

# Auditor Regulation and Oversight Plan 2020-2023

June 2020

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FINANCIAL MARKETS AUTHORITY

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# Executive summary

## Our role

The Financial Markets Authority's main statutory objective is to promote and facilitate the development of fair, efficient and transparent financial markets. Improving audit quality, and maintaining international standards and recognition for our auditors is key in promoting trust and confidence in our capital markets, and supporting our overall objective.

Audited financial statements are a key resource for investors when making investment decisions. Investors' confidence in financial statements is dependent on the perceived quality of the audit. Auditor regulation and oversight helps to ensure that the businesses we regulate (known as Financial Market Conduct (FMC) reporting entities) have access to competent auditors, and that these audits (known as FMC audits) are of a high standard. To achieve this, we:

- review both the systems, policies and procedures audit firms have in place to deliver high-quality audits, and individual audit engagements, to ensure they meet the Auditing and Assurance Standards
- monitor accredited bodies to ensure they are effective frontline regulators of auditors.

To obtain and maintain recognition of New Zealand auditors in overseas jurisdictions we are required to meet international audit oversight standards in various jurisdictions. The FMA is a member of the International Forum of Independent Audit Regulators (IFIAR), an international oversight body, which allows us to maintain best practices, and contribute to and access relevant international knowledge and resources.

## Our focus

Over the three years to 30 June 2023, we will continue to focus on the following areas:

- **Improving audit quality** – We aim to perform audit quality reviews (AQR) of registered audit firms once every three years. We will also ensure our key stakeholders, including audit firms, are informed about developments in audit quality and where improvements can be made. Our reviews are aligned with required international standards.

Our AQRs are risk-based, and we will consider the potential impact of COVID-19 when determining our areas of focus. Accordingly, we may change our audit quality review schedule, perform reviews of unscheduled firms, and select audit areas and audit files with a particular risk focus.

- **Thematic reviews** – We may supplement our routine AQR with thematic reviews. Thematic reviews may focus on a particular aspect of audit practices across a number of firms, or focus on specific audits in more at-risk industries or sectors. We may decide to integrate thematic reviews in our AQR plan.
- **Auditing and accounting standards** – Enhanced auditor reporting has been an area of focus for our monitoring programme. We expect that the impact of COVID-19 will be a key event that auditors need to consider when deciding on the key audit matters (KAMs) for a particular audit. Our AQR will focus on the auditor's compliance with the standards when taking into account these impacts and changes in circumstance.

We will also continue to focus on practical implementation of the latest International Financial Reporting Standards (IFRS) and conduct a 'deeper dive' into the auditors' application of the standards.

- **Developments in the audit profession** – Last year the FMA conducted a survey of investors, directors, managers and auditors to better understand how audit quality is perceived in New Zealand. The survey showed a gap between the expectations of investors and what auditors actually deliver. We will continue to engage with relevant stakeholders and overseas regulators to assess if changes to our audit oversight regime are required to meet our objectives.
- **Monitoring accredited bodies** – We will continue to fulfil our requirement to monitor the accredited bodies and assess their regulatory performance. Our key area, where we will have increased focus, is to assess the accredited bodies' investigation and disciplinary policies and procedures. These reviews will provide insights on the adequacy, efficiency and effectiveness of the audit regulatory systems and processes.

# The purpose of auditor regulation

One of the FMA's statutory functions is to promote the confident and informed participation of businesses, investors, and consumers in the financial markets. Confident and informed participation depends on investors and other stakeholders having access to credible and reliable financial information. Audits of FMC reporting entities' financial statements ensure these statements comply with financial reporting standards and give a true and fair view of the financial position of the entity.

Auditor regulation supports the quality and integrity of audits of FMC reporting entities. By ensuring a high standard of auditing we aim to:

- increase investor confidence in the quality of the audited financial statements of FMC reporting entities
- give wider recognition to the professional status of New Zealand auditors in overseas jurisdictions.

## Improving investor confidence

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

Our report [Perceptions of Audit Quality in New Zealand](#) identifies reasonable levels of confidence in audit quality, but also a serious gap between the expectations of investors, and what auditors are delivering.

Our report provides a baseline measure of confidence, trust, professionalism, perceived quality of the audit process, and perceived benefits from the user perspective. The findings and insights from the survey can help auditors and audit firms improve how they provide assurance to investors. This is particularly important in the current challenging environment brought about by COVID-19. Investors rely on audited financial information to support informed investment decisions, so it is critical for auditors to respond to investors' expectations.

We will use the findings from our report to assess what changes can be made to better inform investors about audit quality.

## Recognition of New Zealand auditors overseas

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

We have received recognition from the European Union (EU) and Switzerland. This means New Zealand auditors can continue to audit the financial statements of businesses listed in the EU and Switzerland. The recognition also confirms New Zealand's regulatory structure is robust, and gives investors confidence that New Zealand auditors meet international standards. We will continue to pursue further recognition where opportunities arise.

The FMA is also a member of IFIAR. The IFIAR membership gives us access to international knowledge on auditor regulation. It also gives us greater opportunity to engage with the six largest international audit firms. IFIAR's Multilateral Memorandum of Understanding (MMOU) contributes to the effective regulation of audit firms by improving information exchange and cooperation among members.

We are actively involved in IFIAR through the Emerging Regulators Group (ERG) and other taskforces. The ERG's purpose is to provide a meaningful platform for new and emerging audit regulators to exchange ideas and build capacity. As the current chair of this group, the FMA has the opportunity to share insights, achieve our objectives to maintain and increase international recognition, and improve our audit oversight. Our membership also provides us access to training and allows us to discuss and learn from the experiences and methodologies of other regulators. We are actively engaged in increasing our cooperation with other regulators.

# Improving audit quality

One way we aim to improve audit quality is by reviewing audit files for compliance with the Auditing and Assurance Standards. During each review of an audit firm we explain the areas where the auditor did not comply with the standards so they understand any issues identified and can improve these areas across their entire audit portfolio.

## How we review audit quality

The Act requires us to perform an audit quality review of each registered audit firm at least once every four years. However, we will aim to keep our review cycle consistent with the EU's three-year cycle, to stay aligned internationally. The frequency of our inspections varies. We inspect larger firms every two years, while other firms are generally inspected every three years.

The reviews are carried out by FMA staff and contractors, including staff from overseas audit oversight bodies who are seconded to the FMA.

We review the systems, policies and procedures of audit firms against the requirements of the Act and the Auditing and Assurance Standards. Audit firms must also use reasonable care, diligence and skill in their FMC audits. We test this by reviewing a reasonable sample of individual audit files.

Our audit quality review process is outlined below.

### Planning

- We produce an annual schedule of the audit firms we will review in line with our review cycle.
- We communicate early with the relevant audit firm to agree on suitable review dates.

- We select files to inspect based on the following risk assessment categories:
  - Risk that the audited entity poses to investors. These entities may include listed companies, financial institutions and large investment schemes
  - Previous compliance record of the engagement partner
  - Entities that frequently change audit firms
  - Entities where we have previously noted non-compliance matters
  - Other factors such as level of audit fees, especially where the audit firm also received substantial fees for non-audit work.

We also include a level of unpredictability in our selection.

- The number of files selected per audit firm depends on the number of FMC audits and the number of audit partners in the firm. Audit files are evaluated for compliance with the Auditing and Assurance Standards.
- We select the number of audit areas to review for each audit file. These areas are driven by the findings in our [Annual Audit Quality Monitoring Report](#) or other trends noted internationally.

### Onsite visit to audit firms

- The reviewers perform an onsite review in line with our standard methodology and procedures, which includes the minimum requirements of Section 68 of the Act.
- The findings of each individual file review are discussed with the engagement leader of the audit. When necessary, the audit team can provide further evidence and explanations.

- The review of the audit firm also covers a review of the root-cause assessment and remediation plan performed by the audit firm following our previous review or the firm's internal review. Looking into these plans helps to understand if firms have addressed the key findings. The subsequent reviews of individual audit files help us assess the effectiveness of the root-cause assessment and the remediation plan of the firm.

### Reporting

- We provide the audit firm with a draft report of our key findings related to the systems, policies and procedures of the audit firm, and individual audit files. The firm has the opportunity to comment and provide us with further evidence about how they complied with the Auditing and Assurance Standards.
- Following the audit firm's comments, we prepare a final draft of the quality review report, which is provided to our Audit Oversight Committee (AOC). The AOC provides independent advice to the FMA to ensure the consistency and fairness of all quality review reports. The committee is made up of a diverse group of professionals, including ex-auditors, partners, company directors, and others with relevant experience.
- We provide the audit firm with a final report containing recommendations and requirements to remediate our findings.

### Next steps

- We require the firm to prepare a remediation plan and a root cause analysis of the findings

outlined in the report. We assess the appropriateness of the plan to ensure it is sufficient to address our findings. If we are not comfortable with the firm's plan we may provide further guidance or issue directions.

- In instances of significant breaches of the Auditing and Assurance Standards, the matters may be referred to the relevant accredited body to further investigate the licensed auditor.

### Areas of focus in our audit quality reviews

We set out our focus areas at the start of a three-year audit cycle<sup>1</sup>. These are chosen based on issues identified by international audit regulators and our own findings from recent reviews<sup>2</sup>. Our reviews will continue to focus on the following areas.

#### Key audit matter reporting

In relation to the key audit matter reporting, we focus on:

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

#### Auditor independence

An important part of an auditor's role is to act in the interests of investors, as well as the client. As such, auditors also need to effectively identify and assess any threats to their independence. They must apply appropriate safeguards to

1: We are currently in year two of the second three-year cycle.

2: See our [Audit Quality Review Report 2019](#)

protect their independence, and report these properly to audit committees and directors.

We will continue to focus on audit firms that provide significant non-audit services to the FMC reporting entities they audit. We will consider whether they have appropriately identified threats to their independence, whether those threats were sufficiently addressed by the controls put in place, and the quality of the audit work performed.

We will also verify whether all aspects of the non-audit services were reported to the entity's board of directors, and are appropriately disclosed in the financial statements and in the audit report. We will also continue to focus on other aspects of the independence requirements such as auditor rotation and relationships between the audit firm and the audited entity.

Auditors should approach independence with the highest integrity and, when in doubt, take a conservative approach. If we see potential non-compliance, we will work with the relevant accredited body, and ask them to investigate and seek clarification on what is considered acceptable under the New Zealand Professional and Ethical Standards.

### **Audit quality control systems and supervision**

We will focus on the adequacy and effectiveness of the audit firm's own control policies and procedures by reviewing:

- governance of the audit firm and its tone from the top
- the firm's internal and external audit quality reviews

- how audit quality impacts staff and engagement leaders' performance
- how the firm conducts root cause analysis when assessing the underlying cause of audit quality findings
- the firm's plans to address findings from internal and external reviews, and how it monitors effective implementation.

The engagement leader plays an important role in achieving high-quality audits. We will focus on whether senior audit team members and engagement leaders have the skills and time to support and review work throughout the audit. This includes sufficient involvement in the planning, execution and final stages of the audit. Additionally, where more junior staff have performed important parts of an audit, we will focus on whether those staff were supervised and reviewed in a timely manner by a sufficiently experienced manager or engagement leader.

The engagement quality control review (EQCR) partner also plays an important role in audit quality. We expect the EQCR partner to be involved in the key areas of risk in the audit file. We also expect the EQCR to be performed during the planning, execution and final audit procedures, to ensure the audit team has sufficient time to address any comments from the EQCR partner. We will review whether the EQCR partner's involvement is clearly documented on each audit file.

### **Professional scepticism**

We expect an appropriate level of professional scepticism to be maintained during every audit. In the audit documentation, we expect

to see sufficient audit evidence demonstrating that appropriate professional scepticism has been applied by the partners, quality control reviewers, and staff. Our focus for this will be on:

- the impact of COVID-19 (i.e. whether it has materially impacted or is it expected to materially impact) on the auditor’s evaluation of management’s assessment of going concern
- significant judgements on accounting estimates and fair value calculations. New uncertainties may be introduced as a result of COVID-19, e.g. have appropriate changes been made to recognise any enhanced uncertainty in the calculation of accounting estimates
- reliability of data provided by management or directors
- impairment calculations and recoverability of assets
- changes in accounting treatments, or use of unusual accounting treatments by the entity.

### Audit evidence

We will review whether licensed auditors have appropriate and sufficient audit evidence to support their opinion, with particular focus on the following areas of financial statements:

- an entity’s going concern
- revenue recognition, including the assumptions of fraud and management override
- key risks identified by the audit team for each audit file.

### Understanding the entity and its environment

We expect auditors to have an adequate understanding of an FMC reporting entity's business model. This should be reflected in the auditor’s risk assessment, to ensure that all key risk areas are included in the audit strategy.

The auditor should consider the impact on the planned audit approach of new or revised risks that have arisen because of COVID-19. For example, we expect auditors to consider the change in the control environment when assessing the entity’s system of internal control, and when planning reliance on controls in determining responses to identified risks of material misstatement.

We will focus on whether the auditor has:

- properly identified the risks
- assessed the controls that are relevant to the audit, and evaluated the design of those controls and determined whether they have been implemented
- appropriately tested reliance that has been placed on controls
- assessed the impact of the controls’ deficiencies on the audit work
- obtained sufficient and appropriately detailed audit evidence.

### Related party transactions

The work currently performed by auditors on related party relationships and transactions varies significantly. We see that auditors often review related party transactions as part of the disclosure review of financial statements,

but do not perform sufficient work to assess completeness and accuracy of the disclosures. Our reviews will focus on the auditor's work in relation to:

- understanding the entity's policies, processes and procedures to identify and record related party relationships and transactions
- testing the completeness of related party relationships
- testing the completeness, accuracy and disclosure of related party transactions
- assessing significant transactions that are outside the normal course of business.

#### **Auditor responsibilities relating to fraud**

One of the auditor's objectives is to identify and assess the risks of material misstatement of the financial statements due to fraud. In our reviews we will focus on:

- the auditor's assessment of the risk of fraud, including fraud in revenue recognition
- the auditor's assessment of significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual
- the auditor's requirement to test journal entries, in particular:
  - the assessment of processes in place at the entity to post and review journal entries. Auditors should consider the impact of COVID-19 when planning reliance on controls over journal entries
  - selection of journal entries and other adjustments made at the end of a reporting period

- the auditor's assessment of the need to test journal entries throughout the period.

#### **Auditor use of experts**

Where financial reports are complex, or include matters requiring specialist knowledge such as valuations of certain assets and liabilities, FMC reporting entities may use the advice of external or internal experts. We expect auditors who rely on the work of these experts to check their competence and objectivity. Auditors should also evaluate the quality of the experts' work, their independence, their key assumptions, and the valuation methods used. We will review whether the auditor considered engaging their own external expert (if the audit firm doesn't have in-house expertise) to challenge the work of the entity's expert.

#### **Audit fees and audit performance**

We have seen some audit fees that continue to decrease or remain flat for several years, or that we otherwise consider low for the level of work required. While we understand that companies want to get value for money from their audits, we are concerned that reduced fees result in inappropriate time pressures that affect the quality of the audit work. The level of the audit fee will influence which audits we select for review, as we want to ensure low-fee audits still meet the required standards.

#### **Execution of audit procedures**

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

## Education and communication

Our audit quality reviews determine the key messages and areas for improvement that will be the focus of our market engagement. We will ensure our key stakeholders, including audit firms, are aware of current issues with audit quality, and are kept up to date on key developments.

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

Over the next three years, this communication may include the following:

- This auditor oversight plan, which sets out the focus areas for our monitoring. The Act requires us to update this plan annually on a rolling three-year basis.
- Quality review assessment reports for audit firms after an audit quality review. These reports contain the findings of reviews and our recommendations for remediation.
- Presentations at audit firms to discuss what we found during their individual audit quality review, and how to improve their overall audit quality.
- Presentations or reports addressed to other stakeholders about the audit oversight regime, and how other businesses and professionals can contribute to audit quality.

- Ongoing dialogue with accredited bodies about our audit quality review findings and other trends in the audit industry. The aim is to improve the joint monitoring of licensed auditors, and address education issues.
- Thematic reports on audit quality matters, such as the key audit matters report.
- Annual reports of audit quality reviews, which summarise the findings for the year. These reports include recommendations for auditors and other stakeholders on how to improve audit quality. This enables auditors to willingly comply with our expectations, and the standards and legislative requirements.
- Letters to directors and audit committees about the quality of information provided to audit firms, or other non-compliance with Accounting Standards identified during our audit quality reviews.
- Collaboration with the External Reporting Board (XRB) to find areas for improvement, which XRB can use to influence international accounting standards where needed.

Additionally, the Perceptions of Audit Quality survey highlighted the need to educate investors on the role of auditors. We will look for opportunities to communicate with investors about the nature of audited information, the oversight regime, and the role of the FMA.

## The role of accredited bodies

While we carry out some areas of the auditor oversight regime directly, accredited bodies also have important responsibilities as frontline regulators. We monitor how well they perform this role, and expect them to achieve the Act's objectives. An overview of the responsibilities of the FMA and the accredited bodies is set out in the Appendix.

## The accreditation process

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

Our policy and guidance document sets out the requirements for accredited bodies. There are currently two accredited bodies: the New Zealand Institute of Chartered Accountants (NZICA)<sup>3</sup> and CPA Australia.

## How we monitor accredited bodies

We review whether accredited bodies have adequate and effective regulatory systems to be effective frontline regulators. We will regularly liaise with accredited bodies about their reports or notifications and, where appropriate, share

intelligence with them. We expect accredited bodies to use their full range of regulatory tools. We will work closely with accredited bodies to coordinate these tasks, to ensure there are no gaps or possible duplication of work, and that appropriate action is taken when an issue is identified.

We will discuss with the relevant accredited body the outcomes of our ongoing monitoring, and report any weaknesses or areas for improvement. We have the power to direct an accredited body to amend its systems and processes where necessary. At the end of each year, we report on our monitoring of the accredited bodies. These reports provide information on the effectiveness of the accredited bodies' policies and processes in each of the areas tabled below. Accredited bodies also need to provide an annual report detailing their relevant systems and processes, and how they have performed their regulatory functions.

The table on the following page sets out the accredited bodies' regulatory functions, how they work and how we monitor them to ensure they are effective.

<sup>3</sup>: NZICA amalgamated with the Institute of Chartered Accountants in Australia (ICAA) on 1 January 2015 to form the Chartered Accountants Australia and New Zealand. However, for the purposes of the audit oversight regime, NZICA continues to be the accredited body.

| Regulatory function  | How the function works   | How we monitor accredited bodies  |
|--|--|---|
| <p><b>Licensing domestic auditors and registering domestic audit firms</b></p> | <p>The FMA issues the prescribed minimum standards that audit firms have to meet.</p> <p>Accredited bodies have to notify us about licensing and registration approvals and failures.</p>  | <p>We review a sample of licences and registrations assessed by accredited bodies to confirm whether the applicants have met the minimum standards. We also provide recommendations to improve accredited bodies’ systems and policies, if and when required.</p>   |
| <p><b>Monitoring licensed auditors and registered audit firms</b></p>          | <p>The FMA reviews the policies and procedures accredited bodies have in place for monitoring licensed auditors and registered audit firms. We can request information about their monitoring at any time.</p>                               | <p>We review the effectiveness of accredited bodies’ monitoring procedures. We also provide recommendations to improve accredited bodies’ systems and policies, if and when required.</p>   |
| <p><b>Promoting and monitoring competence</b></p>                              | <p>Licensed auditors must comply with the minimum standards the FMA sets for professional development and ongoing competence.</p>  | <p>We review the availability of training provided by accredited bodies.</p>  |
| <p><b>Taking action against misconduct</b></p>                                 | <p>Accredited bodies must report any complaints received about licensed auditors or registered audit firms to the FMA. We also have the power to start or take over investigations of misconduct and to take direct disciplinary action.</p> | <p>The FMA reviews accredited bodies’ policies and procedures for dealing with misconduct of licensed auditors or registered audit firms.</p> <p>We review any complaints about a licensed auditor to see if accredited bodies’ policies and procedures were followed. We recommend improvements to accredited bodies’ systems and policies, where necessary.</p> |

# Appendix: Regulatory responsibilities

The table below gives an overview of the most significant auditor regulation activities set out in the Auditor Regulation Act 2011, and describes the role of the FMA and the accredited bodies in each activity.

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

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