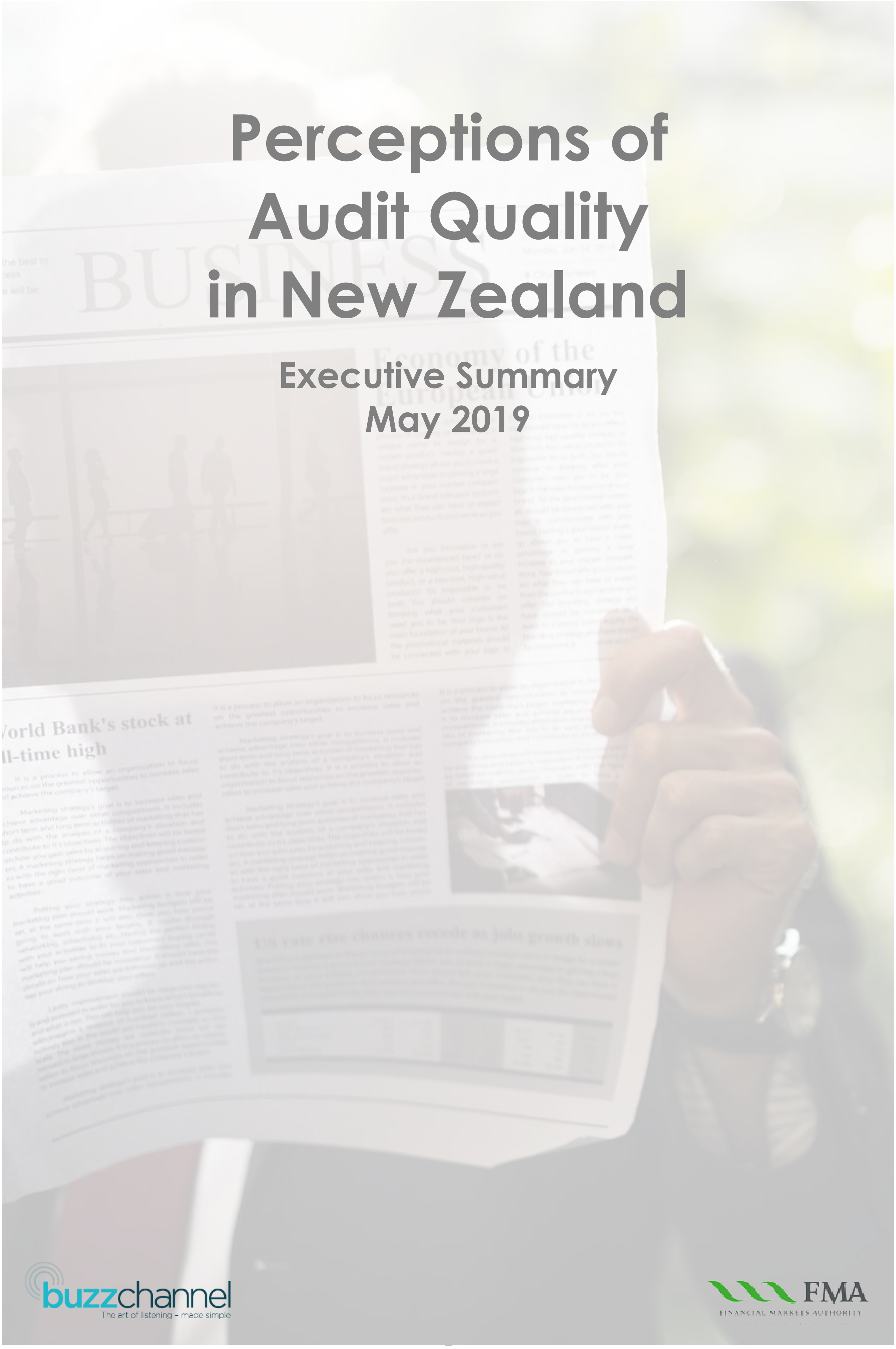


Perceptions of Audit Quality in New Zealand

Executive Summary
May 2019

buzzchannel
The art of listening – made simple

FMA
FINANCIAL MARKETS AUTHORITY

Background

The FMA commissioned Buzz Channel to conduct research to help understand how users of audit services in New Zealand perceive auditors' contribution to fair, efficient and transparent NZ financial markets.

This is the first time the FMA has conducted audit quality research, and therefore provides a baseline measure of confidence, trust, professionalism, and perceived quality of the audit process, and the perceived benefits from a users' perspective.

The overall aim of this research is to inform the FMA of public and industry perceptions of audit quality in New Zealand and enable them to target work to increase understanding of the auditor's role and improve awareness of the FMA's role of oversight and regulation of auditors.

An online survey was distributed via email to audit industry stakeholders, and professional and retail investors who use audit services either directly or indirectly.

A total of 357 people took part in the research, between 28 November and 14 December 2018.

A second round of research took place with a total of 15 investors and other stakeholders taking part in in-depth interviews.

These took place between 19 and 28 March 2019, with interviews carried out by Buzz Channel lasting for between 30 to 40 minutes.

4 individual/retail investors, 2 professional investors, 3 directors/ARC members, 3 managers and 3 auditors were interviewed.

This executive summary highlights the key findings of this combined research project. Results are represented according to the 5 key groups surveyed.

A full version of the quantitative research can be found here.

n=193

Individual/Retail Investors:
Invest in New Zealand businesses, for example through the NZX or as a private equity investor.

n=10

Professional Investors:
Investment Manager or institutional investor such as fund manager, investment broker or manager.

n=56

Directors and ARC: *Company Directors of (listed and unlisted) New Zealand based companies (n=41), members or Chairs of an Audit and Risk Committee (n=15)*

n=36

Managers:
Managers of FMC licensed entity or issuer (firms the FMA regulates and monitors - this includes issuers or providers of equity or debt offers, derivatives and MIS. This may also include banks and insurance companies as they are licensed by the RBNZ.)

n=62

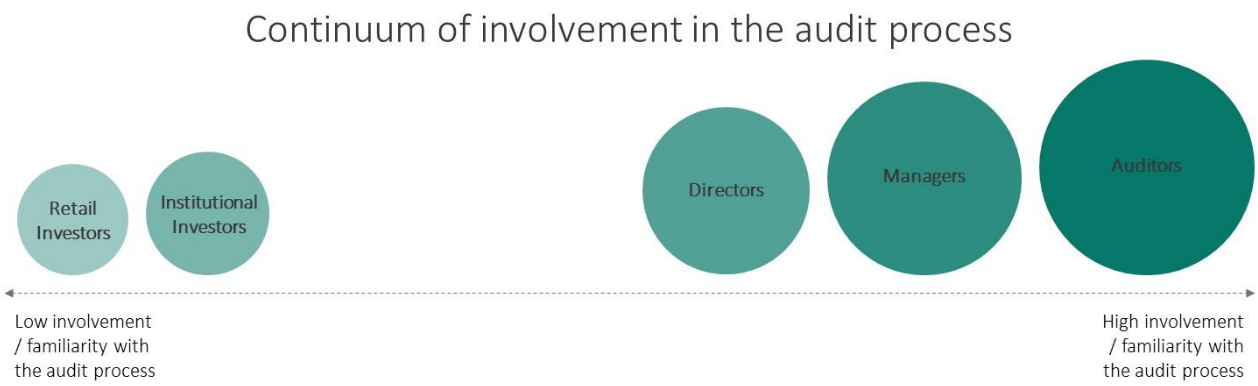
Auditors

Overall: Findings indicate perceptions of audit quality in New Zealand are significantly more negative among investors than directors/ARC

The overall theme emerging from investors showed while there was a range of views, in general there is a lack of faith and trust in the audit profession and the quality of audit in NZ.

Overall, participants felt that the primary reason for this difference in perceptions among the key groups related to the level of involvement or 'closeness' to the audit process. Since the auditors themselves, and the managers (and to a slightly lesser extent directors) are intimately involved in the audit process and get to see first-hand the way audits are conducted, the way the auditor challenges the entity, the robustness of the discussions and debates, the quality and integrity of the auditor etc., participants felt it was not surprising these groups would trust the process. On the other hand, since investors do not get to see the audit process first-hand, people felt it was not surprising they were less trusting.

These results can be summarised as a continuum of involvement in the audit process, as below:



Investors had concerns about the independence of auditors from the entities they audit, lack of professional scepticism, and auditors not asking questions and challenging the judgement of the management and directors. In contrast the directors rated auditor independence fairly high (71% agreed).

A lack of competition and choice was mentioned by investors, referring to a small pool of audit firms available and the big four or five organisations who have a large share of the market. Sector experience was rated as an important factor when selecting an audit firm, and this combined with a small market in New Zealand and audit companies offering other consultancy services to their audit clients was talked about as contributing to an auditor being re-engaged and building a strong relationship with the entity they're auditing, in turn leading to a conflict of interest. This perceived lack of independence came through as a strong concern of investors and some directors.

Areas of opportunity include:

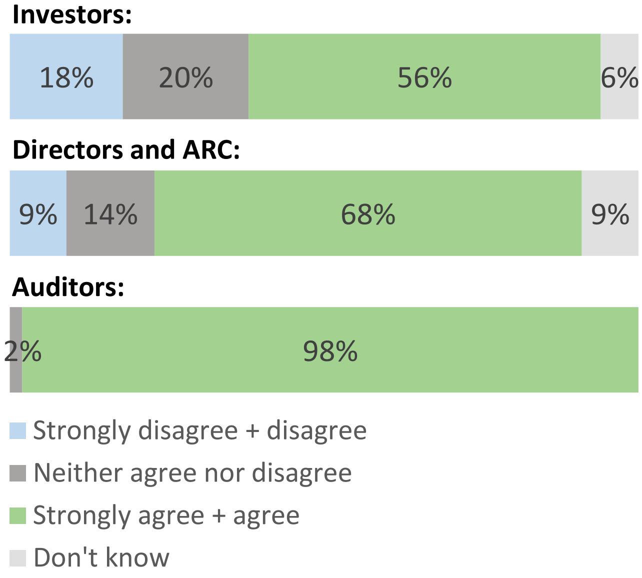
Communicating tangible **examples of the value of audits** to all stakeholders, investors and directors/ARC

Look at ways of addressing the negative perception among some investors regarding the **independence of auditors** and improve trust levels in the auditor engagement process

Audit statements being clear and easy to understand was rated fairly low by both investors and directors – perhaps investigating changes here such as an easy to read summary included would be of benefit

Trust: Trust in the audit profession in New Zealand is significantly lower among investors than other stakeholder groups

Extent agree or disagree '*I **trust the audit profession** in New Zealand **to act with ethics and integrity***':



In depth interviews: Many participants expressed surprise that the ratings were so low among investors and directors. However, many felt that general direction of the findings were logical – those closer to the process would have more confidence. A common theme from many was that the audit industry did not do a great job of promoting itself.

Investors: Just over half of investors agreed they trust the audit profession in NZ to *act with ethics and integrity* (56%) and 18% disagreed. Among those who didn't agree, the main factors influencing trust in the audit profession to act ethically include perceptions that auditors will accept an auditing job even though there is a conflict of interest (due to financial motivation to get the business), awareness of recent cases where audited businesses failed, and instances of breaches of ethics.

Directors and ARC: Trust in the audit profession in NZ is significantly higher among directors/ARC than investors, with 68% agreeing, and only 9% disagreeing. The proportion of those who didn't agree made similar comments to investors relating to instances of conflicts of interest, and scepticism about the independence of auditors from the entities they are auditing.

Managers: The majority of managers agreed they trust the audit profession to *act with ethics and integrity* (97%). Only 3% didn't know / weren't sure.

Auditors: Virtually all auditors agreed they trust the audit profession to *act with ethics and integrity* (98%). 2% gave a neutral rating.

Key comments from in-depth interviews:

Auditor: *"I don't think auditors are great at promoting themselves in terms of quality."*

Manager: *"Investors see the report, but they don't have any real face-to-face involvement, they're not comprehending the process that's undertaken. That's probably why, there is a lack of comprehension of the auditor role in the investment market"*

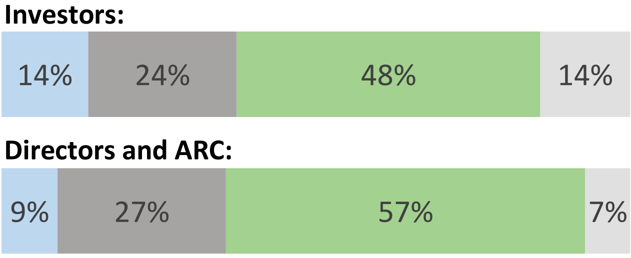
Auditor: *"I suspect if you asked investors why they don't trust auditors it'd be nothing to do with the integrity of the audit, it'd be because the business missed forecast or there was an unexpected loss- nothing to do with the auditor.."*

Retail investor: "*I go to a few AGMs and I think it wouldn't be a bad idea for auditors to be there and make some comments. I think it'd be good if they actually did say something – they produce quite a long form audit report, maybe they could give just a summary of that, a brief synopsis."*

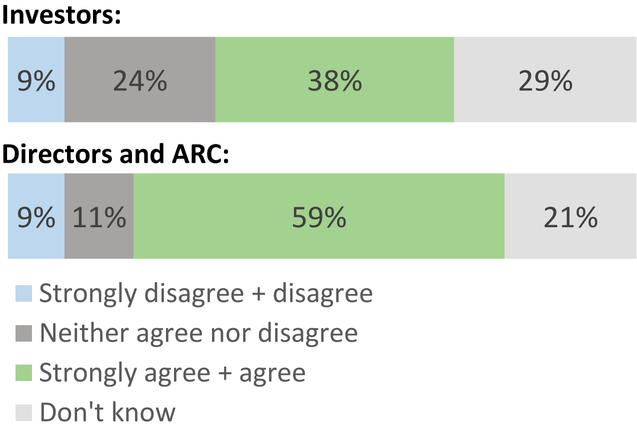
Director: *"On trust you need to distinguish between those who read the newspaper, the mum and dad investors and institutional investors. For the general public and average investor, the damage is done when they see high profile cases of failure... and the auditor gets tarred even if the failure is nothing to do with the audit..."*

Quality: Opinions about audit quality in NZ more positive among directors/ARC than investors

Extent agree or disagree '*The **quality of auditors** in New Zealand is generally of **a high standard**'*:



Extent agree or disagree '*The **quality of the audit firm** acting on your behalf, or on behalf of your business, is of **a high standard***':



Investors: Just under half of investors agreed the *quality of auditors* in NZ is of a high standard (48%) and 38% agreed the quality of the audit firm is of a high standard.

Directors and ARC: Directors and audit and risk committee members have much stronger opinions than investors about the quality of auditors and the audit firms acting on their behalf. Well over half agreed that the quality of the auditor (57%) or audit firm (59%) acting on behalf of their business is of a high standard.

Managers: The majority of managers agree that the quality of the auditor (92%) or audit firm (97%) acting on behalf of their business is of a high standard.

Auditors: The most important factor auditors feel contribute to audit quality in their firm is the *culture*. Auditors believe a good culture in the audit firm drives consistency, long term results and a higher overall quality of work. When considering the entity being audited, auditors rate the *quality of the financial reporting* of the entity as the most important factor influencing audit quality.

Reasons for not agreeing:

***Retail Investor:** "I believe the standard should be much higher than it generally is. Also, that there are not enough measures in place to avoid conflicts of interest, not enough competition or performance oversight."*

***Director:** "Auditors are rarely independent of management and investment communities; they risk losing income from client base if they set high standards."*

***Director:** "Lack of oversight and conflicts of interest."*

Auditor perceptions:
Most important factors at an audit firm that contribute to audit quality:

33%
Culture at the audit firm

15%
Expertise in the audit team

13%
Senior staff time spent on audit

Most important factors to the entity being audited that influence audit quality:

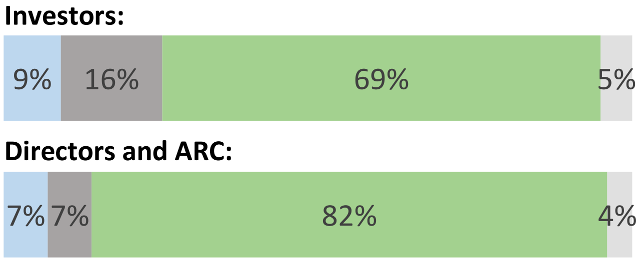
47%
Quality of entity's financial reporting

16%
Open / constructive relationship

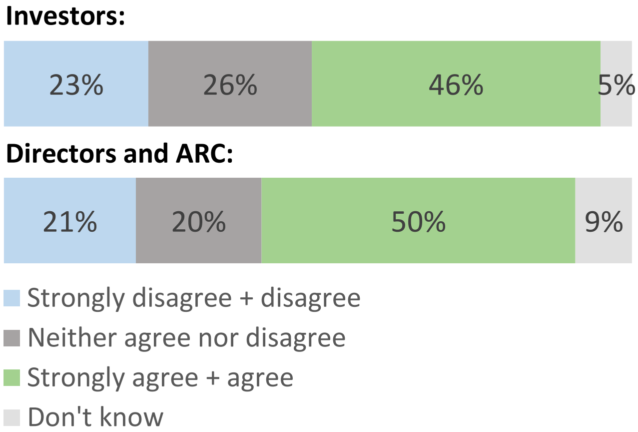
10%
Quality of the audit committee

Reliability and clarity of audited information: Directors/ARC indicated higher agreement than investors that audited information is more reliable

Extent agree or disagree ‘*Audited information provides investors with* ***more reliable information*** *than unaudited information*’:



Extent agree or disagree *‘I find audited financial statements and information* ***clear and easy to understand’***:



Investors: 69% of investors agree that audited information *provides more reliable information* than unaudited information. Of the quarter who didn’t agree, the main reasons given include raw information provided being accepted by auditors without question. Audited financial statements are considered *clear and easy to understand* by just under half of investors (46%), while 23% disagree. The main reason for not agreeing is the complexity of the financial data.

Directors and ARC: Directors and audit and risk committee members indicate significantly higher agreement than investors that audited information is *more reliable than unaudited information* with 82% agreeing. Director/ARC perceptions of the audited information being *clear and easy to understand* are very similar to investor views, with similar ratings and similar comments made by those not agreeing, such as the complexity and technical data.

Managers: The majority of managers agree that *audited information is more reliable than unaudited information* (97%). Three quarters (75%) agree that *audited statements are clear and easy to understand*, while 22% disagree.

Reasons for not agreeing:

Director: *“Auditors are more concerned with non-sensical accounting standards than they are with the truth.”*

ARC: *“Information needs to be presented in plain English and practical terms including even diagrams. We are supposed to be communicating for the benefit of the investor.”*

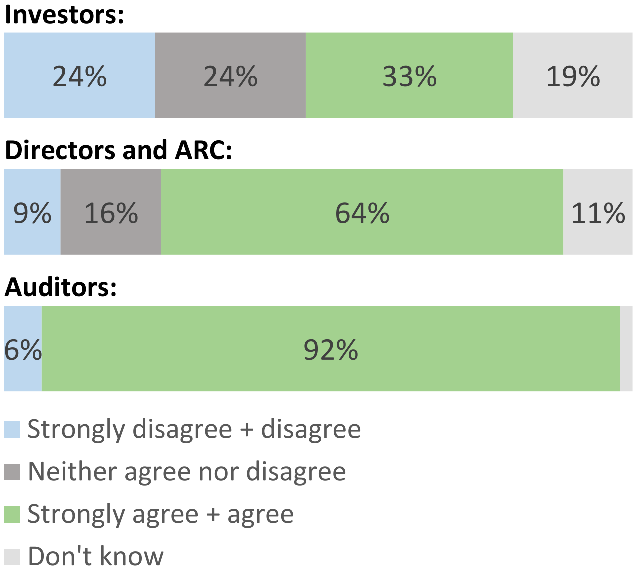
Director: *“Opinion based on experience and healthy skepticism.”*

Retail Investor: *“Mainly because it is couched in obscure language and there is doubt over the independence of auditors.”*

Retail Investor: *“Formal financial data presented too technical for lay person. A summary of relevant points would be helpful.”*

Competition and choice: Investors perceive there is a lack of competition and choice when selecting an auditor/audit firm in New Zealand

Extent agree or disagree that '*There is **sufficient competition and choice** when selecting an auditor/audit firm in New Zealand*':



Investors: A third of investors agreed there is *sufficient competition and choice* when selecting an auditor/audit firm (33%), and a quarter disagreed (24%). The main comment made by those not agreeing is that there is a limited pool, with the four or five big audit firms mentioned. Some investors talked about it being rare for businesses to change auditors leading to a close relationship over time. Also mentioned by a few is that for larger companies only the big audit firms would have the competence and resource to conduct the audit, and a few mentioned that New Zealand is a small market so there is limited expertise in some sectors.

Directors and ARC: In comparison to investors, two thirds of directors/ARC agree there is *sufficient competition and choice* (64%) and only 9% disagreed. Comments from those disagreeing are similar to investor views, relating to the dominance of a small number of big audit firms.

Managers: Three quarters of managers agreed that there is *sufficient competition and choice* when selecting an auditor/audit firm (75%).

Auditors: Almost all auditors agreed there is *sufficient competition and choice* (92%). The small number of auditors who disagreed (N=4, 6%) mentioned the limited pool of audit firms in NZ.

Reasons for not agreeing:

ARC: *"We look for big four type firms and the mid-range firms are often not able to assist a licensed entity. Brand does matter."*

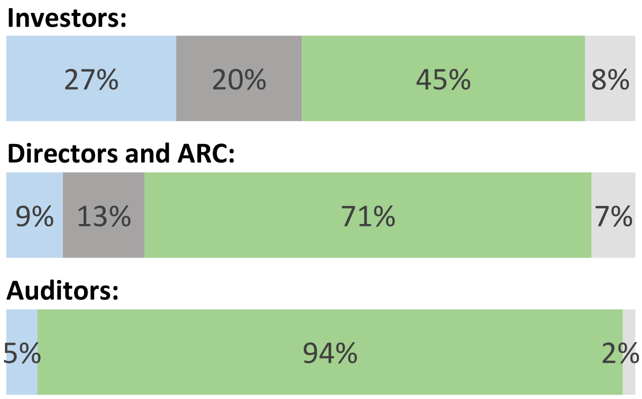
Auditor: *"There are fewer and fewer audit firms available to FMC entities, thus reducing the pool of choice. This has come about from over regulation."*

Retail Investor: *"I accept there is choice, but I am not sure auditors work in a really competitive environment. It seems to me that it is fairly rare for a company to change auditors."*

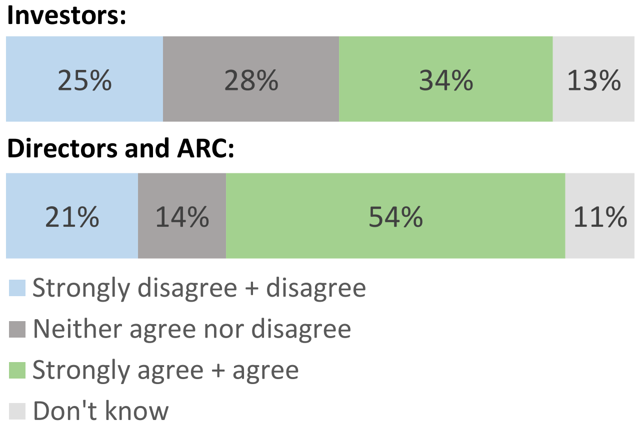
Retail Investor: *"A very small range/number of auditors is available… and there are not enough specialised auditors in various fields, e.g. construction."*

Independence: Directors/ARC views are very different to investors

Extent agree or disagree ‘*Auditors are **sufficiently independent** from the entities they audit*’:



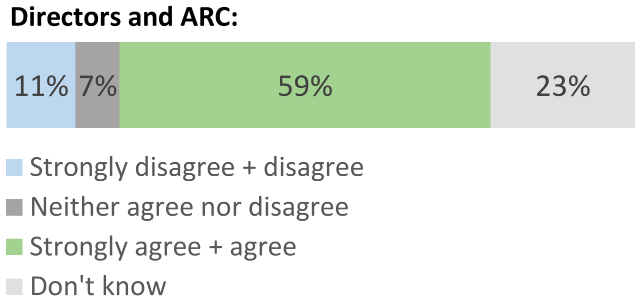
Extent agree or disagree ‘*Auditors **challenge the judgement** of the management and directors of the entities they audit*’:



Auditors: Auditors felt their firms processes prevented any conflict of interest arising from the provision of non-audit services. Beyond internal rules and processes, they also felt that even if other parts of the firm have a relationship with the entity, they didn’t get involved in these services, had little knowledge of what was being provided and this had no impact on the audit. Some auditors were aware of the separation of duties that was being imposed in the UK and could see this happening in NZ in future.

Auditor: *“There are scenarios where sometimes two partners are asked to operate on different sides of the transaction, we’d meet internally and inform the client we couldn’t do it, it’s all about disclosure.”*

Extent agree or disagree ‘*The audit firm acting on behalf of your business **demonstrates sufficient independence and objectivity** in auditing your financial statements and other services they provide*’:



Investors: Investors had concerns that an audit firm providing other non-audit services to the entity could potentially influence the integrity of the audit. Some retail investors felt that audit firms should only provide audit services and that all other services should be prohibited. Others recognised it as a potential driver of conflicts of interest but could also see benefits in terms of an audit firm getting to know an entity well. Some saw the need to apply a cap or ratio of *audit to non-audit fees*.

Retail investor: *“I think there are cases when the relationship impacts the accuracy of the financial statements….they should be audit only.”*

Retail investor: *“I think this can be an issue…maybe there needs to be prohibition on the level of other services”*

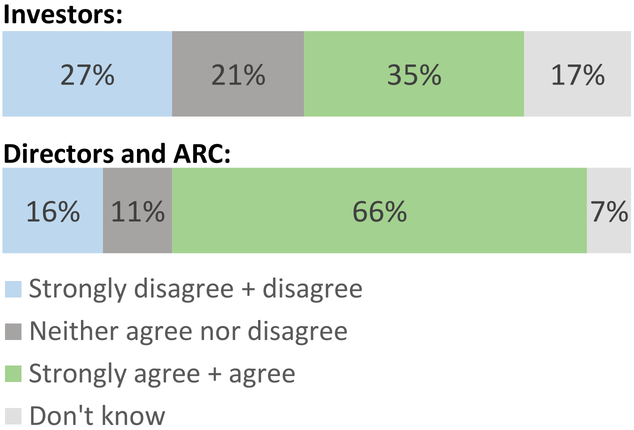
Institutional investor: *“Depends on the magnitude…we give this a lot of scrutiny. Need to see more disclosure on this.”*

Managers and Directors views: These stakeholders could see the potential for conflict, as well as the perception of conflicts among investors. There were often internal policies around prohibited services. Ultimately, they felt this came down to judgment, that there were no hard and fast rules and each entity had a slightly different way of handling the issue.

Director: *“They provide very, very limited services. Generally, it would be qualified by the type of work and by value to ensure they maintain independence.”*

Professional scepticism: Directors/ARC views are very different to investors

Extent agree or disagree '*Auditors **show sufficient professional scepticism** when they are auditing financial statements*':



In depth interviews showed:

Investors: Investors were much less likely to feel auditors used sufficient scepticism. Some retail investors felt if the auditor challenged too much, the entity would simply replace them with another auditor. Institutional investors acknowledged the potential for conflicts of interest but tended to feel it was being resolved fairly well.

Retail investor: "*It is hard to say, the power lives with the company. If they disagree with the auditor, they can change the auditor."*

Institutional investor: *"…Historically probably not… More recently they are becoming more sceptical. Partner rotation is making them more sceptical."*

Retail investor: *"They have a high level of independence. If it's a large accounting firm doing the audit, they're not so captured, the loss of the client is not going to be significant, but if it's a smaller size firm doing the audit it may form a significant part of its revenues and that's where you have issues."*

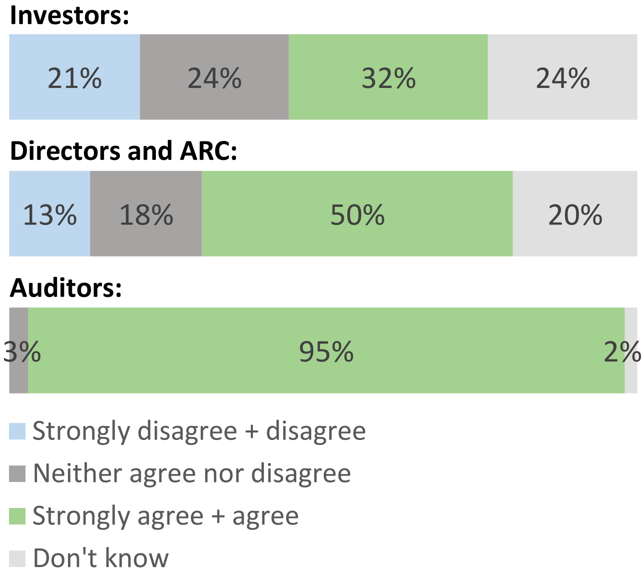
Directors, Auditors and Managers: These views showed that audits are generally conducted in a robust way. They felt that auditors frequently challenge management and directors on a range of accounting treatments, judgments and levels of disclosure. Evidence that auditors could be persuaded by management's arguments, while at other times, management were not able to persuade auditors and had to accept their judgment, were cited as appropriate and evidence of professional scepticism. Auditors were described as not being willing to sign off an audit with material points they disagreed with.

Manager: *"..sometimes they do accept things without too much questioning, but on others they dig their toes in…generally I am satisfied with their scepticism."*

Director: *"…they do challenge, increasingly I think the auditors are very careful not to sign off on anything that could be deemed to be misleading."*

Oversight and regulation: Agreement there is sufficient oversight/regulation of licensed auditors is higher among directors/ARC than investors

Extent agree or disagree '*There is **sufficient oversight and effective regulation** of licensed auditors in New Zealand*':



Reasons for not agreeing:
Some investors who disagreed did not recognise that licensing was anything more than registration.

"There needs to be a more thoroughly regulated approach to licensing of audit agencies."

"I am aware there is legislation and requirements in place for auditors however, like every industry there are always cowboys or independent auditors outside the system."

"Need more regulation regarding "conflict of interest."

In depth interviews showed:

Investors: Around half to two-thirds of the investors interviewed were aware that audit firms are licensed based on FMA's standards, that the FMA reviews licensed audit firms, refers misconduct to the disciplinary body and prepares an annual report into audit quality. However, none of the investors interviewed knew that the FMA's oversight is recognised by the EU.

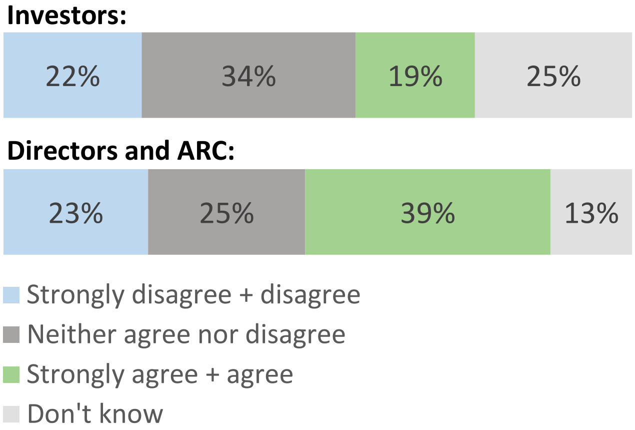
Directors and ARC: Agreement that there is *sufficient oversight and regulation* of licensed auditors is higher among directors/ARC (than investors) with half agreeing (50%) and 13% disagreeing. Those who disagree indicated a lack of awareness of the regulation that applies to individual auditors and/or would like to see a more thorough regulated approach to licensing. In interviews, directors seemed less aware of the FMA's role, but felt that it made sense that the FMA monitored audit quality.

Managers: 89% of managers agree there is *sufficient oversight and effective regulation of licensed auditors.* 11% don't know or are neutral. Some managers mentioned that auditors regularly use the fact that they are reviewed by the FMA as a justification for the level of detail they had to include to ensure the audit is complete and robust.

Auditors: Auditors were well aware of the FMA, its compliance monitoring scheme and that it is a member of IFIAR, the international forum of independent audit regulators.

Value perceptions: Directors/ARC are more likely than investors to agree they get good value from the fees charged by their audit firm

Extent agree or disagree '*You get **good value from the fees** the audit firm charges*':



Investors: A slightly higher proportion of Investors disagree (22%) than agree (19%) that they get *good value from the fees the audit firm charges*. A third of investors were neutral (34%) and a quarter were unsure (25%) about the value they receive. The main factor driving a negative perception of value is a general feeling thataudit fees are too high. Some investors talked about an audit being a compliance process and value being difficult to gauge.

Directors and ARC: Directors/ARC are significantly more likely than investors to agree they *get good value from the fees charged* by their audit firm (39% agree compared with 19% of investors). However, a similar proportion to investors disagree (23%), with similar opinions that the fees are too high and/or it being a compliance cost rather than something they get value from.

Managers: 61% of managers agree they get *good value from the fees the audit firm charges* and 22% of managers disagree.

Reasons for not agreeing:

Institutional Investor: *"Just believe audit fees are expensive and with the ever-increasing regulatory requirements around audit requirements the cost will continue to escalate."*

ARC: *"The cost of audits seems unjustifiable and it would help if they were easily challenged."*

Retail Investor: *"When you are not getting an honest report for the auditors, any charge is not good value."*

ARC: *"The fees charged are incredibly high, so I expect a quality report and critique however the findings and feedback to our organisation lack the pertinent and important points we expect to see."*

Selecting an auditor/audit firm: Investors, directors/ARC, and auditors have differing opinions on the top factor influencing selection of an audit firm

Investor perceptions:

Most important factors directors/ARC should consider when selecting an audit firm: Investors believe that having confidence in the audit firm's independence is the most important factor that directors/ARC should consider as it eliminates any potential bias by having separation between the two parties.

30%
Confidence in the independence of audit firms

27%
Providing assurance to directors in instances where auditors detect non-compliance

21%
Sector expertise of the industry

Director/ARC perceptions:

Most important factors you should consider when selecting an audit firm: In contrast to investors, directors/ARC rate sector experience and professional reputation as the two top factors they consider when selecting an auditor. Directors believe industry knowledge gives better insight, and a strong reputation ensures the auditor/audit firm has the expertise and experience to do the job. Managers perceptions were similar to directors/ARC with both parties having the same top three factors.

27%
Sector expertise of the industry

20%
The auditor's professional reputation

14%
Providing assurance to directors in instances where auditors detect non-compliance

Auditor perceptions:

Most important factors directors/ARC should consider when selecting an audit firm: The top factor auditors believe influence the decision of directors/ARC is price, followed by industry experience and reputation (which aligns with director/ARC responses).

44%
Price

22%
Sector expertise of the industry

19%
The auditor's professional reputation

Perceived value of publishing quality reviews: Similar proportions of investors and directors/ARC see value in publishing summary information

69% of **investors**, 64% of **directors/AR**C agree there is value in the FMA publishing summary information about the findings of quality reviews of individual registered audit firms. Both investors and directors/ARC believe it would provide greater transparency and/or confidence in decision making. Investors also mentioned it would make audit firms more accountable.

In contrast, only 27% of **auditors** agree there is value in the FMA publishing summary information. Auditors currently tend to let their clients know when an audit has been reviewed. If the review is negative, they have an obligation to inform the client. Auditors felt the FMA's reporting is already effective, and publication would lead to less constructive interactions with the regulator and have the potential for auditors challenging the FMA on every point in its report.

Question asked:

"The FMA conducts quality reviews of registered audit firms and issues an annual report on its findings. This is based on reviews of audit files in one year but focuses on general themes rather than individual firms.

Do you see value in the FMA going further and publishing summary information about the findings of quality reviews of individual registered audit firms?"