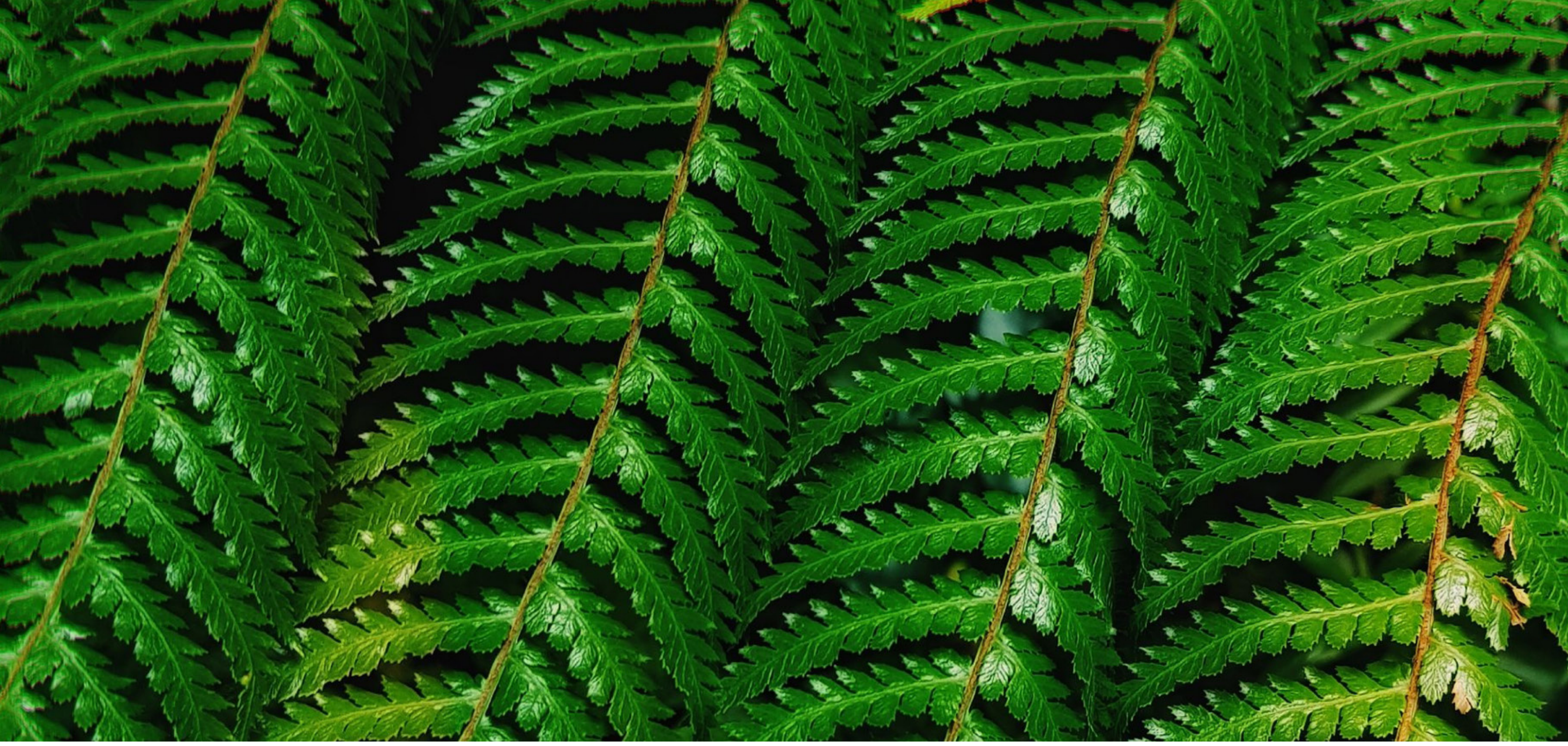


NOVEMBER 2021

Audit Quality Monitoring Report

1 July 2020 – 30 June 2021

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Purpose of this report

Under the Auditor Regulation Act 2011 (AR Act), we must carry out a quality review of the systems, policies and procedures of registered audit firms at least once every four years. We also review a selection of audit files of these registered audit firms on the compliance with the Auditing and Assurance Standards.

Our reviews help improve audit quality and ensure audit opinions are reliable. The reviews also help us to achieve our strategic goal of ensuring investors make active choices based on clear, concise, and effective information.

Where we note significant misconduct, we refer these matters to the appropriate disciplinary bodies.

We are required to prepare a report each year on the reviews we completed in the preceding financial year.

This report summarises our findings from the quality reviews we carried out between 1 July 2020 and 30 June 2021 and is intended for accredited bodies, auditors, chartered accountants, company directors, investors, and FMC reporting entities.

This year's report highlights the key areas we believe our stakeholders need to be aware of, along with our expectations for directors and auditors on how to achieve and maintain audit quality. We have also updated our guidelines for how directors can contribute to improving audit quality.

Contents

Summary of reviews

Composition of licensed auditors and registered audit firms reviewed

	2020/21	2019/20	2018/19	2017/18	2016/17
Firms with more than 10 licensed auditors*	2	2	3	2	3
Firms with multiple offices and fewer than 10 licensed auditors	2	1	1	2	1
Firms with fewer than four licensed auditors	1	1	2	1	3

** This includes Audit New Zealand*

Number of audit firms, number and type of audit files reviewed

2020/21	2019/20	2018/19	2017/18	2016/17
5 registered firms	4 registered firms	6 registered firms	5 registered firms	7 registered firms
21 audit files, including 11 listed companies and 10 other companies	20 audit files, including 13 listed companies and 7 other companies	27 audit files, including 9 listed companies and 18 other companies	24 audit files, including 9 listed companies and 15 other companies	27 audit files, including 12 listed companies and 15 other companies

2021 Market snapshot

On 30 June 2021 there were:

- 138 domestic licensed auditors
- 18 domestic registered audit firms
- 186 NZX-listed companies
- 1,130 FMC audits

Audit quality in 2020/21

What we have seen

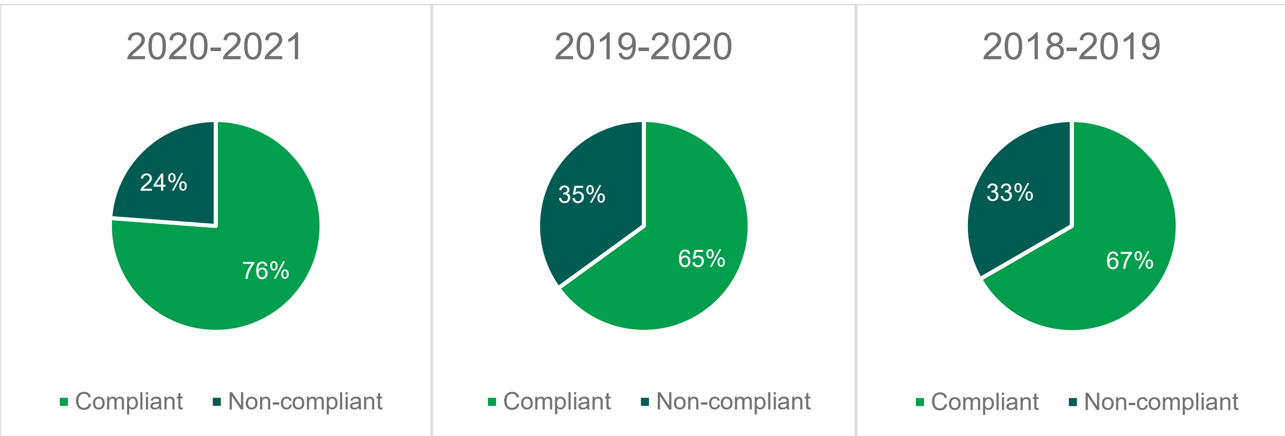
The economic disruption caused by COVID-19 has raised critical accounting and auditing issues, with the pandemic environment presenting new challenges for auditors and audit firms. While sympathetic to these challenges, the FMA indicated early in the pandemic that auditors should adhere to the same robust standards, and that quality audit work was ever more important in this challenging environment.

This year we reviewed audit files with balance dates between 31 December 2019 and 30 June 2020. Consequently, a number of these audits were completed during lockdowns, in New Zealand and other parts of the world.

Our reviews showed that auditors responded well to the various challenges. We noted increased documentation in areas of accounting estimates and how auditors had applied professional scepticism. Auditors used new technologies to replace or supplement audit procedures. These were positive developments that increased the quality of audits overall.

We expect the learnings from the last year to be applied going forward, and audit firms to continue developing innovative audit solutions.

We were pleased to see the number of findings per audit file has reduced, resulting in fewer non-compliant audit files. This year the rate of 'non-compliant' audit files decreased to 24%, down from 35% in our prior year report. Of course, the audit firms and files we review are different each year, nevertheless this is an encouraging result.



We encourage audit firms to share the messages from this report with their clients, who play an important role in addressing some areas of focus.

Focus areas

Each year we highlight key areas for auditors and directors to focus on that will contribute to improving audit quality. From our reviews this year, we have highlighted the following areas:

- FMA's observations on auditing in the COVID-19 environment
- Case study in relation to accounting estimates
- How materiality and sample sizes impact audit evidence
- The importance of audit firm culture
- How root cause analysis can improve audit quality

In this year's report we also highlight the findings from our review of finance company audits over the past five years. The findings emphasise the importance of a good audit approach and ensuring that audit procedures obtain sufficient evidence to address the risks associated with finance companies.

Follow up on non-compliant audit files

When we rate an audit file as 'non-compliant' we can take several actions. Depending on the nature of the findings and the timing of our review, we assess the best approach to remediation, which may involve contacting the entity to enquire about the accounting treatments. In the table below we set out what we found and how we responded:

Results from non-compliant audit files[1]	Number of files 2020/21	Number of files 2019/20
Material misstatement in financial statements	2	1
Insufficient evidence available to make a reliable assessment of material misstatement	2	4
Insufficient evidence, additional audit work required, impact to be assessed	1	2
Investigate or referral to the disciplinary bodies	0	0

This year we identified two financial statements that were materially misstated due to the following issues:

- Incorrect accounting treatments applied by the entity and incorrect disclosures. Following our enquiry the financial statements and audit report were re-issued.

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[1] Where we rate an audit as 'non-compliant', it does not necessarily mean the financial statements do not show a true and fair view or require restatement. Equally, where we rate an audit as 'good' or 'compliant' this is not an endorsement that the financial statements are free from misstatement.

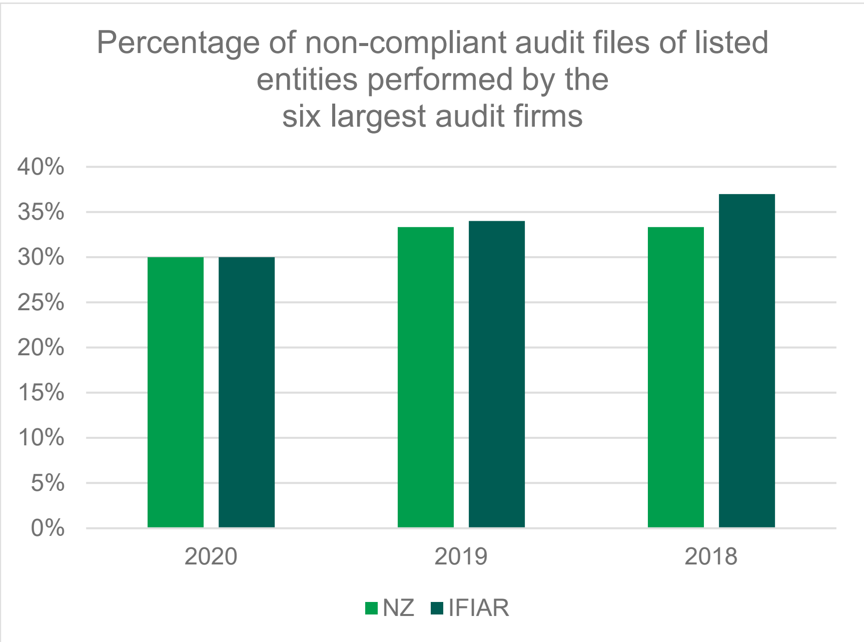
- Incorrect disclosures and accounting policy of an asset. After enquiry with the entity and auditor, these were restated in the next year's financial statements.

For the audit files where we concluded that insufficient evidence was obtained:

- In one instance the entity was subsequently wound up and the assets were realised.
- In one instance the audit deficiency could not be remediated by additional audit work.
- In one instance we requested that the auditor perform remedial work in the next audit. We will assess the remedial work on completion of this audit.

International comparison and developments

We continue to track our observations in New Zealand against those reported by the International Forum of Independent Audit Regulators (IFIAR). IFIAR provides an overview of the review findings of various audit regulators, including the FMA, from reviews of listed entity audits by the six largest audit firms[2]. The survey findings provide an overview of key trends, findings of audit quality reviews and the overall percentage of non-compliant audit files. The graph below compares our 'non-compliant' file ratings with those in the IFIAR report[3].



In 2021 we did not report any non-compliant audit files of listed audits performed by the Big 6. The IFIAR number was not available at the time this report was published. As we only review eight to 12 listed audits each year, the New Zealand percentages may fluctuate signficantly between years.

Throughout the pandemic we have continued to be actively involved with IFIAR. We chair IFIAR's Emerging Regulators Group, which gives us an opportunity to engage with the leadership of large audit networks, to help us address issues at a local level.

[2] The 'Big 6' – BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC

[3] We apply the same file rating standards as IFIAR in our audit quality reviews.

We were also involved in the taskforce that prepared IFIAR's report on "Internationally Relevant Developments in Audit Markets" released in July 2021, which summarises observations on five audit policy topics.

We continue to assess international developments and enquiries, especially in the UK and Australia, to identify potential changes that would be applicable in the New Zealand audit market.

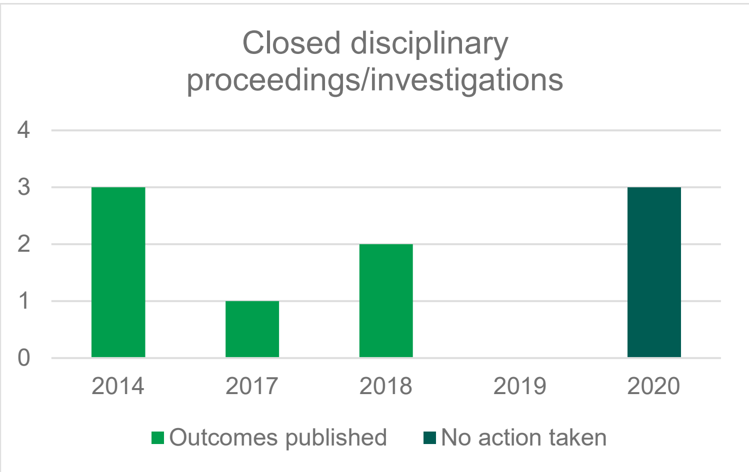
Disciplinary proceedings

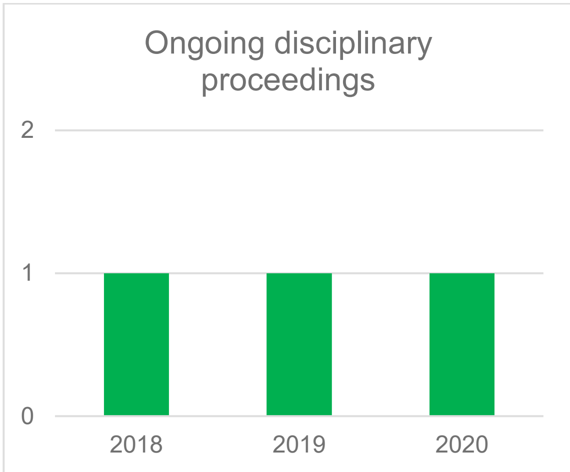
Accredited bodies have primary responsibility in New Zealand for investigating potential auditor misconduct. The FMA can investigate only those matters that accredited bodies have referred to us or have decided not to investigate.

We may refer matters to the relevant accredited body for further investigation following an audit quality review, a complaint, or any other intelligence obtained by the FMA. These referrals are made if we believe the issue had a significant impact on the audit's outcome, or where Professional Ethical Standards may have been breached.

The graph below provides an overview of how many matters we referred to accredited bodies or investigated ourselves.

Number of matters referred to accredited bodies





As at the date of this report, there are three ongoing investigations of referrals made by the FMA between 2018 and 2020. These cases may involve several licensed auditors and could take several years to conclude, depending on their complexity.

Analysis of our reviews

In this year’s review cycle, we reviewed five audit firms and 21 audit files.

Observations on audit firms’ quality control systems

For each of the audit firms reviewed, we assess the adequacy and effectiveness of the firm’s own control policies and procedures, and whether these procedures comply with Professional and Ethical Standards (PESs). We assess this by reviewing:

- the overall governance of the audit firm and the culture modelled by its leadership
- the audit firm’s internal and external audit quality reviews
- how audit quality is considered in the performance assessment of staff and leaders
- how the audit firm conducts root cause analysis when assessing the underlying cause of audit quality findings
- the audit firm’s plans to address findings from internal and external reviews, and how it monitors effective implementation.

The table below shows the number of findings in each area of the quality control system, across all five firms we reviewed. The findings are categorised as either significant departures from the PES, or other areas where the audit firm did not comply with all the requirements of the auditing standards.

Area of quality control system	Significant departures from PESs	Other departures from PESs
Human resources	-	6
Monitoring	1	3
Engagement performance	1	2
Independence and ethical requirements	-	2
Client risk assessments, acceptance and continuance	-	1
Leadership responsibility for quality within the audit firm	-	1

Where the departure from PESs is significant, we are of the view that this could affect the firm’s audit quality and therefore should be addressed immediately. Our significant findings this year related to:

- The audit firm’s methodology and guidance allowing for unreasonably high materiality benchmarks, which could impact the level of evidence obtained on the audit files where these benchmarks were applied.

- The audit firm not implementing an effective system of internal monitoring of its quality control policies and procedures.

Risk-based file selection

We choose some audit files to review at random, as well as selecting audits from higher risk industries.

- Risk-based selections include businesses that are more vulnerable to risks from existing and emerging market conditions, such as businesses that are newly listed, experiencing significant growth, represent a significant market value, have compliance issues or has a qualified audit report.
- Non-risk-based selections include audit files selected to cover auditors previously not reviewed, or to provide sufficient coverage of the audit firm's work.

Those audit files that are specifically selected are chosen on a risk-basis. The audit firms and audit files we review change each year, so it is difficult to compare year-on-year results. Trends in audit quality should be analysed over several years to better understand what progress has been made. Due to the small sample sizes and the selection approach, the result may not be indicative of the overall quality of audit firms reviewed.

Audit files selected on a risk basis are often more complex and, therefore, have a higher chance of being non-compliant than those selected at random. Historically, our risk-based selections have had a higher level of non-compliant files. The tables below show the split between risk-based and non-risk-based sampling, and the number of files we have rated non-compliant.

	2020/21	2019/20	2018/19
All files			
Risk-based selection	16	10	17
Non-risk-based selection	5	10	10
Non-compliant files			
Risk-based selection	3	6	8
Non-risk-based selection	2	1	1

Areas covered in each audit file review

When we review audit files, we assess whether the auditor complied with Auditing and Assurance Standards, including Professional and Ethical Standards, and otherwise exercised reasonable care, diligence and skill in carrying out the audit.

Our reviews focus on key areas rather than the entire audit file. The areas we look at are either:

- fundamental to overall audit integrity, such as auditor independence, and sufficient oversight by the engagement leader and the engagement quality reviewer (EQR); or
- selected based on the potential risks they pose – for example, they may be significant to the entity's financial statements, include complex issues for the auditor, and/or involve complex judgements.

The table below shows how many times we reviewed these key areas across the 21 audit files in our sample, and how frequently we noted issues. In total, we noted that five audit files were non-compliant. Across these five audit files, there were 12 areas where the auditor did not obtain sufficient audit evidence or did not detect a material misstatement. Where we noted other non-compliance with auditing standards improvement is required in these areas, but overall sufficient audit evidence was obtained in this area through other procedures. The number of findings in areas where the auditor did not obtain sufficient evidence decreased from 4.7% to 3.8% and the area of other non-compliance with auditing standards decreased from 26.2 % to 22.2%.

Areas reviewed	Number of times these audit areas were reviewed	Auditor did not obtain sufficient audit evidence	Other non-compliance with auditing standards
Accounting estimates, including FV measurement	21	2	9
Adequacy of financial statements presentation and disclosure	21	2	9
Audit report	21	1	0
Audit sampling	21	0	4
Communication to those charged with governance	21	1	3
Engagement quality review	21	1	1
Fraud procedures	21	0	9
Going concern	16	1	3
Group audits	16	0	3
Internal control testing	13	1	4
Inventory procedures	13	1	7
Other	21	1	8
Related party transactions	21	0	6
Revenue recognition	21	0	4
Risk assessment	21	1	2
Substantive analytical procedures	21	0	7
Use of experts/specialist	10	0	1
Total	**320**	**12**	**71**

Level of non-compliance in each file

We rate a file as non-compliant if the audit was not performed in accordance with Auditing and Assurance Standards and where insufficient audit evidence was obtained in at least one key risk area. Other reasons we rate the file as non-compliant are:

- the auditor failed to identify a material misstatement in the financial statement; or
- the auditor breached independence requirements; or
- an incorrect audit opinion was issued.

An indication of the overall quality of the audit file can be derived from the number of areas in which the auditor did not obtain sufficient evidence. The table below shows the extent of insufficient evidence in files from our last two review cycles.

Sufficient audit evidence not obtained in:	Number of files 2020/21	Number of files 2019/20
One area	2	1
Two areas	1	4
Three areas	1	2
More than three areas	1	0

Focus area: Auditing in the COVID-19 environment

The COVID-19 pandemic presented the audit industry with several challenges. Due to the lockdowns, auditors were, at times, unable to visit client premises and perform their audit procedures on-site. This led to some instances where auditors were unable to obtain the necessary audit evidence through their standard audit procedures.

The lockdowns and other disruptions also created higher levels of uncertainty for entities in making accounting estimates. This was due to entities being unable to obtain sufficient evidence, or the lack of an active market to value assets and liabilities. Also, entities were required to put additional disclosures in their financial statements to reflect these uncertainties.

Auditors on the other hand were mainly concerned with how to confirm the appropriateness of valuations, what evidence was available to corroborate the assumptions made by management in determining fair values, and how lack of information may impact the audit opinion. Additional emphasis was also given to the entities' going concern assessment and the potential impairment of assessments. Key Audit Matters in the auditor reports reflected any difficulties or challenges the auditor encountered during the audit process.

In this reporting period we reviewed several audit files that had been completed during the lockdowns between March and May 2020. Below are our observations on how auditors and the FMA responded to these challenges.

FMA's response

The FMA maintained regular dialogue with audit firms throughout 2020 to better understand the practical challenges they faced in undertaking their work. We also engaged with a range of other parties to assess the impact of COVID-19 on financial reporting and auditing. We used the information from these discussions to assess the impact on the timing of audit work and how a lack of evidence may affect audit opinions. We will continue to engage with audit firms as part of our monitoring reviews to ensure we remain in touch with how audit firms are impacted by the changing environment and to assess whether changes are required to support the resilience of the audit profession.

What we have seen

We noted that audit firms made changes to policies and ways of working to respond to the challenges of the pandemic. Initially we envisaged that COVID-19 could have a far-reaching impact on the quality of financial statements and auditors' ability to perform high-quality audits.

When reviewing the audit files, we noted the impact was not as severe as we initially thought. There were difficulties, but in most instances entities and auditors were able to overcome these and produce audited financial statements in a timely manner.

Audit firms also implemented additional procedures to ensure audit quality was not compromised due to remote working practices. We believe these changes in procedures could be beneficial to audit quality not only during the pandemic but also more broadly improve the way audits are performed. Examples of these procedures are:

- Implementation of additional checklists and mandatory working papers to support audit teams with the challenges posed by COVID-19. These checklists provided step-by-step guidance in areas such as uncertainty surrounding forward estimates, inability to carry out physical procedures and other challenges with audit evidence.
- Involvement of senior staff and experts during the audit process, especially:
  - increased involvement of the engagement partner, EQR and other senior team members
  - more consultations with specialists and quality assurance teams on complex areas and financial statement disclosures.
- Creation of focus groups to perform an initial assessment of entities impacted by COVID-19, to provide the engagement team with the necessary specialised skills and knowledge.
- Increased and enhanced documentation of issues identified by auditors in audit committee reports, setting out the level of uncertainties and other potential audit challenges. We also noted enhanced documentation detailing how audit firms challenged entities in several aspects of the audit, highlighting the level of professional scepticism applied by audit team.
- More focused training to ensure engagement teams are consistent and have the tools to tackle challenges faced during the audit.
- The audit firms increased their focus on the acceptance or continuance procedures. Due to resource constraints, audit firms applied a more stringent focus on clients with good corporate governance when accepting or continuing a client relationship. We also noted that audit firms may decline audit tenders or resign from audits where the fees are insufficient to perform a quality audit.
- Fast-tracked use of technology in audits, including the use of video conferencing and screen sharing, use of remote technologies such as drones or cameras to observe stocktakes, and enhancing ways of gathering audit evidence through secure data boxes and transfers.

We also noted instances where auditors should have performed additional procedures due the changing environment:

- During inventory stocktakes where certain items were unable to be sighted, the auditor did not assess the risks or perform alternative procedures.
- Where internal controls did not operate effectively because of lockdown, the auditor did not assess the impact or revisit their audit approach.
- Audit documentation was insufficient to assess whether management's cashflow assumptions were reasonable.

Our expectations for auditors

As a result of COVID-19 challenges, auditors have been able to rethink and explore new ways of working. We expect audit firms to continue adapting to changing circumstances, to ensure a strong audit profession can be maintained.

Auditors must also stay alert to the quality of audit evidence and whether the evidence and audit tests are sufficient and appropriate to address the audit risks. We further expect auditors to use professional scepticism when evaluating management assessments and remain alert to contradictory information.

We expect audit firms to change their processes to facilitate remote working. This includes processes to perform remote reviews of audit files, both internally and externally by their regulator.

Although the pandemic created challenges, we also noted opportunities for auditors to rethink the traditional ways they operate and how they collect their audit evidence. We encourage audit firms to continue to implement changes and new ways of working that enhance audit quality.

Our expectations for directors

Directors must be in regular contact with management to understand the continued impact of the pandemic on their business. This includes an understanding of whether the existing controls are operating effectively or if changes are required to ensure controls function in circumstances such as remote working.

Directors must also have regular conversations with their auditors to ensure management is providing sufficient evidence for auditors to complete their work in a timely manner.

Although the timely submission of financial statements is important to ensure investors can make decisions, the quality of the financial statements and the audit should not be compromised by the delay of key information. Management and directors need to be flexible, plan their financial statements process appropriately and consider potential disruptions such as lockdowns. If entities are experiencing difficulties finalising their financial statements which may result in delays, we expect directors to contact the FMA as soon as possible to provide us with a timeframe of when the financial statements will be finalised and submitted.

FMA focus

We will continue to monitor pandemic-related challenges impacting auditors. We will also engage proactively with registered audit firms and discuss events that may impact individual audit firms or the entire audit profession. Where necessary, we will provide guidance or solutions to issues that are within our mandate.

Focus area: Accounting estimates case study

Accounting estimates and judgements are important because of their impact on financial results and the going concern of the company.

Accounting estimates and judgements are an ongoing focus for us, as they are often complex, and we continue to have findings in this area. The findings often relate to the following assessments by auditors:

- Whether the Cash Generating Unit (CGU) is appropriate
- The useful life of intangible assets
- Impairment analyses by the entity
- Reasonableness of the assumptions used by management
- Whether appropriate disclosures have been made in the financial statements.

In the following case study, we provide examples where the auditor did not obtain sufficient evidence in relation to the impairment assessment of intangible assets, and areas that were performed in accordance with Auditing and Assurance Standards.

Case study

This entity holds intangible assets with an indefinite useful life following an acquisition over 10 years ago. Information provided by the entity did not include clear information about the nature of the intangible assets and how the value was measured. It was unclear if there were any separate assets acquired or if the entire balance consisted of goodwill.

Management prepared an accounting paper, but this did not explain why the useful life of the assets was classified as indefinite. At year-end the entity performed an impairment assessment of the intangible assets and reported an impairment charge of $1 million. It used a DCF impairment model with the following inputs criteria:

- Describing the level of the CGU
- Discount rates: pre-tax nominal WACC using market rates and adjusted for company-specific risk adjustment and capital structure
- Cash flows: 5 years cash flow model

What the auditor did well

The auditor noted that the accounting estimate was non-routine, complex and involved management's judgement, and therefore identified it as a significant risk. When performing the audit work the auditor performed the following procedures to the required standard:

- Analysed the historical accuracy of the estimates and assessed the valuation technique applied by entity.

- Evidenced their consideration of this information throughout the audit engagement, and its impact on their risk assessment.
- Engaged a technical specialist to assess certain elements of the valuation such as discount rates.
- Challenged the assumptions used in the accounting estimate and corroborated the information with other audit evidence obtained.
- Developed a range of estimate by stress testing assumptions.

What the auditor didn't do well

In performing their audit procedures, the auditor did not address the following areas, which could have a material impact on the accounting and disclosures in the financial statements:

- Did not have clear documentation of its understanding of the intangible asset and how this may have impacted its impairment assessment.
- The audit documentation did not include an appropriate assessment of whether the CGU identified by the entity was the entity's lowest level of CGU, and how the various requirements of the accounting standards were satisfied. The entity's intangible asset valuation paper was also not included on the audit file. This paper did include some background information on the entity's assessment of the CGU.
- Did not identify that the disclosures in the financial statements were incorrect – the entity stated that the asset was another intangible rather than goodwill – which raised questions about whether the impairment of this intangible asset was appropriate.
- We did not see how the incomplete information impacted the auditor's overall assessment on the financial statements.

Our expectations for auditors

When assessing accounting estimates there are a number of areas we expect auditors to pay more attention to, such as:

- Requesting an entity's accounting papers for each class of transaction and checking if these are sufficient to verify the entity's compliance with accounting standards. It is not the auditor's role to prepare the accounting papers that support the chosen accounting treatment.
- Challenging and confirming if management's chosen accounting treatments are compliant and provide sufficient levels of disclosure.
- Paying attention to the application guidance in auditing standards when challenging the appropriateness of assumptions and judgements made by management. We also expect audit teams to take a step back and consider whether they have obtained sufficient audit evidence.
- Carefully considering errors identified in audits. It is important that auditors consider the point of view of investors when assessing whether an error is material, rather than simply considering the magnitude of a number.
- Clearly communicating the findings of audit work to directors. This should include any disagreement with management and how the audit team has resolved these disagreements, or how disagreements have impacted the audit opinion.

Auditors are encouraged to seek support from their technical team to review the complex areas in financial statements.

Our expectations for directors

Directors are responsible for ensuring financial statements fully comply with IFRS, including ensuring that estimates can be supported with evidence. When dealing with accounting estimates we expect directors and management to do the following:

- Consider all the key judgements made in preparing impairment tests and the disclosure requirements under IAS 36. FMC reporting entities should carefully assess whether there are indications of impairment and whether an impairment review is required. If so, they should ensure that the recognition, measurement and disclosure requirements of IAS 36 are met in full.
- Seek accounting advice for unusual or complex transactions and ensure this covers both measurement and timing of the accounting.
- Have appropriate accounting records in place, including a paper that supports the accounting treatment adopted by the entity for each material class of transaction. This is particularly relevant in areas of judgement or disclosure of key assumptions made by management.
- Consider whether disclosures are sufficiently clear, concise and effective. Directors can find more information on the FMA's expectations in our 'Improving financial statements' monitoring report.

FMA focus

We continue to make efforts to ensure that investors are provided with compliant financial statements, through our audit quality reviews and financial reporting monitoring. When our audit quality reviews indicate potential issues with accounting standards, we may contact FMC reporting entities to seek information to support their financial reporting disclosures.

Focus area: Materiality and audit sampling

Why materiality and sample sizes are important

An auditor’s key role is to form an opinion on whether the financial statements of an entity are free from material misstatements. As they cannot test all transactions to form an opinion, auditors instead use two important concepts to determine the level of transactions they should test: materiality and audit sampling.

Setting incorrect levels of materiality and insufficient sampling of transactions could result in auditors not identifying material errors or misstatements in financial statements.

Materiality

The concept of materiality is defined in both accounting and auditing standards. Misstatements, including omissions, are material if they, individually or in the aggregate, could reasonably be expected to influence economic decisions of users taken based on financial statements.

In the planning stage of an audit, auditors determine the appropriate basis, percentage, and material benchmark to scope the audit approach. During the audit, they will, if necessary, revise the materiality of financial statements based on information they receive. The auditor is also required to take other qualitative matters into account when assessing whether or not financial statements are materially misstated – for example, whether an entity provided the level of disclosures required by the accounting standards.

Sampling

As it is not always possible or efficient for an auditor to test all transactions, they can test a sample of transactions to obtain a reasonable level of assurance over an entire population. There are several factors that impact sample size and how it is selected. Often an auditor will use different techniques for different types of assets, liabilities or items in a profit and loss account. They can apply their professional judgement in different ways to select a sample size. As judgement is involved, they should document their considerations and the purpose of the audit procedure, the characteristics of the population from which the sample will be drawn, and other relevant decisions made to select a sample size that is sufficient to reduce sampling risk to an acceptably low level.

What we have seen

Materiality is a matter of professional judgement; however, auditing standards provide guidance and examples of benchmarks that may be appropriate in certain circumstances. Data collected from our reviews, our key audit matters research, and research conducted by other regulators, show that the application of materiality by different audit firms seems to be similar, in equal circumstances.

Our audit quality reviews this year found one instance where materiality was deemed unreasonable for obtaining sufficient audit evidence. We also noted other areas of non-compliance in setting materiality and selecting appropriate sample sizes. We did notice that materiality assessments were impacted by Covid and that this resulted in the use of slightly different benchmarks to previous years. In these instances we did not have any specific concerns with the benchmarks chosen.

Our reviews have highlighted the following instances where auditors were not complying with requirements:

Materiality

- Where auditors were using different ranges within firms' allowable benchmarks, we did not see explanations or support for using higher ranges within the benchmark.
- We saw instances of benchmarks that were out of line with guidance in auditing standards and comparisons with industry practice.
- An audit file that contained insufficient documentation for instances where the chosen materiality benchmark was adjusted for one-off items.
- Where the auditor determined a separate materiality for a specific account balance or specific audit procedures, the documentation did not clearly justify the chosen thresholds.
- Where a group audit was performed, the auditor set materiality for the group audit but did not consider the aggregation risk of untested portions of material account balances within each subsidiary, and the impact on the group audit.
- An audit file that did not contain sufficient information about whether errors detected by the auditor were material to the overall financial statement from both a qualitative and quantitative aspect.

Sample sizes

When assessing audit documentation:

- Auditors did not clearly identify the population selected nor justify how the audit sampling method was appropriate.
- Auditors incorrectly relied on other procedures, reducing the sample sizes used. This is common when the auditor places reliance on an entity's controls without testing these controls for operational effectiveness.
- Tests performed did not address all assertion risks identified. For example, a test may have addressed the completeness but not the accuracy of a balance, and no further testing was performed to address this assertion.
- When an auditor performed audit sampling, they selected their transactions based on items above a certain value Therefore, this selection did not comply with the requirements of the standard, that each sampling unit should have the chance of being selected.
- Errors identified from tests were not assessed correctly, by either extrapolation or to see if the errors identified indicated systematic failure of controls.

Our expectations for auditors

If unusual benchmarks are used, the audit documentation should explain why the chosen benchmark was used and how it better responds to the needs of the users in comparison to other more common benchmarks. Although the firm's methodology will include templates for calculating materiality, the auditor should still document the judgements made in selecting the appropriate benchmark, and the allowable range within the benchmark.

Auditors should also continue to focus on the way audit teams perform audit sampling, especially:

- The appropriateness of tests and whether they address the risks identified for that class of transaction.
- Where errors are identified, whether conclusions drawn for the overall population are appropriate.
- Ensuring the audit team have obtained sufficient comfort in relation to the untested population.

The auditor should make a robust assessment on the impact of errors and other areas of non-compliance with the accounting standards. In their assessment the auditor should not only focus on the value of the uncorrected errors, but also pay attention to the standard[4] that states it is inappropriate to make, or leave uncorrected, immaterial departures from NZ IFRS to achieve a particular presentation of an entity's financial position, financial performance, or cash flows.

Our expectations for directors

Directors should obtain an understanding of how the auditor sets their materiality and how it affects the audit work performed. Directors should also ensure that management and board papers provide sufficient evidence to support the financial statement decisions and disclosures. Regardless of an auditor's assessment, directors and management should make their own assessment as to whether - and why - errors or omitted disclosures should be included in financial statements. To do this, directors and management need a good understanding of accounting standards. Specific attention should be paid to the requirements of NZ IAS 8 to ensure compliance with the FMC Act.

FMA focus

We will continue to review auditor compliance with materiality and sample size requirements on each audit file. In instances of non-compliance, we will assess if the root-cause analysis and remediation plans are sufficient to address our concerns in these areas.

[4] NZ IAS 8, paragraph 8

Focus area: Finance companies

Audits of finance companies have been identified as higher-risk audits due to the number of finance company failures since 2006 and the impact these failures had on retail investors.

External auditors have previously been criticised for not providing timely warnings to investors about some entities' going concern risks. These entities are frequently included in our audit file selections due to the potential impact of failures.

In the last five years we have reviewed nine finance companies across eight audit firms. We found that in two of these audits the auditor did not obtain sufficient audit evidence. In these instances, we decided to perform a re-review of the audit files in the subsequent period.

Although the companies reviewed vary in size, due to the nature of the industry these audits are deemed complex requiring the auditor to exercise a high level of professional scepticism and professional judgement. Our findings in this sector show auditors still have work to do to improve the quality of their finance company audits.

What we have seen

We noted a number of areas where auditors did not obtain sufficient evidence to support their audit opinion. In most files we noted issues in both design of the audit approach and execution of the audit procedures.

The most common findings on auditor approach relate to auditors placing reliance on controls from operating systems without performing the necessary audit procedures to obtain sufficient and appropriate audit evidence to be able to rely on these systems. Without systems testing, auditors should perform higher levels of detailed testing, and this did not occur in most instances. There are also instances where the lack of control testing may not be able to be compensated for by detailed testing due to the volume of transactions or complexity of the entity.

Other areas that require further improvements include:

- ensuring the existence and accuracy of member loan balances
- impairment of loan balance
- interest income and expenses
- related party transactions
- disclosures in financial statements.

IT general controls

IT general controls (ITGCs) are the basic controls that can be applied to IT systems. They provide the foundation for reliance on data, reports, automated controls, and other system functionality underpinning business processes. The security, integrity, and reliability of financial information relies on proper access controls, change management and operational controls.

Auditors are required to obtain an understanding of the relevant controls around systems and perform risk-assessments of the risks of material misstatement at each assertion level. Depending on the entity's IT control environment, the auditor may be unable to rely on these controls. Our reviews identified instances where the auditor:

- did not appropriately consider whether the initial design of the control was effective. Where deficiencies were identified, the auditor did not assess the impact of those deficiencies and whether additional procedures were required.
- failed to test if key ITGCs were operating effectively when relying on application controls, which resulted in inappropriate reliance on systems and the auditor ultimately not obtaining appropriate evidence.
- tested the application controls but with an insufficient sample size, or the design of procedures was inappropriate to assess the effectiveness of that control.

Testing the existence and accuracy of member loan balances

Although the existence and accuracy of loan balances may not be identified as a key risk, the integrity of the data may be important for other tests in the audit. Some of our most common findings include:

- In testing the existence of loans, auditors relied on internal sources from the entity (such as computer-generated reports) without testing the sources, such as signed loan documents. Without testing the integrity of the data, they did not obtain sufficient audit evidence to rely on internally produced reports.
- In testing the accuracy of the loans, auditors selected a sample size that did not cover the entire population.
- Where the auditors relied upon prior-period testing this was not documented, and auditors did not consider if this testing still provided relevant audit evidence. For example, an auditor tested the accuracy of the loan documentation in the entity's system in prior years but did not ensure that conditions hadn't changed (both in the system and in the agreement), even though it is common to make changes to existing loans.

Impairment of loan balance

Assessment of whether loan balances are impaired is important in audits of finance companies, especially those that provide unsecured lending. Some of our most common findings include:

- Auditors not obtaining a full understanding of various types of loans , and which loans have a higher risk indicator. Hence, audit risk assessments and testing did not cover all loans considered higher risk.
- When performing impairment testing, auditors not corroborating management's assessment with supporting evidence, and not testing the integrity of entity-prepared arrears reports which the auditor relied on for their testing.

Interest income and expenses

The completeness of interest income and accuracy of interest expenses are often tested as a substantive analytical procedure due to the direct correlation between loan and deposit balances, and interest income and expenses. Our reviews identified the following areas of concern:

- Reliance on entity-produced reports without testing aspects of reliability.
- Insufficient assessment of relationships between historical financial data and non-financial data, in order to test for plausible correlations behind particular movements.
- In some instances, insufficient disaggregation of financial data to investigate differences, which would enable the auditor to draw supportable conclusions.

Related party transactions

We often see finance companies involved in complex related party transactions. Related parties may be considered a significant risk, depending on the size of the entity, and if there is a lack of robust internal controls around the identification and disclosure of related parties' transactions. Our reviews of finance company audits continue to identify issues around auditors not testing the existence and completeness of related party transactions, including:

- not assessing entity's policies and procedures for identifying related parties and related party transactions.
- not performing sufficient and appropriate procedures to review the completeness and accuracy of related party transaction disclosures. Auditors often reconcile information to prior-year disclosures or to documents prepared by the entity, without considering if other records exist or if any other related party transactions were evident in systems.
- audit documentation identifying related parties or transactions with related parties that were not disclosed in the financial statements; and auditors not documenting their assessments on why these omissions were deemed appropriate or how this impacted the audit opinion.
- failure to obtain an understanding of unusual transactions, and if related parties were involved.
- no searches for undisclosed related parties being performed. For example, the auditor did not review the Companies Office register for directors or key management personnel to determine if the entity's list of related parties is complete.
- no verification of the accuracy of financial statement disclosures. For example, where an entity stated the transactions were on an arm's length basis, we did not see any evidence of how the auditor confirmed this statement.

Disclosure in the financial statements

We noted areas for improvement when reviewing the financial statement disclosures. We continue to see auditors not evaluating the adequacy of the disclosures. Examples include testing whether the loan portfolio, as presented, fairly reflects the underlying information. Further, we have seen instances where the auditor does not test management's assessment of the expected maturity of loan balances.

Our expectations for auditors

We expect auditors to improve documentation of their understanding of an entity's overall control environment, including an ITGC assessment and assessment of the design effectiveness of controls. Auditors should ensure a robust risk assessment is made at each assertion level, and appropriately link this to audit evidence obtained from controls and substantive testing. If auditors rely on application controls these should be tested, including relevant ITGCs controls. Substantive testing should include an appropriate sample of existing and new loans, to ensure samples represents the entire population being tested.

If an auditor does not request third-party confirmations, they should consider – and document – what additional or alternative procedures are required to obtain sufficient and appropriate evidence over the valuation and existence of loans.

Auditors should also consider whether their current procedures are sufficient and appropriate to address all the risks and assertions associated with related party transactions. Senior team members involved in this area of the audit should adequately share with other team members the findings identified during their testing, especially any concerns. Other team members should also communicate any findings identified in other parts of the audit that may have an impact on related parties.

We expect auditors to clearly communicate to directors any concerns about the entity's policies, procedures and control environment, and the impact this may have on the accuracy of information they receive throughout the year.

Our expectations for directors

Directors are responsible for ensuring financial statements comply with the requirements of the FMC Act. We therefore expect them to ensure management has implemented controls that operate effectively to prevent or detect any material misstatements.

Directors must also maintain all documentation and accounting records that support their accounting positions, and in such a way that documentation is readily available for review at all reasonable times by either the FMA or their audit firm. Additional attention should be given to related party transactions. Entities should have appropriate monitoring systems in place to verify the completeness and accuracy of relationships and transactions. Independent directors have an important oversight role to ensure this process is working effectively.

FMA focus

We will continue to review finance companies as part of our audit quality reviews and financial reporting monitoring, focusing especially on key risk areas.

Focus area: Audit firm culture and audit quality

This section examines why the culture of an audit firm is important and how it can impact audit quality.

It is important that audit firms have a culture of challenge, and that auditors draw the right conclusions from their work. Maintaining a culture of challenge may be threatened by pressures to complete multiple audits on time and on budget, compromising time for adequate consultation and review. Such threats can be mitigated by ensuring that audits are properly resourced with the right talent. Putting culture at the core of auditors' professional mission can help firms retain and attract the appropriate talent needed to complete all audits to a high standard.

PES 3 states that an internal culture based on quality is needed for a firm to achieve quality in all the engagements it performs, and that promoting such an internal culture includes:

- The establishment of policies and procedures that address performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, in order to demonstrate the firm's overriding commitment to quality.
- The assignment of management responsibilities so that commercial considerations do not override the quality of work performed.
- The provision of sufficient resources for the development, documentation and support of its quality control policies and procedures.

Our reviews of firms' quality control systems cover compliance with these requirements, for example by reviewing governance documents and providing us with insight into the firm's culture.

Challenges

We identified the following challenges in culture in two of the five firms we reviewed this year:

- Business growth was at times prioritised ahead of public interest responsibilities.
- Entrepreneurial cultures could lead to excessive risk taking with few consequences.
- Some auditor mindsets were not sufficiently geared toward professional scepticism and challenge.
- Leadership sent mixed messages about key priorities, such as the importance of client satisfaction over audit quality.

Audit quality issues cannot be fixed solely by training or improving audit procedures – culture also plays an important role as the cornerstone of what is valued and the way things are done in an organisation. A 'just culture'[5] is about getting to the root cause of what happened and learning from these mistakes, rather than focusing on blame. It is important to create a culture of trust where reporting of incidents and concerns are not penalised. This includes building a culture of psychological safety, where people can share opinions

[5] 'Just culture' refers to a system of shared accountability in which organisations are accountable for the systems they have designed and for responding to the behaviours of their employees in a fair and just manner.

and express concerns, and where they are allowed to make mistakes. This environment needs to be cultivated throughout an organisation by leaders, managers, and teams.

Our expectations for auditors

In general, we associate high-quality audits with compliance with auditing standards. The International Federation of Accountants (IFAC) has identified five factors in maintaining a high-quality audit ecosystem:

1. **Right audit process:** this continues to evolve as the purpose and scope of audits change and technological enhancements are integrated into audit methodologies
2. **Right people:** to retain and attract the best and brightest mix of expertise and talent
3. **Right governance:** to set the tone from the top
4. **Right regulation:** includes the right supervisory framework, balancing intervention with allowing the market to get it right, the right standards that apply across jurisdictions forming the baseline, the right business model, and the right approach to auditor liability
5. **Right measurement:** includes both quantitative and qualitative elements.

All these factors are important and contribute equally to high-quality audits. One area that has been overlooked is culture, which is a critical component of an audit firm's ability to deliver on the five points above.

We expect audit firms to develop cultures that encourage the exercise of professional scepticism and challenge of management's judgements and assumptions.

When performing audits, we expect auditors to take into account the interests of investors and the public. The culture of audit firms needs to drive both independence and expertise. Independence is probably an auditor's biggest asset, as it ensures they perform their audits and express their opinion in an unbiased and honest manner and provide credibility to the audit opinion. This message should be communicated and supported by the entire firm, not only the audit department.

Our expectations for directors

Directors and audit committees have a key role to play in driving audit quality. An engaged and informed audit committee asks insightful questions and sets the tone for a company's financial reporting and its relationship with the auditor. The audit committee also sets expectations for clear and honest communication with the auditor, between the auditor and the company's management, and with other stakeholders (e.g. the investor community and the regulator).

Indicators that directors and audit committees should look for in their auditors to assess the extent to which firm culture supports high-quality audits include:

- whether the audit team creates a supportive environment where it is recognised that mistakes can be made, and a supportive culture that gives auditors the opportunity to learn from their mistakes.
- whether there are adequate resources at the audit firm to support auditors' ability to deliver high-quality audits.

- whether the skill of the audit partner demonstrates an ability to manage competing challenges between management, the audit committee, and the public interest.

Directors should provide support if an audit team encounters difficult challenges with management and offer separate discussions without management to overcome these challenges.

FMA focus

Our approach focuses on influencing, as well as sharing and promoting good practices, particularly where culture has driven positive audit quality results.

We will continue to engage with firms to increase their awareness of the importance of culture and behaviours, and how to drive actions to improve culture. Culture will be a focus during our quality reviews: we will highlight to firms’ areas identified for improvement, share examples of good practices where culture has driven positive audit quality results, and suggest mechanisms that an audit firm may use to assess their own culture.

We continue to evolve to ensure we can address areas such as culture, sustainability and better social policies, which are increasingly important to employees, consumers and society more broadly, so public confidence is maintained.

Focus area: Root cause analysis

In our 2020 Audit Quality Monitoring Report, we set out our observations and expectations of audit quality control systems. We focused on the development and implementation of root cause analysis processes. Root cause analysis is intended to improve audit quality by identifying the underlying causes of internal and external review findings. When performed well, root cause analysis provides audit firms with opportunities to develop bespoke responses and prevent recurrence of negative outcomes across all the audits the firm performs.

What we have seen

While we noted improvements at some audit firms, such as the implementation of effective review systems to check the success of firms' responses to root causes analysis, other firms still require improvements in this area. Below we highlight two areas where ongoing focus is required.

Root cause analysis and remediation plans

Audit firms made efforts to perform root cause analysis and develop remediation plans to address our findings. Our reviews have highlighted the following areas that require further attention:

- The audit firm did not assess the effectiveness of remediation plans by, for example, testing whether remedial training was fully understood by participants, or reviewing areas identified for improvement by internal or external reviews across a sample of the firm's audits.
- The audit firm did not assess whether findings on individual files were addressed in subsequent audits.
- We did not see whether audit firms considered performing root cause analysis on good quality audits (in line with global firm policy) to evaluate positive audit quality indicators that may enhance the quality of other audits.

Evaluating the effectiveness of training to address root causes

Additional training is often the remedial action applied after root causes are identified by audit firms. Although ongoing training is required at all registered audit firms, we noted a range of practices used to evaluate the effectiveness of training. We recommend that audit firms continue to focus on:

- developing a strategic process or dedicated learning plans to assist in meeting learning needs
- monitoring the effectiveness of all training that occurred during the year
- identifying whether training is mandatory and implementing mechanisms to monitor attendance.

Our expectations for auditors

We expect that the root cause analysis of internal and external review findings should include a broad range of considerations to determine the actual root causes, and not jump to a solution-driven outcome. We expect audit firms to have good processes in place to test the effectiveness of remedial actions, including the assessment of training activities. When an effectiveness review indicates that findings were not addressed or not consistently addressed, we expect an audit firm to repeat the root cause analysis.

Our expectations for directors

Audit committees can play an important role in facilitating high-quality audits. Good governance requires attention to audit quality and robust processes to challenge audit firms and management throughout audit engagements.

Directors should implement ongoing review processes to measure audit quality and determine whether an audit firm should be retained or put up for tender. Audit committees should appoint their auditors based on quality, with a focus on the skills of the audit team and the extent to which specialists are involved. Directors are reminded that the audit is an investment rather than a cost.

To support directors in assessing audit quality, the FMA has issued an audit quality guide for directors that sets out how they can contribute to the quality of an audit, and what they can expect from both the FMA and the auditor.

Going forward, we will issue letters to directors informing them when their entity is reviewed as part of our audit quality review process and direct them to contact the audit firm for a discussion on the outcomes of our review.

FMA focus

We will continue to evaluate audit firms' quality control systems as part of our reviews. We remind audit firms that PES 3[6], the equivalent to International Standards on Quality Management (ISQM1), will be effective by 15 December 2022, and that we will increase our focus on a successful implementation of these standards. The new requirements are more onerous than current requirements and increase the accountability of management at audit firms. We recommend audit firms create robust plans to address these new requirements now, and not wait until the implementation date.

[6] PES 3: Quality Management for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance or Related Services Engagements

Appendix 1 – Audit oversight regime

Oversight of FMC auditors

The Ministry of Business, Innovation and Employment (MBIE) sets the policies for the oversight of auditors of FMC reporting entities. The regulations are set out in two key pieces of legislation:

- **the Financial Market Conduct Act 2013** (FMC Act), which establishes which entities require their financial statements to be audited by a licensed auditor/registered audit firm
- **the Auditor Regulation Act 2011** *(*AR Act), which sets out the rules regarding the licensing and oversight of auditors of FMC reporting entities.

What are FMC reporting entities?

The FMC Act defines an FMC reporting entity as:

- an issuer of a regulated financial product (for example, managed investment schemes and other registered schemes)
- listed entities
- registered banks and licensed insurers
- credit unions and building societies
- a number of other licensed entities under the FMC Act.

Financial Markets Authority

The FMA is the Crown entity responsible for enforcing securities, financial reporting and company laws as they apply to financial services and financial markets. This includes the regulation of auditors of FMC reporting entities, and the accreditation and monitoring[7] of professional bodies. The FMA also licenses and registers overseas auditors and audit firms.

External Reporting Board

The External Reporting Board (XRB) is an independent Crown entity responsible for standards related to auditing in New Zealand. In relation to FMC reporting entities, the XRB has issued the following standards:

- Accounting Standards, which each FMC reporting entity must comply with

[7] CA ANZ: https://www.fma.govt.nz/news-and-resources/reports-and-papers/accredited-body-report-new-zealand-institute-of-chartered-accountants/
CPA Australia: https://www.fma.govt.nz/news-and-resources/reports-and-papers/accredited-body-report-cpa-australia/

- Auditing and Assurance Standards, which all auditors must comply with when auditing FMC audits.

Both standards are based on international standards, being International Financial Reporting Standards (IFRS) and International Auditing Standards (IAS).

Professional bodies

Two professional bodies in New Zealand are accredited by the FMA: Chartered Accountants Australia and New Zealand and CPA Australia. To be accredited, these bodies are required to have adequate and effective systems, policies and procedures in place to perform the following functions:

- licensing domestic auditors and registering domestic audit firms using the standards set by the FMA
- monitoring those auditors and registered audit firms
- promoting and monitoring the competence of these members
- taking action against misconduct.

All licensed auditors can be found on the Auditors Register.

Monitoring audit quality

The FMA issues an annual Auditor and Regulation Oversight Plan. This plan helps licensed auditors, registered audit firms and accredited bodies to understand how we will approach auditor regulation and which areas we will focus on during our reviews.

We report annually on our findings by issuing the following reports:

- Audit Quality Monitoring Report (this report)
- Audit Quality: A director's guide

Quality review methodology

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

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

We review the 'Big Four'[8] firms every two years, and all other audit firms every three years. As a result of our Memorandum of Understanding (MOU) with the Auditor-General, we may review audits of FMC reporting entities carried out by private audit firms on behalf of the Auditor-General. The results of these reviews are included in this report and our findings are communicated directly to the Auditor-General.

All of our reviews undergo a robust moderation process. Each audit quality review assessment report is peer-reviewed by a reviewer not involved in the initial review. Our final report goes to the Auditor Oversight Committee (AOC) for consideration. The AOC provides an independent forum to review the consistency

[8] The 'Big 4' –Deloitte, EY, KPMG, and PwC

and fairness of all quality review reports. It comprises a diverse group of professionals including former auditors, company directors, and others with relevant experience who are independent of the audit profession.

Quality control framework

The requirements of a quality control system are 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 whether the audit firm's internal monitoring of its audit quality control system is effective. This internal monitoring includes the audit firm performing an engagement quality control review (EQCR) on each audit file. The EQCR process is designed to provide an objective evaluation of the significant judgements the audit team has made, and the conclusions reached in the auditor's report.

We have prescribed additional requirements[9] for the EQCR given its importance to the audit process. We expect the EQCR partner to be suitably qualified and have relevant experience to enable them to give an objective evaluation and therefore the FMA required the EQCR to be licensed.

Individual file reviews

We carry out individual audit file reviews to check the auditor has complied with Auditing and Assurance Standards, and exercised reasonable care, diligence and skill in carrying out the audit.

Key attributes of audit quality are:

- an independent audit is carried out by a licensed auditor
- the auditor demonstrates appropriate levels of professional scepticism
- adequate and appropriate audit evidence is obtained
- the auditing and assurance standards are followed
- an appropriate audit opinion is issued.

File selection and ratings for individual audit files

The number of audit files we select for each audit firm is determined by the number of licensed auditors at the audit firm, the number of FMC audits completed and the results of the audit firm's previous review.

In selecting specific files for review, we take into account:

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[9] Paragraph 8(1)(f) of the Auditor Regulation Act (Prescribed Minimum Standards and Conditions for Licensed Auditors and Registered Audit Firms) Notice 2012

- businesses of significant public interest, given the value of financial products 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 that experienced significant growth
- other businesses considered higher risk, such as finance companies, or businesses that have non-compliance issues such as qualified audit reports, or have not complied with laws and regulations
- a cross-section of different licensed auditors in each registered firm.

If a previous review found an audit file did not meet the required standards, it is likely we would review that auditor or audit file again.

File ratings

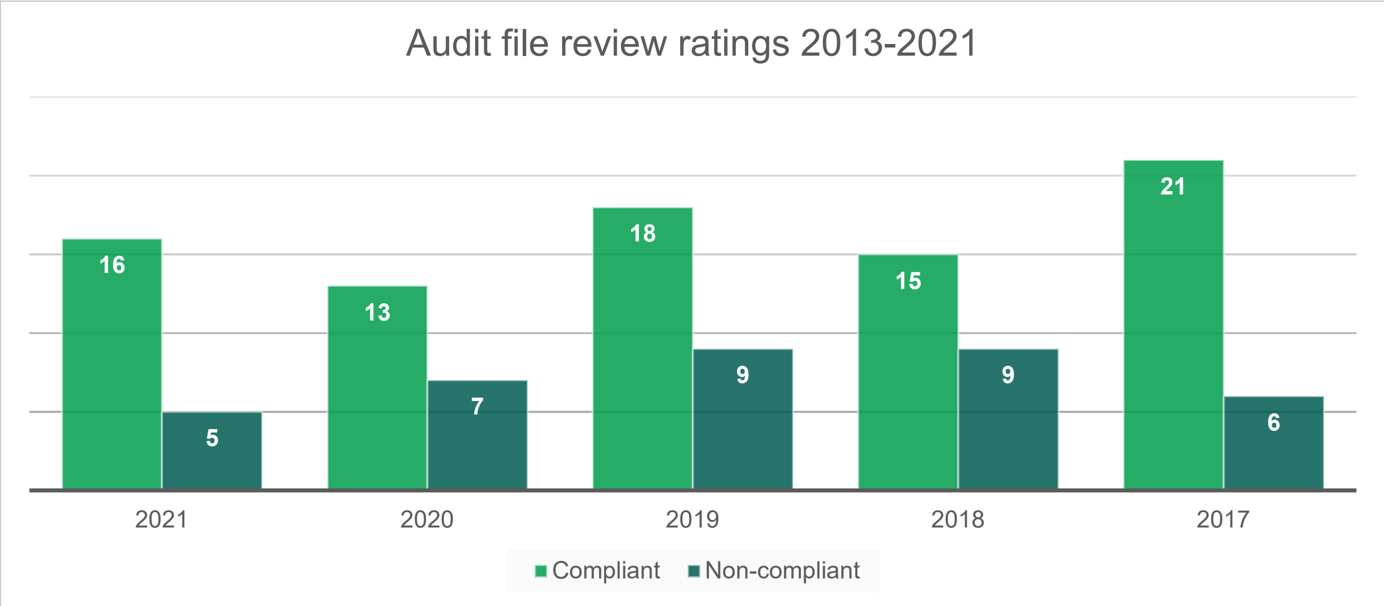
When we complete a file review, the reviewer gives each individual finding on that file a rating from low to high, and proposes a final overall file rating from the categories below:

- **Good** – we either had no findings or the findings 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.
- **Compliant, but improvements needed –** we identified several areas in the file where the audit wasn't performed in accordance with the audit standards. However, the reviewer found that overall, there was sufficient and appropriate audit evidence obtained in the key risk areas.
- **Non-compliant –** the file showed several areas where the audit wasn't performed in accordance with the standards. The reviewer found insufficient or inappropriate audit evidence obtained in at least one key risk area of the audit, or the review showed a material misstatement that required restatement of the financial statements and/or the audit opinion.

The ratings are moderated by the AOC.

Summary of review ratings

The graph below provides an overview of how we rated the individual audit files reviewed over the last eight years.



This is broken down further between listed and other businesses as follows:

Listed businesses

Year	Compliant		Non-compliant
	Good	Improvements needed	
2021	6	5	0
2020	5	3	5
2019	1	5	3
2018	3	3	3
2017	2	8	2
2016	0	6	7

Other FMC reporting businesses

Year	Compliant		Non-compliant
	Good	Improvements needed	
2021	3	2	5
2020	2	3	2
2019	6	6	6
2018	1	8	6
2017	4	7	4
2016	0	9	8

Background to our rating criteria

Our reviews focus on audit processes and procedures, and do not assess whether the underlying audited information is correct. Where we rate an audit as non-compliant, it does not necessarily mean that the financial statements do not show a true and fair view or require restatement. Equally, where we rate an audit as good or compliant this is not an endorsement that the financial statements are free from misstatement.

Our reviews cover different audit firms each year and files are selected on a risk basis. The sample is therefore not statistically representative, and the summary of results needs to be interpreted cautiously. Our findings do, however, provide insights in trends in audit quality and highlight areas for improvement applicable for the majority of FMC audits.

Possible post-review actions

Following an audit quality review, we consider if further action is required. Actions we could take include:

- Requiring an audit firm to perform additional work to address our findings.
- Requiring an entity to restate the financial statements, if we find material misstatements.
- Completing a follow-up review within 12 to 18 months of the previous review to ensure the audit firm has taken appropriate action to address our findings.
- Issuing directions to remediate any findings.
- Referring complaints to the professional body to be dealt with under its disciplinary procedures.

Appendix 2 – Market data

Entities, actions	Data for year ending			
	30 June 2021	30 June 2020	30 June 2019	30 June 2018
Domestic licensed auditors	138	135	132	138
New licences issued to domestic auditors	9	10	11	5
Domestic auditor licences cancelled	6	7	8	8
Domestic registered audit firms[10]	18	18	18	19
Domestic audit firms licensed	0	1	0	0
Domestic audit firms' registrations cancelled or expired	0	1	1	2
NZX-listed companies	186	178	205	190
FMC audits	1,130	1,200	1,250	1,300
Firms reviewed	5	4	6	5
Audit files reviewed	21	20	27	24

[10] This includes six registrations of firms that operate under two brand names

Glossary

Accounting standards/NZ IFRS	New Zealand equivalent to the International Financial Reporting Standard issued by the External Reporting Board.
AR Act	Auditor Regulation Act 2011
AOC	Auditor Oversight Committee established by the FMA that provides an independent forum to review the consistency and fairness of all quality review reports. The members of AOC are a diverse group of professionals including ex-auditors' partners, company directors, and other people with relevant experience.
Audit firm	Registered audit firm as defined by the AR 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 as issued by the External Reporting Board
Auditor	Licensed auditor as defined by the AR Act.
Culture	A reflection of shared beliefs and one of the most important factors in explaining motivation, commitment, and decision-making. An intangible factor that explains why larger groups do similar things, talk in similar ways, and use similar tools to achieve an outcome.
EQR	Engagement Quality Review; 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.
EQR partner	Licensed auditor who performs the EQR. This may be a licensed auditor who is not a partner in the audit firm.
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 plan to liquidate their business, cease operations, or have no alternative than to stop doing business.
IFIAR	International Forum of Independent Audit Regulators

ISA (NZ)	International Standard on Auditing (New Zealand) issued by the External Reporting Board
Financial statements assertions	When auditing accounting balance in the financial statements, the auditor should ensure the following assertions are covered: existence/occurrence, rights and obligations, completeness, accuracy, valuation, presentation/classification.
FMC reporting entity	Same meaning as in section 6 of the AR Act
FMC audit	Same meaning as in section 6 of the Auditor Regulation AR Act.
Materiality	Information is material if its omission or misstatement could influence the economic decisions of users based on the financial statements.
NZICA	NZICA and the Institute of Chartered Accountants of Australia (ICAA) formally amalgamated on 1 January 2015 to form the Chartered Accountants Australia and New Zealand (CA ANZ). After the amalgamation, NZICA continues to regulate the accountancy profession for Chartered Accountants ANZ members who remain resident in New Zealand (and by virtue of their residence continue to be NZICA members) according to the NZICA Act 1996, and the terms of the amalgamation agreement. For the purpose of the audit oversight regime, NZICA continues to be the accredited body.
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 Standards issued by the External Reporting Board
Non-assurance service	Any engagement provided by the audit firm that doesn't meet the definition of 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.
Quality review	A review of an audit firm as defined by the AR Act.