

June 2016

# Auditor regulation and oversight plan 2016-2019

This report is for:

Auditors, preparers of financial statements and directors of  
FMC reporting entities

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# Executive summary

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## Our role

Our main statutory objective is to promote and encourage the development of fair, efficient and transparent financial markets. Our *Statement of Intent 2015-2019*<sup>1</sup> outlines how we will measure our performance against all of our objectives. Our *Strategic Risk Outlook 2015* also outlines our strategic objectives for the medium term. Two of these objectives are particularly relevant to the work that auditors do.

They are:

- ensuring investors have access to resources that help them make better-informed financial decisions
- ensuring frontline regulators are effective in their role.

Audited financial statements are a key resource for investors, and their confidence in them is dependent on the perceived quality of the audits. The purpose of auditor regulation and oversight is therefore to ensure that businesses we regulate (known as 'FMC reporting entities') have access to competent auditors, and that these audits (known as 'FMC audits') are performed to a high standard.

To achieve this, we:

- review the quality of audits to ensure they meet the Auditing and Assurance Standards
- monitor accredited bodies to ensure they are effective as frontline regulators of auditors.

## What we intend to do

Over the next three years to 30 June 2019, we will focus on three main areas.

- **Improving audit quality** — We aim to perform audit quality reviews of registered audit firms once every three years. We will also ensure our key stakeholders, including audit firms, are informed about developments in audit quality, and any potential areas of improvement. Our areas of focus for our reviews have not significantly changed compared to previous years and are aligned with what audit regulators are doing internationally.
- **Monitoring changes in the new standards for auditor reporting** — A new standard for auditors' reports, including more comprehensive information, will be required for all New Zealand listed issuers with a reporting period ending on or after 15 December 2016, and can be used earlier. For other FMC reporting entities considered to have a higher level of public accountability, the effective date will be periods ending on or after 31 December 2018. We will pay specific attention to the implementation of the new standard.
- **Monitoring how we perform audit quality reviews** — These were previously done by the New Zealand Institute of Chartered Accountants (NZICA) on our behalf, but to align with international practice we will perform these ourselves from 1 July 2016. For these reviews we will use staff of the FMA and independent contractors.

This plan also outlines how we will monitor accredited bodies.

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<sup>1</sup> The report can be found on our website: <https://fma.govt.nz/assets/Statement-of-intent/150618-Statement-of-Intent-2015-2019.pdf>

# The purpose of auditor regulation

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Investor confidence is fundamental to successful financial markets and depends on investor access to credible and reliable financial information. Audits of FMC reporting entities' financial statements are designed to enhance investor confidence. The audits help to ensure these statements comply with the regulatory financial reporting standards and give a true and fair view of the business' financial position.

Auditor regulation aims to ensure the quality, expertise and integrity of these audits. By maintaining high standards of auditing we aim to:

- ensure investors are confident in the quality of the audited financial statements of FMC reporting entities
- give wider recognition to the professional status of New Zealand auditors in overseas jurisdictions.

## Increasing investor confidence

The *Auditor Regulation Act 2011* (the Act) has been put in place to regulate auditors performing financial statement audits of FMC reporting entities. The Act recognises that this is a specialist job that cannot necessarily be performed by any qualified accountant.

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

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

## Recognition of New Zealand auditors overseas

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

We are currently working with the European Union to get full recognition of New Zealand auditors within the EU. This will allow New Zealand auditors to continue to audit financial statements in the EU. European recognition also helps show the robustness of New Zealand's regulatory structure, and gives investors' confidence that New Zealand auditors meet international standards. New Zealand auditors currently have a transitional recognition until a final equivalence decision is made.

In December 2014, we joined the International Forum of Independent Audit Regulators (IFIAR). Our membership of this organisation helps us to access international knowledge on auditor regulation, and to influence the largest six international audit firms. Our IFIAR membership also enables us to use the experiences and methodologies of other regulators, and provides important training for our staff and reviewers. We are also included in several taskforce groups within IFIAR, such as the taskforce for smaller regulators, which helps us improve as a regulator.

# Improving audit quality

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Audits of FMC reporting entities' financial statements are designed to increase investor confidence. One of the ways we ensure these audits are done well is by reviewing audits at registered audit firms. Explaining the results to each firm is also important, to ensure they understand any issues identified and can improve their higher-risk audits in particular.

## How we review audit quality

At the start of the auditor oversight regime in 2012, we contracted NZICA to perform audit quality reviews of audit firms on our behalf, as we did not have the expertise and resources to do these ourselves. In 2015 we decided not to extend this contract, and do the reviews ourselves from 1 July 2016.

We will use FMA staff and contractors to do this. Doing our own reviews aligns us with international audit regulators and is not a reflection on NZICA's performance. Audit firms should not notice any significant differences in how audit quality reviews are done, and we may use some of the same individual reviewers to ensure consistency.

The Act requires us to perform an audit quality review of each registered audit firm at least once every four years. To remain internationally aligned, we will aim to keep our review cycle consistent with the European Union's three-year cycle. For large audit firms we split our review work into two visits about 18 months apart.

During an audit quality review, we review the systems, policies and procedures audit firms have in place to comply with the requirements the Act, and Auditing and Assurance Standards. Audit firms must also use reasonable care, diligence and skill in carrying out FMC audits. We test this by reviewing whether individual audit files comply with these laws and regulations.

The audit quality review process we use will be similar to the one used by NZICA on our behalf, and is outlined below.

### Planning

- We select the reviewers.
- We select the audit files to be inspected, based on the risk the audited business poses to investors. These businesses may include listed companies, financial institutions and large investment schemes. Audit files are also selected to check compliance with a wide range of Auditing and Assurance Standards.
- We select the key areas for reviewers to focus on when reviewing the audit file.
- We communicate early with the relevant audit firm to agree suitable dates for the review.

### Onsite visit of the audit firm

- The reviewers perform the onsite review according to our standard methodology and procedures, which include the minimum requirements for audit quality reviews under section 68 of the Act. We aim to follow international best practice to perform these reviews.
- The findings of the individual file reviews are discussed with the team that performed the audit. The team is able to provide further evidence and explanations.
- The reviewers communicate their key findings at the end of the onsite visit to the team in charge of audit quality at the audit firm.

## Reporting

- We provide the audit firm with a full draft report of our findings for comment. The firm has the opportunity to provide us with further evidence on how they have complied with the Auditing and Assurance Standards.
- Following the audit firm's comments, we prepare a final draft quality review report which we provide to our Audit Oversight Committee (AOC) for consideration. This is a new committee that will provide an independent forum to review the consistency and fairness of all quality review reports. Previously, this role has been performed by a similar committee established by NZICA (the Auditor Regulation Advisory Group or ARAG). The members of AOC will be a diverse group of professionals including ex-auditors, partners, company directors, and other people with relevant experience. Some members of ARAG may become members of AOC to ensure consistency.
- We provide the audit firm with a final report, with our key findings and recommendations for remediation.
- We require the audit firm to provide details on how the key findings identified in the final report will be mitigated. We may give directions to the audit firm if its response is insufficient.

### Are you interested in becoming a reviewer?

We would like to hear from auditors who have recently left the audit industry, who might be interested in becoming a reviewer for the FMA. For more information, please contact Jacco Moison on [jacco.moison@fma.govt.nz](mailto:jacco.moison@fma.govt.nz).

## The new audit report

In September 2015, the External Reporting Board (XRB) issued the New Zealand-equivalent auditing standard for a new auditor's report. This will be required for all New Zealand listed issuers with a reporting period ending on or after 15 December 2016, but can be used earlier. For other FMC reporting entities considered to have a higher level of public accountability, the effective date will be periods ending on or after 31 December 2018.

Under the new standard, the auditor will be required to communicate key audit matters, and their report will include the name of the engagement partner. Key audit matters are matters that, in the auditor's professional judgment, were most significant in the audit of the financial statements for the current period. The auditor will be required to report why each matter was considered to be significant and how the matter was addressed in the audit. This will provide users of financial statements with previously unavailable information.

The inclusion of key audit matters will increase the importance of communication between the auditor, directors and audit committees. We believe this will improve the information available for investors. As each business has different key audit matters, auditors will need to apply their judgment accordingly. We expect to see reporting that is unique and specific for each business.

The auditor's report also gives auditors the opportunity to explain their work and to provide additional information, such as an explanation of the application of materiality to the audit work. An example of the early adoption of this new style of auditor's report is available in the *NZX Annual Report 2015*.

We will pay specific attention to the implementation of the new standard. This will be one of our focus areas in our audit quality reviews in the next three years. In the first two years of implementation, we will focus on the quality of information in the audit report, and the audit work supporting key audit matters. We will review the process followed by the audit firm to determine key audit matters, to assess whether information in the audit report fairly reflects the audit work. We will work with audit firms to further improve communication, including clearer and better audit reports that give investors and other users of financial statements the most relevant information.

## Other areas we will focus on

During our audit quality reviews, audit firms' internal quality control and the quality of individual audit files will also be assessed. We have selected the following focus areas based on issues identified by international audit regulators and our own findings from our most recent reviews<sup>2</sup>.

### 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.

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

### Audit quality control systems and supervision

We will focus on the adequacy and effectiveness of the audit firm's own control policies and procedures, especially where our reviews indicate findings not detected by the firm's own quality review procedures.

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

### Professional scepticism

We expect an appropriate level of professional scepticism to be maintained during every audit. In the audit documentation, we expect to see sufficient audit evidence to show that the engagement partners, engagement quality control reviewers and staff have applied professional scepticism. In particular, we will focus on whether there is sufficient documentation of professional scepticism in the following areas:

- significant judgments on accounting estimates and fair value calculations
- reliability of data provided by management or directors
- management and directors' representations
- impairment calculations and recoverability of assets
- changes in accounting treatments, or use of unusual accounting treatments by the FMC reporting entities.

### Audit evidence

We will review whether licensed auditors got appropriate audit evidence to determine whether the FMC reporting entities' financial statements were free of material misstatements. Our focus on audit evidence will concentrate on ensuring audit firms obtained sufficient evidence in the following areas:

- going concern
- revenue recognition, including the assumptions of fraud and management override
- the completeness and accuracy of related-party transactions.

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<sup>2</sup> See our *Audit Quality Review Report 2015*, which is available on our website, for findings from our most recent reviews.

## Understanding the issuer and its environment

We expect auditors to have an adequate understanding of an FMC reporting entity's business model. This should be reflected in the auditor's risk assessment to ensure that all key risk areas are included in the audit strategy. All key areas of risk should be covered by procedures that get appropriate and sufficient audit evidence.

We will focus on:

- the appropriate identification of risk
- reviewing whether the audit procedures have been appropriately executed
- whether they got sufficient evidence from the procedures.

## The auditor's responsibilities relating to fraud

One of the objectives of the auditor is to identify and assess the risks of material misstatement of the financial statements due to fraud. We will review the auditors' assessment of this risk, and whether they adequately performed the procedures used to address this risk. We will increase our focus on the review of journal entries and other specific fraud procedures.

## Use of an auditor's expert

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

## Audit fees and audit performance

We have noted that some audit fees have decreased or remained flat for several years. While we are keen to see companies get value for money from their audits, we would be concerned if reduced fees led to inappropriate time pressures that affected the quality of audit work. We will continue to focus on FMC audits that have a very low audit fee or where the audit fees don't reflect the complexity of the business, to assess whether sufficient audit work has been completed.

## Education and communication

It is likely that our audit quality reviews will reveal some breaches of auditing standards or identify areas for improvement. We will ensure our key stakeholders, including audit firms, are informed about key developments in audit quality and any issues arising from our audit quality reviews.

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 the overall improvement in audit quality in New Zealand. Our communications for the next three years will include:

- This auditor oversight plan, informing our stakeholders of our areas of focus for ongoing monitoring. The Act requires us to update this plan each year on a rolling three-year basis.
- Quality review assessment reports for audit firms, following an audit quality review. These reports provide the findings of reviews and recommendations for remediation where necessary.
- Presentations at audit firms about the individual findings identified during their audit quality review, and other areas of interest that could improve their overall audit quality.
- Presentations to other stakeholders about the audit oversight regime and how other businesses and professionals can contribute to audit quality.

- An ongoing dialogue with accredited bodies on our audit quality review findings and other trends in the audit industry. The aim is to improve the joint monitoring of licensed auditors and to address education issues.
- Annual reports on audit quality reviews, summarising the findings of reviews done during the year. These reports include recommendations to both auditors and other stakeholders on how to improve audit quality. This enables auditors to willingly comply with our compliance expectations, the standards and legislative requirements.
- We will work with the XRB to identify areas for improvement so these can be addressed by influencing international standards, providing more guidance, and informing stakeholders about our expectations.

# The role of accredited bodies

While some areas of the auditor oversight regime are carried out by us directly, accredited bodies also have important responsibilities as frontline regulators. We monitor how well they perform this role, and expect them to make a significant contribution to achieving the objectives of the Act.

## Accreditation of accredited bodies

Professional bodies are required to have the appropriate systems, policies and procedures to perform their regulatory functions. Our accreditation process evaluates the robustness of professional bodies' procedures and indicates whether amendments to policies or processes are required to meet standards. We described the requirements in our *Policies and guidance for the assessment of applications to be an accredited body*<sup>3</sup>, available on our website. Currently we have two accredited bodies: the New Zealand Institute of Chartered Accountants (NZICA) and CPA Australia.

## How we monitor accredited bodies

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

The table below sets out the regulatory functions performed by accredited bodies, the mechanisms that ensure they are appropriate and effective, and how we monitor them.

| Regulatory functions   | How they work   | How we monitor them  |
|--|---|--|
| Licensing domestic auditors and registering domestic audit firms | We have issued prescribed minimum standards auditors and audit firms are required to meet.<br><br>Accredited bodies have to notify us of all licences and registrations approved and declined.    | We review a sample of licences and registrations assessed by accredited bodies to confirm whether the applicants have met the minimum standards. We also provide recommendations to improve accredited bodies' systems and policies, if and when required. |
| Monitoring licensed auditors and registered audit firms          | We review the policies and procedures accredited bodies have in place for monitoring licensed auditors and registered audit firms. We can request information about their monitoring at any time. | We review the effectiveness of accredited bodies' monitoring procedures. We also provide recommendations to improve accredited bodies' systems and policies, if and when required.   |

<sup>3</sup> A copy can be found at: <https://fma.govt.nz/assets/Guidance/120401-policy-and-guidance-on-applications-for-accreditation-and-conditions-of-accreditation.pdf>

|                                     |   |   |
|-------------------------------------|---|---|
| Promoting and monitoring competence | Licensed auditors are required to comply with the minimum standards set by us for professional development and ongoing competence.  | We review the availability of training provided by accredited bodies. We also review their processes for reviewing professional development requirements and whether members meet the minimum standards set by us.                                |
| Taking action against misconduct    | We review accredited bodies' policies and procedures for dealing with misconduct of licensed auditors or registered audit firms. Accredited bodies must report to us any complaints received about licensed auditors or registered audit firms. We also have the power to start or take over investigations of misconduct and to take direct disciplinary action. | We review whether accredited bodies' policies and procedures have been followed when complaints have been made about licensed auditors. We also provide recommendations to improve accredited bodies' systems and policies, if and when required. |

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

At the end of each year, we report on our monitoring of each accredited body<sup>4</sup>. These reports provide information about the effectiveness of the accredited body's policies and processes in each of the areas set out in the table above. As part of this, the accredited body has to provide us with an annual report on its relevant systems and processes and how it has performed its regulatory functions.

<sup>4</sup> These reports can be found on our website.

# How we will measure our performance

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Our *Statement of Intent 2015-2019*<sup>5</sup> outlines how we will measure our performance against all of our objectives. The following measures directly or indirectly reflect the objectives of the auditor oversight regime.

**Measure:** Frontline regulators take action to address issues raised by the FMA relevant to those they supervise.

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

**Measure:** Stakeholders agree that:

- frontline regulators are effective in their role
- the FMA does a good job in regulating New Zealand's financial markets
- the FMA's actions help raise standards of market conduct
- the FMA's actions support market integrity.

**Explanation:** We will survey stakeholders to understand their views.

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

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

**Measure:** FMA's thematic reports on initial, periodic and ongoing disclosures lead to improvements in the areas identified.

**Explanation:** We follow up to check improvements are made when matters are highlighted in our annual reports on audit quality.

The outcome of these performance measurements will be included in our *Annual Report*.

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<sup>5</sup> This report can be found on our website.

## Appendix: Regulatory responsibilities

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

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