

AUDIT QUALITY ANNUAL REVIEW

1 July 2014 – 30 June 2015



FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND



AUCKLAND

Level 5, Ernst & Young Building 2 Takutai Square, Britomart PO Box 106 672, Auckland 1143

Phone: +64 9 300 0400 Fax: +64 9 300 0499

WELLINGTON

Level 2, 1 Grey Street PO Box 1179, Wellington 6140

Phone: +64 4 472 9830 Fax: +64 4 472 8076

November 2015

Contents

Key trends	02
Executive summary	03
Key findings	05
Auditor independence	05
Monitoring of audit quality	06
Professional scepticism	07
Using a management or auditor's expert	08
Responsibilities relating to fraud	09
Materiality	10
Areas for improvement	11
Going concern assumptions	11
Sampling	12
Analytical procedures	13
Related-party transactions	13
Future focus	14
Auditor reporting	14
Quality reviews	15
Auditor regulation survey	16
Appendix 1 – Quality review framework	18
Appendix 2 – Market data	21
Glossary	22

Key trends

Audit quality reviews 2014/15



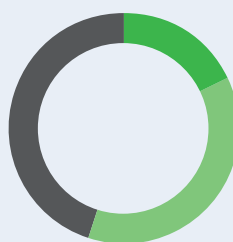
12

registered audit firms



38

audit files, including 13 listed companies
and 25 other companies



- good, with limited improvements required 18%
- improvements required 37%
- significant improvements required 45%

Audit quality reviews 2013/14



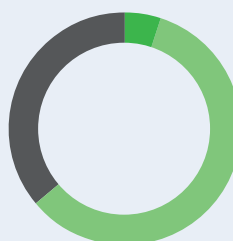
17

registered audit firms



56

audit files, including 14 listed companies
and 42 other companies



- good, with limited improvements required 5%
- improvements required 59%
- significant improvements required 36%

Audit quality reviews 2012/13



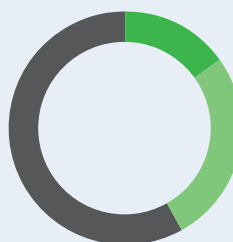
9

registered audit firms



33

audit files, including 7 listed companies
and 26 other companies



- good, with limited improvements required 15%
- improvements required 27%
- significant improvements required 58%

Executive summary

Purpose of this report

One of the FMA's seven strategic priorities is to ensure investors have access to resources that help them make better-informed financial decisions.

Audited financial statements are a key resource for investors, and their confidence in them is mainly dependent on the auditor's opinion. Quality reviews of audit firms help ensure audits are high quality, and audit opinions are reliable.

The *Auditor Regulation Act 2011* (the Act) requires the FMA to ensure that a quality review of the systems, policies and procedures of registered audit firms and licensed auditors is carried out at least once every four years. We are also required to prepare a report annually on the quality reviews that have been carried out in the preceding financial year.

This report summarises the overall findings from quality reviews undertaken between 1 July 2014 and 30 June 2015.

Key findings

As at 30 June 2015, we completed our first full cycle of audit quality reviews, having carried out at least one review of every registered audit firm since the introduction of the Act. Our overall observation is that the quality review regime has had a positive impact on audit quality.

Our findings from the audit quality reviews carried out over the past year are similar to those from previous years, and are also consistent with the findings reported by the International Forum of Independent Audit Regulators (IFIAR) from their 2014 Survey of Inspection Findings¹.

We reviewed 12 registered audit firms during the year, covering half the licensed auditors in New Zealand.

This involved 38 audit files, including 13 listed companies and 25 other FMC reporting entities. Of these, 18% of the files were categorised by us as good, with limited improvements required (5% last year). Another 37% required improvement (59% last year). The remaining 45% required significant improvement (36% last year).

The audit files we select for review tend to be more risky and more complex than the norm. The results are therefore different than we would expect to see in a neutral sample.

Audit firms have tended to make improvements to their systems, policies and processes following their first quality review, but these have not always resulted in improvements on individual audit files. We expect that further improvements in audit quality will only be visible when audit firms have fully implemented any changes required following quality reviews, and those changes have been adopted by all auditors within the firm.

Where we carried out follow-up reviews, we saw improvements in audit quality. However, further improvements were required to fully comply with the auditing standards. Audit firms should therefore continue to ensure that changes in policies, processes and procedures, and additional training, have the desired effect on audit quality.

We have seen improvements in some areas previously reported on, including:

- going concern assumptions
- sampling
- analytical procedures
- related-party transactions.

However, the systems, policies and processes for monitoring independence and audit quality continue to require improvement.

1. A copy of the survey can be found on: <https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR%20Global%20Survey%20Media%20Coverage/IFIAR-2014-Survey-of-Inspection-Findings.pdf>

The review of audit files indicated that although the frameworks are sufficient, improvements are also needed in:

- professional scepticism
- use of experts
- the risk of fraud, especially in revenue recognition
- setting materiality.

These are all areas where an auditor's judgment and knowledge of the business are important to ensure a high quality audit.

During the year we identified three sets of financial statements with material errors. These financial statements needed to be restated.

Detailed comments on the areas for improvement can be found in the 'Key findings' and 'Areas for improvement' sections of this report.

Investigations

During the year, we received one complaint regarding the audit of an FMC reporting entity. We requested NZICA as an accredited body to perform an investigation of this audit file, as required under section 75 of the Act. The investigation has now been completed and will result in additional monitoring of this audit.

Complaints

During the year, accredited bodies made three complaints against licensed auditors. Two complaints came after follow-up quality reviews (required due to previous complaints made by us). The other complaint related to undisclosed alterations of the audit documentation immediately before a quality review visit and breaches of independence requirements. All complaints are currently before the professional conduct committee.

Our expectations

Audit firms should continue to improve quality and consistency in performing audits. Audit firms not subject to quality review during the year should take note of the areas highlighted in this report.

Many people play a role in improving the quality of FMC audits. We encourage directors and audit committees to have regular discussions with their auditor regarding audit quality. They can also help improve the audit process by providing robust policies, processes and systems, and by providing the auditor with high quality audit evidence. We recommend that directors and audit committees monitor and evaluate their interactions with their auditors to improve the overall quality and value of their annual audit. This should include seeking assurance of the auditor's ongoing independence, especially where the audit firm provides other non-audit services.

Future focus

Each year we aim to review approximately a third of licensed auditors and registered audit firms. Our focus during the second cycle of review will be on the effective implementation of firms' remediation plans and will allow us to review certain areas in more depth. In the 2015/2016 period, our programme will focus on the risks that non-complying FMC reporting entities pose to investors, and will build on the results of previous quality reviews.

A new standard for auditors' reports has been issued for all New Zealand listed companies with a reporting period ending on or after 15 December 2016.

Under the new standard, the auditor will be required to communicate key audit matters, and the auditor's report will include the name of the engagement partner. This will provide users of financial statements with additional information about the audit that was previously not available. We will pay specific attention to the implementation of the new standard, and we intend to report our findings following the first two years in a separate report.

Key findings

Auditor independence

An important part of the auditor's role is acting in the interest of investors, as well as the client. The effective identification and assessment of threats to the auditor's independence, the application of appropriate safeguards, and the proper reporting of these to audit committees or directors, are critical.

Most audit firms have systems, policies and processes in place to monitor their independence. Although these may be adequate to meet the requirements of the Professional and Ethical Standards (PES), they may not address all requirements of the standard. A breach of auditor independence requirements could still occur. Not following all the requirements of the standard could undermine the independence and objectivity of an auditor.

Our concerns mainly relate to non-audit services being provided by audit firms. In some instances where significant non-audit services were provided to FMC reporting entities, we were unable to determine whether threats to independence had been considered, or whether they had been sufficiently addressed. The audit files also lacked documentation on all independence requirements, so it was difficult to conclude whether they had been met by the audit firm. When we got further information from the audit firm, we found that in some cases it had not complied with the standard.

Audit plans provided by audit firms sometimes included documentation on providing prohibited services, such as preparing tax calculations for inclusion in the financial statements. There was no evidence that the audit committee had challenged the services or asked further questions about the auditor's independence.

Our expectations

We expect audit firms to improve their assessment of independence threats, the safeguards they have in place to mitigate these threats, and the audit work performed to ensure the mitigation was effective. This work has to be clearly documented on the audit file. Further, this information should be clearly communicated to those charged with governance, both at the start and the end of the audit. A reference to the financial statements in this instance is not sufficient to address the requirements of the auditing standard.

Due to the potential impact of the above work, we expect it to be reviewed by both the engagement partner and the engagement quality control review (EQCR) partner.

Audit committees, or directors of FMC reporting entities, should emphasise the need for high standards of reporting of independence threats by their auditors. They should also challenge auditors on the safeguards they have in place to protect their independence, especially when non-audit fees are high, relative to the audit fee. Audit committees and directors should also consider engaging other audit firms for non-audit services.

Monitoring of audit quality

We believe regulation has had a positive impact on the overall attention to audit quality in audit firms. FMA quality reviews, together with international regulation of network firms and the reviews performed internally by these networks, have resulted in additional investment in audit quality.

Where audit firms performed robust internal reviews, we noticed a higher standard in audit quality. Where senior management of audit firms were visibly focused on audit quality, we also saw better results in their quality reviews. It's important for audit firms to embed systems and processes that promote audit quality, and effectively monitor these systems and processes. They should also reward staff who deliver high quality audits.

However, we noted opportunities for some registered audit firms to improve the monitoring of audit quality.

We found that quality control procedures, and the monitoring of those procedures, could be improved to ensure the policies and processes within a quality control system are relevant, adequate, and operating effectively. We also noted that where internal reviews had been performed, they were not always followed by effective remediation plans to address the findings. The findings in many instances were not communicated to the wider audit team or other audit staff, which resulted in issues not being addressed in subsequent audits. These reviews were therefore ineffective.

We believe that the mistakes in the financial statements that required restating following our review could have been prevented if the licensed auditor had followed internal procedures, or if the audit firm had required appropriate consultation processes on complex technical matters.

Our expectations

We require firms to have quality control manuals that comply with the most recent Audit and Assurance Standards, and set out the policies and procedures licensed auditors have to follow. This should include monitoring systems to ensure compliance with these policies and procedures. Audit firms should not solely rely on regulators to test whether their systems of quality control are effective.

Results of reviews should be better analysed by audit firms. Audit firms should identify why their audit teams don't comply with the required standards. Staff training alone is not always sufficient to remediate such issues. Audit teams should also be provided with ongoing support during audits to ensure that high quality audits are performed. If insufficient support is available within the firm, the audit firm should find ways to address this, either within their international network or externally.

The EQCR partner can also play an important role in improving audit quality.

EQCR partners should critically review the key risk areas of the audit file and ensure it contains appropriate and sufficient audit evidence.

Audit committees and directors can significantly contribute to a high quality audit. Directors should ensure the business has appropriate policies and procedures to address complex accounting issues or business transactions, and not solely rely on their auditor to address such issues. We also expect active involvement from management to ensure appropriate audit evidence is provided to the auditors that helps improve audit quality.

Audit committees or directors should also discuss with audit firms their policies and procedures for reviewing their internal quality. Audit committees and directors may also be interested in whether their audit has been subject to an FMA review or review by another regulator, what lessons were learned by the audit firm from the review, and what actions it has taken to address any issues identified. We encourage audit firms to share findings from our quality reviews with their FMC audit clients as part of their audit planning.

Professional scepticism

Professional scepticism is defined in the auditing standard as *'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.'* Professional scepticism continues to be an area of concern in a large number of FMC audits, especially in areas where significant judgment is required by both the preparer of financial statements and the auditor.

Professional scepticism is affected by certain conditions and pressures that arise or change during an audit. Judgments made during the planning and performance of the audit, such as the level of skill and expertise needed, as well as audit evidence and audit work to be conducted, are likely to change during an audit. It is therefore important that each member of the audit team applies the right level of professional scepticism.

Areas where we continue to see a lack of professional scepticism include:

- accepting accounting treatments without documenting the auditor's consideration of the merits of the treatment, possible alternative treatments, the extent to which the proposed treatment complies with International Financial Reporting Standards, and the impact of these accounting treatments on other laws, regulations or covenant ratios the business has to comply with
- placing undue reliance on IT-generated reports, valuation reports, or other reports, without appropriately testing the reliability of this data
- failing to get any independent audit evidence when the vast majority of the audit evidence is prepared and provided by management or related parties of the business
- seeking audit evidence to corroborate estimates or data, rather than appropriately challenging them
- no consideration of fraud risk (including financial reporting fraud) and management override in the audit.

Our expectations

Audit firms should continue to emphasise the importance of professional scepticism in their audit work. Staff training can help to improve professional scepticism. However, training alone will not resolve all issues. We expect auditors to evaluate the quality of audit evidence they get in key areas of the audit. If the businesses provide insufficient evidence in areas of key judgment, the auditor should evaluate whether they are able to get other sufficient and appropriate audit evidence to mitigate the risks sufficiently. When the auditor has insufficient audit evidence, we expect to see documentation on how this has affected the audit opinion.

Audit committees and directors should encourage professional scepticism from their auditors, and discuss the work performed and the concerns auditors have regarding management's key judgments. When reviewing audit committee reporting, we noticed a lack of communication regarding key assumptions and the work performed by the auditor in these instances.

We expect to see more discussions between audit committees and auditors regarding these matters. Audit committees and directors could also help the auditor by providing high quality audit evidence to support assumptions made in the key judgment areas of the financial statements.

Using a management or auditor's expert

Accounting standards require businesses to value certain assets and liabilities at fair value. Businesses may either use their own expert or a third party to value these assets or liabilities. In many instances these valuations have a significant impact on the financial results.

The valuation reports provided by these experts vary significantly in scope. In some cases, the third party values the assets and liabilities based on market data; in others, all information included in the valuation is provided by management of the business. The level of the expert's work regarding the reliability of the data varies significantly and requires testing by the auditor. Reports of experts may also contain disclaimers that affect the reliability of the report. When auditors rely on the work of these experts, they are required to:

- evaluate their competence, capabilities and objectivity
- understand their work
- evaluate the appropriateness of their work as audit evidence for the relevant assertion.

In most of the audit files reviewed, auditors' use of experts' work could have been improved.

Examples where audit firms failed to comply:

- Firms failed to assess the competence and capabilities of the expert. In most cases, auditors confirmed whether an expert was independent and qualified. However, this doesn't always mean that the expert has the expertise required. An audit firm's actuary, for example, may not have sufficient expertise in each industry that the audit firm's clients operate in.
- The expert report contained significant disclaimers regarding completeness of information or the reliability of data used, or the value was based on conditions that weren't met at the time of the valuation. The impact of these comments was not addressed by the auditor.
- The audit firm did not engage its own expert when complex methods were used by the expert in an industry the auditor was not familiar with.
- The auditor did not test the completeness, accuracy and reasonableness of significant source data used by the expert.
- Where the audit firm engaged its own expert, the scope of this expert was limited and the audit team did not address the remaining requirements of the standard. Therefore not all matters required were addressed.

Our expectations

We expect to see significant improvement in auditors' use of management or auditor's experts. The main area for improvement is the audit team's evaluation of the adequacy of the expert's work. This is often difficult and challenging, and requires highly skilled staff.

We therefore expect to see significant involvement from both the engagement partner and EQCR partner. Where businesses have significant valuations that require significant industry expertise, we expect the audit firm to engage its own expert to assess the relevance and reasonableness of the key assumptions. This could be an appropriately qualified and knowledgeable in-house, or external,

expert. The auditor's own expert should evaluate the relevance and reasonableness of assumptions underlying the valuation. If experts are not available in New Zealand, the auditor should use overseas experts. The audit team should ensure that either their expert or the audit team addresses all the requirements of the auditing standards.

Audit committees and directors could improve the quality of experts' reporting. The scope of the experts' work for material valuations should be discussed between the directors, management, the expert and the auditor. Where experts disclaim items regarding the reliability of data or assumptions used, the effect of these disclaimers and the level of uncertainty should be clearly documented in the experts' report.

Responsibilities relating to fraud

Auditors are responsible for getting reasonable assurance that the financial statements taken as a whole are free from material misstatement caused by fraud or error. They are required to assess the risk of fraud due to management override, and should also consider the possibility of fraud in revenue recognition.

For many companies, revenue is one of the largest items in the financial statements and is an important driver of a company's operating results. Revenue is typically a significant account, often involving significant risks that warrant special audit consideration. Because of the importance of auditing revenue, it is often an area of focus in our reviews. We continue to observe audit deficiencies in which auditors do not perform sufficient auditing procedures for revenue and management override risk.

All firms' methodologies require audit teams to perform the risk assessment and audit procedures required by auditing standards for fraud. The matters raised below mostly relate to how audit teams apply these in practice. We have identified several areas where auditors should improve the quality and effectiveness of the audit procedures performed.

Issues noted during our reviews include:

- failure to identify the specific risks of fraud or, if circumstances changed during the audit, not considering the risk of fraud in these changed circumstances
- not performing audit procedures to address risks identified in the risk assessment
- lack of appropriate professional scepticism when setting the presumption of fraud by audit teams, or comments that circumstances were unlikely to occur and therefore no audit work was performed
- testing of journal entries to address the risk of fraud and management override not executed appropriately
- relying on the effectiveness of controls without testing their effectiveness, or noting errors in effectiveness and not mitigating this with additional audit work.

- IT-generated reports were used to address risk procedures without establishing the reliability of those reports and without performing any general IT controls.

Overall, we found the documentation of the identification of fraud risks, and the presumption of fraud in revenue recognition, could have been improved. Also, the link between these risks and the audit comfort taken from the audit procedures on an assertion level should be improved.

Our expectations

Auditors should increase their focus on identifying fraud risk factors in both planning and conducting the audit. Auditors should ensure that fraud risk discussions in the audit team are led by the engagement partner, and are focused on identifying fraud risk factors as well as the risks of material misstatement in the financial statements due to fraud.

The assessment of fraud risk factors could be improved by having more meaningful discussions with management, including internal audit and those outside the finance function. These discussions should focus more on fraud risks rather than any frauds already identified. Further, fraud risk factors should be reassessed at the end of the audit and a conclusion reached as to whether fraud risks have been reduced to an acceptable level.

Audit committees also play a role in ensuring audit quality. Their discussions with the auditors about the audit plan, as well as the audit findings, can be particularly helpful. Audit committees could improve their oversight of fraud risks in the audit process. We expect audit committees to discuss fraud risk factors with their auditor, and the controls the business has in place to mitigate the risk of material misstatement in the financial statements due to fraud. Audit committees should also discuss with their auditors how they have concluded on their audit procedures to respond to the risks of material misstatement due to fraud.

Materiality

The auditing standards recognise that setting materiality is a key part of the audit. The auditor uses the concept of materiality in planning and performing the audit to detect material misstatements. At the conclusion of an audit, the auditor determines whether the uncorrected misstatements identified are, individually or in aggregate, material to the financial statements.

Determining materiality requires the auditor's judgment and takes into account the needs of those who use financial statements. Information is material if misstating or omitting could influence users' decisions based on the audited financial statements. Misstatements or omissions may be judged to be material due to their size and/or nature.

When reviewing materiality calculations we noted that all firms have templates for setting overall materiality, performance materiality and 'clearly trivial' limits. While the templates require or encourage narrative explanations of judgments, auditors did not always appropriately explain and justify their judgments. In particular, when an auditor decided that profit before tax was not an appropriate benchmark, we noted that the decision to choose another benchmark was poorly documented.

Most firms also have acceptable percentage ranges for determining both overall materiality and performance materiality, and there is a clear distinction between public interest and non-public interest businesses. In most cases, materiality levels were at the maximum permitted under the firm's guidance, irrespective of the risks identified. This approach is not consistent with the appropriate exercise of individual judgment required by the auditing standards.

Further, we noted that some firms use a two-tier materiality approach, where they use a different materiality for testing the balance sheet and profit-and-loss account.

This does not comply with the auditing standards, which require setting a single materiality level for the audit. Since errors in a balance sheet account may affect the profit, the use of a higher balance sheet materiality level may result in material error in the profit not being identified.

Our expectations

Audit firms should help audit teams judge materiality and appropriately address the areas identified in this report. We expect to see internal consultation where either complex judgments are required, or audit teams propose to use a higher percentage of a chosen benchmark than is generally used within the firm for determining materiality. We also expect better documentation of the consideration of risk in setting performance materiality. This should not necessarily be set, as a default, at the highest level allowed under their firm's guidance.

Audit committees can also play an important role in ensuring that the materiality levels set are appropriate. They should understand the basis for the materiality levels set, including how these reflect the needs and expectations of those who use the financial statements, and how materiality levels affect the extent of audit work undertaken in significant areas.

Areas for improvement

In our two previous audit quality reports, we noted 10 key areas that required improvement. We have seen improvement in some of these areas. Several factors can affect the cumulative results of the quality reviews, such as the audit firms and audits selected for review. Although we have seen improvement in the areas below, there is still room for further improvement.

Going concern assumptions

Last year we raised concerns about the audit work, disclosures in financial statements, and audit opinions issued about 'going concern' assumptions. We also issued a separate report on the disclosures of going concern assumptions in financial statements. In the audit files reviewed over the year, we saw more consideration by auditors of the specific requirements of the auditing standard. However, we still have some concerns.

These include:

- audit files lacked audit evidence that assumptions made by directors regarding going concern were appropriate
- auditors identified a material uncertainty, but the financial statements did not meet the mandatory disclosures
- a lack of communication with those charged with governance regarding the going concern assumption, where an auditor intended to issue a modified opinion.

Our expectations

We expect to see further improvements in the work on going concern assumptions, especially where there is a material uncertainty.

We recommend that audit firms communicate promptly with the audit committee, directors and management if the auditor believes a material uncertainty exists regarding going concern.

The auditor should provide specific guidance regarding the required disclosure, as mentioned in the auditing standard, and ensure the business provides high quality audit evidence for their assumptions. The documentation for the type of audit opinion issued should be supported by the audit evidence, and the disclosures provided by the business in the financial statements, and clearly documented.

Sampling

The appropriate use of audit sampling in performing audit procedures is important to determine whether there is sufficient audit evidence. We have seen improvements in the documentation of sample sizes that are chosen according to audit firms' methodologies. However, we have continued to see issues in the audit work, including:

- tests of details were conducted by applying the sample size formula for a controls test. In such cases, the audit team may not have applied the correct sample size under the firm's methodology
- where the firm's methodology did not provide guidance on sample sizes, the auditor used mainly professional judgment to select the sample size. In such cases, the audit team did not document the basis for determining the sample size, and how the audit team ensured the sample was representative of the population. This was evident in areas such as cut-off testing or testing the reliability of IT-generated reports
- the documentation for the selection of sample sizes for statistical sampling did not show how the sample was designed, or which items were selected for testing. In other instances, the selection was based on the highest values. In these cases, not every sampling unit had a possibility of being selected and therefore did not comply with the auditing standard
- where exceptions were found in sample tests, they were often explained without any further enquiry. The auditor did not project errors to the total population or, in instances of control testing errors, did not seem to consider the appropriateness of relying on the effectiveness of these controls.

Our expectations

While an audit firm's methodology may be fully compliant with the auditing standard, the main issue we noted during quality reviews was the application of the methodology. Sample selections and sizes may differ when an auditor's judgment is applied. It is therefore important that all factors influencing audit sampling are clearly documented to support this judgment.

We expect to see better documentation in audit files regarding the selection of samples. Where exceptions are found in sample tests, auditors should investigate the nature and cause of the exceptions, and evaluate their possible effect on the purpose of the audit procedure and other areas of the audit. Exceptions should only be treated as an anomaly in rare circumstances where the auditor has a high degree of certainty that the exceptions are not representative of the population. Additional audit procedures should be performed to support such a conclusion.

Analytical procedures

We have noted some improvements in the use of analytical procedures. This may be a result of an overall reduction in the use of analytical procedures in key areas of the audit. Where analytical procedures were used, we have seen more audit evidence that enabled the auditor to perform higher quality analytics. However, we still noted areas for improvement within the four-step model auditors are required to use to ensure they get sufficient audit evidence from these procedures. Examples include:

- the comfort that was intended to be obtained from the analytical procedures, together with other substantive procedures, could have been made clearer
- thresholds used in the analytics that exceeded the overall materiality. In other instances, the financial information in the analytics were significantly disaggregated while maintaining the overall performance materiality. We believe that in these examples the expectation in the analytics was not 'sufficiently precise' to detect a material misstatement
- where differences were noted between the recorded amounts and expected values above the threshold, no further appropriate audit evidence was obtained
- auditors used IT-generated reports for analytical procedures without establishing the reliability of these reports.

Our expectations

When audit teams consider relying on substantive analytics as a test of detail, each step of the four-step model required by the auditing standard should be performed to a high standard, to get sufficient and appropriate audit evidence from analytical procedures.

Related-party transactions

The auditor is required to get appropriate and sufficient audit evidence for related-party transactions. These include the requirements that they are appropriately disclosed in the financial statements. We noted improvements in the disclosure of related parties in financial statements. However, we still found that auditors place undue reliance on information provided by management. In such cases, we did not see evidence that the audit team had performed procedures designed to identify undisclosed related parties and related-party transactions, and whether these transactions were on commercial terms as disclosed in the financial statements.

Our expectations

Audit firms should reinforce to engagement leaders and staff the need to document their understanding of matters, all audit work performed, and the audit evidence for related-party transactions, to ensure compliance with the auditing and assurance standards.

We expect clear documentation demonstrating how all assertions on related-party transactions have been substantiated.

Future focus

Auditor reporting

The global financial crisis of 2007 and 2008 resulted in an increased focus on financial reporting and the role that auditors play in supporting the true and fair view of financial statements.

The auditor's report is the key communication of the results of the audit process. Investors and other financial statement users have asked for a more informative auditor's report and for auditors to provide more relevant information to users. The International Auditing and Assurance Standards Board (IAASB) and the External Reporting Board (XRB) in New Zealand have researched, consulted the public about, and discussed with stakeholders, a new auditor's report. These initiatives have indicated that improved auditor reporting is critical to influencing the perceived value of financial statement audits.

A new auditor's report will be required for all New Zealand listed issuers with a reporting period ending on or after 15 December 2016. Under the new standard, the auditor will be required to communicate key audit matters, and the auditor's report will include the name of the engagement partner.

Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. The auditor will be required to report why the matter was considered to be so significant, and how the matter was addressed in the audit. This will provide users of financial statements with additional information about the audit that was previously not available.

Our expectations

The inclusion of key audit matters will increase the importance of communication between the auditor and directors and audit committees. We welcome the new reporting as we believe this will improve the information that is available for investors.

As each business has different key audit matters, and auditors will apply their judgment differently, we expect to see reporting that is unique and specific for each business. The auditor's report also provides auditors with the opportunity to explain their audit work to users of financial statements.

To enable a successful transition from the old reporting to the new reporting, we recommend audit committees and directors engage early with their auditors on the new requirements. Where possible, we also recommend performing a 'test run' of the new audit report in the upcoming reporting period, before the standard comes into effect.

Our work on the new reporting

We will pay specific attention to the implementation of the new standard. In the first two years of its implementation, we will focus our work on the disclosures made in the audit opinion, and the audit work supporting the key audit matters in the audit report.

When reviewing audit files we will review the process followed by the audit firm to determine the key audit matters, and whether the audit work fairly reflects the disclosure in the audit report. After the first two years, we will report our findings in a separate report.

Quality reviews

In the 2015/2016 period, our quality review programme will focus on the risks that non-complying FMC reporting entities pose to investors, and will build on the results of previous quality reviews.

Where audit firms have been subject to quality review, they are required to report to us on how they have addressed any issues identified, within our prescribed timeframe.

Where we believe responses by the audit firm are not appropriate, we may issue directions to the audit firm to make required changes. We will conduct follow-up reviews of firms where we conclude that a review is unsatisfactory.

These ongoing reviews help ensure that registered audit firms are taking appropriate actions to address our findings.

Each year we will aim to review approximately a third of licensed auditors and registered audit firms. Our focus during the second cycle of review will be on the effective implementation of firms' remediation plans and will allow us to review certain areas in more depth.

The areas of focus for quality reviews for this period are set out in the following table:

Area	Standard
Auditor independence	PES 1
Audit fees and audit performance	ISA (NZ) 200
Professional scepticism	ISA (NZ) 200
Audit quality control system and monitoring	ISA (NZ) 220
The auditor's responsibilities relating to fraud in an audit of financial statements	ISA (NZ) 240
Understanding of the FMC reporting entity and its environment	ISA (NZ) 315
Audit evidence and documentation	ISA (NZ) 500 & 230
Use of management's experts	ISA (NZ) 500 & 620

For a full overview of our key areas of focus, refer to our *Auditor Regulation and Oversight Plan 2015-18*, which is available on our website.

We also continue to expand our relationships with other regulators such as the Australian Securities and Investment Commission, which may lead to joint reviews in the future.

Auditor regulation survey

In April 2015 we did a survey on the implementation of the auditor oversight regime. We invited market participants to complete an online survey to help us measure the impact of auditor regulation in New Zealand.

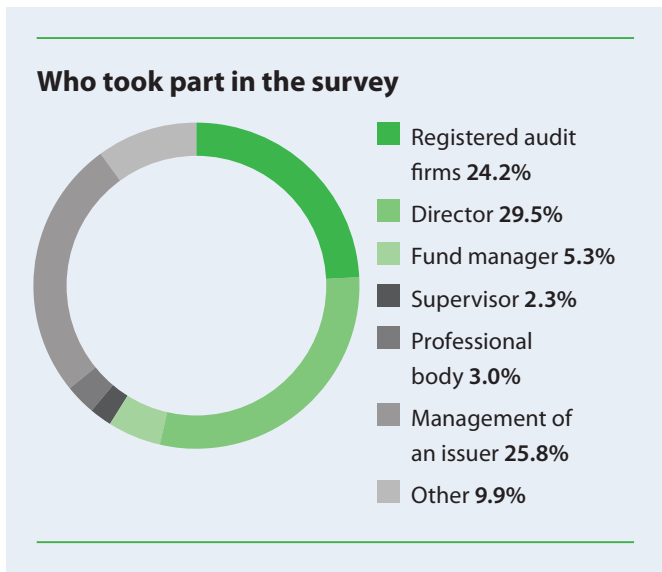
In total, 132 participants completed the survey, with 50% coming from Auckland and 20% from the Wellington region. Questions in the survey could be skipped, so about 80 to 100 participants answered each question.

Full results of the survey are available on our website.

- use of professional scepticism by the auditor
- use of management or auditor experts
- audit evidence and documentation, together with monitoring of audit quality by audit firms.

Quality reviews

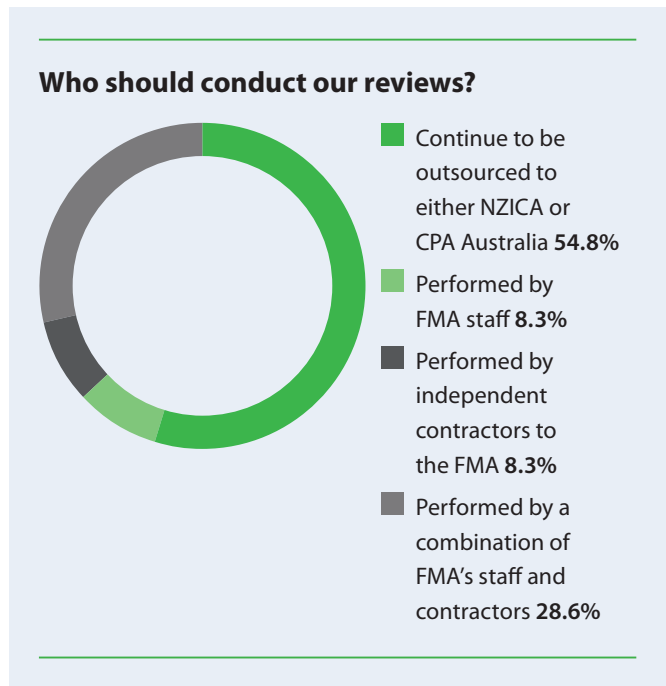
At the start of the auditor oversight regime in 2012, the FMA was not set up to perform quality reviews in-house. We therefore engaged the New Zealand Institute of Chartered Accountants (NZICA) to do so on our behalf, as permitted by the Act. The contract was renewed in 2014. The Act provides us with the opportunity to outsource our quality reviews, and we asked in our survey how we should conduct our reviews once this contract ends on 30 June 2016.



Audit quality

Most of those surveyed noted an improvement in audit quality over the past two years. They indicated several reasons for this, including the introduction of auditor oversight, but also regulation in other jurisdictions that has an impact on global networks. They also believe that smaller audits have benefited from regulation.

When evaluating the results of the quality reviews over the previous two years, those surveyed were most concerned about the following non-compliance (in order of importance):



While we acknowledge the results of the survey, we have decided to bring the quality reviews in-house and will use a combination of FMA staff and contractors to perform the work.

We will therefore not be extending the agreement with NZICA. This decision will ensure we are aligned with international audit regulators and is not a reflection on NZICA's performance of quality reviews.

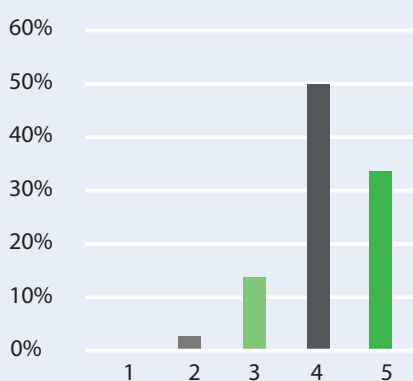
Independence

An important part of the audit profession is public perception of the auditor's independence. The following table shows that most participants believe audit firms are independent from FMC reporting entities. Where participants rated the independence between 1 and 3, most believed that independence is affected by the provision of non-audit services by the audit firm.

In total, 109 participants responded to the question regarding the level of independence of audit firms performing FMC audits. As auditors may be biased on this issue, we have excluded their responses from the results.

How independent are audit firms?

(On a scale of 1 to 5, 1 is 'not independent' and 5 is 'very independent').



Availability of auditors

Most participants told us there are sufficient auditors available. However, some regions are concerned, including Northland, Bay of Plenty, Marlborough, Manawatu and Southland. We note that there are few or no auditors in these regions and that this is unlikely to change in the near future.

International recognition

An important function of auditor regulation is the international recognition of New Zealand auditors. Only 13% of the survey participants thought that international recognition could be improved, especially in Australia and the UK. We continue to focus on the European recognition of New Zealand auditors. The trans-Tasman mutual recognition arrangement addresses the recognition of New Zealand auditors in Australia.

Reporting

We asked whether we should make individual monitoring reports public or partly public, similar to the US or the UK. Just under two-thirds of respondents were in favour.

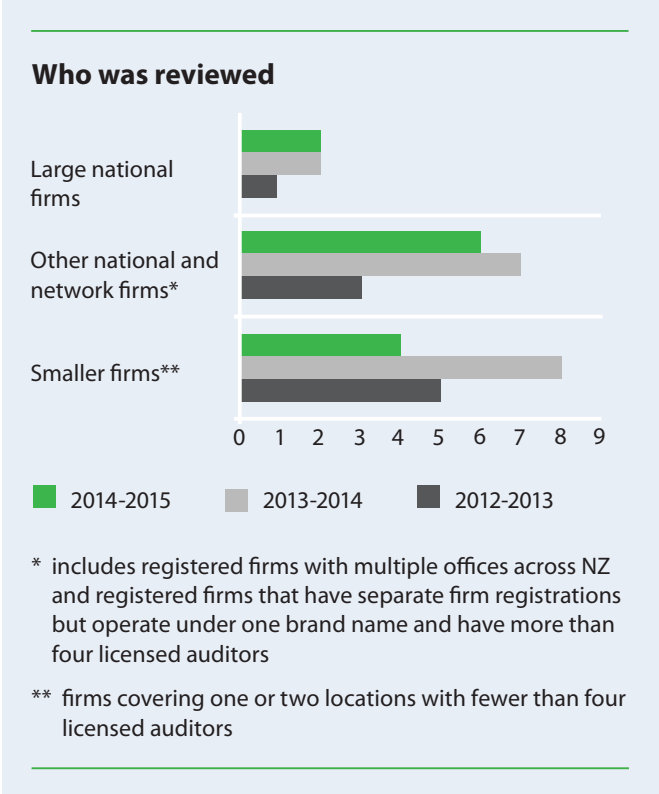
We also noted that our published reports, such as the auditor oversight and regulation plan and our annual quality review report, are not always noticed by the intended users. We will try to improve the visibility of these reports and ensure that we use our technology better to reach a wider public. Both reports are available on our website in our reporting section.

Appendix 1 – Quality review framework

Under the Act, each registered audit firm and every other audit firm that has at least one partner, director, or employee who holds a licence issued under the Act, will be subject to a quality review at least once in every four-year period. To remain internationally aligned, we try to keep our review cycle consistent with the EU, which currently has a three-year cycle.

The New Zealand Institute of Chartered Accountants (NZICA) conducts the quality reviews as a delegate of the FMA under the Act. These quality reviews are carried out under our approved methodology, and we approve the programme and schedule of the firms and licensed auditors selected for review. The timing and frequency of reviews and selection of audit files are determined using a risk-based framework and will therefore differ between audit firms.

During the year, 12 registered audit firms were reviewed, covering half the licensed auditors in New Zealand.



Quality review methodology

The purpose of quality reviews is to ensure that the systems, policies and procedures of audit firms comply with the requirements of the Act and other relevant legislation, as well as Auditing and Assurance Standards. Audit firms must also use reasonable care, diligence and skill in carrying out FMC audits.

The Act prescribes certain matters that must be included in a quality review and our review methodology is designed accordingly. Our primary focus is on the quality of FMC audits. There are two key elements:

- assessing the audit firm's overall quality control systems
- reviewing a selection of individual FMC audit engagement files.

Quality reviews during the year focused on the key areas set out in our *Auditor Regulation and Oversight Plan 2015–2018*.

Quality control systems

Auditors and audit firms must comply with several different sets of governing standards, including standards that set out requirements for the quality control of audit engagements. These requirements include that audit firms must establish and maintain a system for quality control, which must include policies and procedures to address particular matters such as acceptance and continuance of client relationships, ethical requirements, and monitoring of the quality control system.

Assessment of an audit firm's quality control system is focused on whether the system is compliant with the relevant standards, whether the policies and procedures within the system are being adhered to, and whether the system is contributing to high quality FMC audits. We also evaluate the effectiveness of the internal monitoring of the audit quality control system by the audit firm.

Another important aspect of quality control is the requirement to perform an engagement quality control review (EQCR) on each FMC audit file.

The EQCR is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team has made and the conclusions it has reached in formulating the auditor's report. The EQCR has to be performed by a licensed auditor who is suitably qualified, with sufficient and appropriate experience and authority to give the objective evaluation required.

Individual file reviews



Individual file reviews are carried out to assess compliance by the licensed auditor with auditing and assurance standards, and whether the licensed auditor has exercised reasonable care, diligence and skill in carrying out FMC audits.

A quality audit should include, at a minimum:

- the performance of an independent audit by a licensed auditor
- the application of an appropriate level of professional scepticism
- the issuance of an audit opinion that can be relied upon, because sufficient and appropriate audit evidence has been obtained and the auditing and assurance standards have been followed.

Our selection of individual FMC audit engagement files for review is based on the level of risk that the FMC reporting entity may pose to investors, and the level of public interest in the FMC reporting entity. It also takes into account the audit firm's policies and procedures regarding audit quality.

During the year, the selection of audit files focused, where possible, on:

- businesses that are likely to be of significant public interest based on the value of securities issued to the public, such as KiwiSaver schemes and listed companies
- businesses and industries that are more vulnerable to risks from existing and emerging market conditions, and other higher-risk entities such as finance companies.

We also try to ensure that audits carried out by different licensed auditors within a registered firm are subject to review. We rate the quality of the audit work we examine on individual FMC audits on three levels:

- good, or good with limited improvements required
- improvements required
- significant improvements required.

An audit is classified as requiring significant improvements if:

- we have significant concerns about the sufficiency or quality of the audit evidence in one or more key areas of the audit; or
- the review detected a material error in the financial statements; or
- we have significant concerns about the appropriateness of audit judgments in one or more key areas of the audit; or
- the implications of concerns in other areas were considered to be individually or collectively significant.

Appendix 2 – Market data

	30 June 2015	30 June 2014	30 June 2013
Domestic licensed auditors	150	141	150
Domestic registered firms	29 ²	30 ²	40 ³
NZX listed companies	162	147	135
FMC audits	1,700	1,700	1,550

	30 June 2015	30 June 2014	30 June 2013
New licences issued to domestic auditors	10	8	18
Licences cancelled from domestic auditors	1	17	18
Registrations cancelled or registration expired from domestic auditors	0	11	5
Firms reviewed	12	17	9
Audit files reviewed	38	56	33

² This includes nine registered firms that have separate firm registrations, but operate under two brand names

³ This includes 13 registered firms that have separate firm registrations, but operate under two brand names

Glossary

Accounting standards	The New Zealand equivalent to International Financial Reporting Standard issued by the External Reporting Board
Act	<i>Auditor Regulation Act 2011</i>
Audit firm	Registered audit firm as defined by the Act
Auditing and assurance standards	The auditing and assurance standards issued by the External Reporting Board
Auditing standards	International Standard on Auditing (New Zealand) to be applied in conducting audits of historical financial information as issued by the External Reporting Board
Auditor	Licensed auditor as defined by the Act
EQCR	Engagement quality control review. This is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team has made and the conclusions it has reached in formulating the auditor's report.
EQCR partner	Licensed auditor who performs the EQCR. This may be a licensed auditor who is not a partner in the audit firm
FMA	Financial Markets Authority
Going concern	Under the going concern assumption, a business is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless those charged with governance either intend to liquidate the business or to cease operations, or have no realistic alternative but to do so
ISA (NZ)	International Standard on Auditing (New Zealand)
FMC reporting entity	Has the same meaning as in section 6 of the <i>Auditor Regulation Act 2011</i>
FMC audit	Has the same meaning as in section 6 of the <i>Auditor Regulation Act 2011</i>
NZICA	New Zealand Institute of Chartered Accountants
Professional scepticism	An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

PES Professional and Ethical Standard

Quality review Means a review of an audit firm as defined in the *Auditor Regulation Act 2011*

Revenue recognition Incorporating the gross inflow of economic benefits (cash, receivables, and other assets) arising from the ordinary operating activities of a business (such as sales of goods, sales of services, interest, royalties, and dividends) in the income statement when it meets the following criteria:

- it is probable that any future economic benefit associated with the item of revenue will flow to the business, and
- the amount of revenue can be measured with reliability.
