

June 2019

Auditor Regulation and Oversight Plan 2019-2022

This report is for:

- Auditors
- People who prepare financial statements
- Directors of FMC reporting entities

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Executive summary

Our role

The FMA's main statutory objective is to promote and encourage the development of fair, efficient and transparent financial markets. Our [Strategic Risk Outlook](#) outlines what we believe are the current and main drivers of risk to achieving this objective. Based on these drivers of risk, we have strategic priorities that guide our activities. Improving audit quality is a key activity to drive change for our priority area of promoting trust and confidence in capital markets.

Audited financial statements are a key resource that investors rely on when making investment decisions. Their confidence in the financial statements is dependent on the perceived quality of the audit. Auditor regulation and oversight helps to ensure the businesses we regulate (known as FMC reporting entities) have access to competent auditors, and 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.

What we intend to do

Over the three years to 30 June 2022, we will continue to focus on the following 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 where improvements can be made. There has been no significant change in the focus of our current reviews compared with previous years. Our reviews are aligned with what audit regulators are doing internationally.
- **Changes in auditing standards** — In 2017 and 2018 we incorporated the new auditor reporting requirements into our monitoring programme. These enhanced requirements have been extended to FMC reporting entities with higher public accountability. We will continue to pay specific attention to this area. Additionally, a number of new accounting standards are becoming effective in 2018 and 2019. These new standards relate to leasing, revenue, and financial instruments. Our focus will be on entities that are significantly affected by these new standards.
- **Developments in the audit profession** --- The audit profession is under significant scrutiny in a number of jurisdictions. Our research project (see page 5) with investors, directors, managers and auditors also identified a serious gap between investor expectations and what auditors deliver. We will remain mindful of these developments, and assess if changes to the audit oversight regime are required to meet our objectives. We will continue to engage with relevant stakeholders and overseas regulators to ensure that we are fully informed on the developments.
- **Monitoring accredited bodies** — We will continue to fulfil our requirement to monitor the accredited bodies and their performance of their regulatory role.

The purpose of auditor regulation

Investor confidence is key to successful financial markets. This confidence depends on investors having access to credible and reliable financial information. Audits of FMC reporting entities' financial statements aim to enhance investor confidence. Auditing ensures 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.

Increasing 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.

In November 2018 we commissioned Buzz Channel to conduct research on how users of audit services in New Zealand perceive auditors' contribution to fair, efficient and transparent financial markets. The overall aim of this research was to provide an understanding of public and industry perceptions of audit quality, and help identify work the FMA and auditors can do to increase awareness and understanding our respective roles.

In May 2019 we issued our findings report [Perceptions of Audit Quality in New Zealand](#). The research identified reasonable levels of confidence in audit quality, but also a serious gap between the expectations of investors, and what auditors are delivering.

The findings and insights from the survey can help auditors and audit firms improve how they provide assurance to investors. Investors are the end users of audit services, in terms of relying on the audited financial information to make informed investment decisions, so it's critical for auditors to respond to investors' expectations.

This was the first time we have conducted research into perceptions of audit quality, and it therefore provides a baseline measure of confidence, trust, professionalism, and perceived quality of the audit process, and the perceived benefits from the user perspective. We will use the findings from this 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.

In 2016 and 2017, we 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 markets and Switzerland. The recognition also confirms New Zealand's regulatory structure is robust, and gives investors confidence that New Zealand auditors meet international standards.

In December 2014, we joined the International Forum of Independent Audit Regulators (IFIAR). Our 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). The ERG's purpose is to provide a meaningful platform for new and emerging audit regulators to exchange ideas and build capacity. As the chair of this group, 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.

Improving audit quality

One way we ensure FMC audits are carried out to a high standard is by reviewing the audit files. We explain the results of each review to the audit firm so they understand any issues identified, and can improve their higher-risk audits.

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. These reviews are carried out by FMA staff and contractors, including staff from overseas audit oversight bodies.

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 individual audit files.

Our audit quality review process is outlined below.

Planning

- We produce an annual schedule of the audit firms we will review.
- We communicate early with the relevant audit firm to agree on suitable review dates.
- We select files to inspect, based on the risk the audited entity poses to investors. These entities may include listed companies, financial institutions and large investment schemes. The number of files selected per audit firm depends on the number of FMC audits and the number of audit partners in the firm. It may vary between two and eight audit files per audit firm. Audit files are checked for compliance with the Auditing and Assurance Standards.
- We select the key focus areas for each audit file we review.

Onsite visit to audit firms

- The reviewers perform an onsite review in line with our standard methodology and procedures, which include the minimum requirements of Section 68 of the Act covering audit quality reviews.
- 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.

Reporting

- We provide the audit firm with a draft report of our key findings. This covers both the systems, policies and procedures of the audit firm, and the 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), which gives an independent review of 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 our findings and recommendations for remediation.
- We require audit firms to provide details of how they will mitigate the key issues outlined in the report. We will assess the appropriateness of these plans to ensure they are sufficient to address our findings.

Areas of focus

During our audit quality reviews, we assess:

- the audit firm's internal quality controls; and
- the quality of individual audit files.

We decide our focus areas at the start of a three-year audit cycle¹. The focus areas are chosen based on issues identified by international audit regulators and our own findings from recent reviews².

Key Audit Matter reporting

In our review of the new auditor 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 protect their independence, and report these properly to audit committees or directors.

In our reviews, we will 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 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 the audit.

Auditors should approach independence with the highest integrity and, when in doubt, take a conservative approach. If we see potential non-compliance issues, 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 at 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 they monitor 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 important parts of an audit have been performed by more junior staff, 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.

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

² See our [Audit Quality Review Report 2018](#)

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 following areas:

- significant judgements on accounting estimates and fair value calculations
- 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.

We will focus on whether the auditor has:

- properly identified the risks
- assessed the controls that are relevant to the audit, and has evaluated the design of those controls and determined whether they have been implemented
- appropriately tested reliance that has been placed on controls
- 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 review will focus on the auditors 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
 - 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 also should 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.
- 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.

Policies and guidance for the assessment of applications to be an accredited body sets out the requirements for accredited bodies. There are currently two accredited bodies: the New Zealand Institute of Chartered Accountants (NZICA)³ and CPA Australia.

The table below sets out the regulatory functions accredited bodies carry out, how they ensure these 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. | <p>We issue 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> | 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. |

³ 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.

Promoting and monitoring competence.

Licensed auditors must comply with the minimum standards we set for professional development and ongoing competence.

We review the availability of training provided by accredited bodies.

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 any complaints received about licensed auditors or registered audit firms to us. We also have the power to start or take over investigations of misconduct and to take direct disciplinary action.

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.

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 bodies 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 above. Accredited bodies also need to provide an annual report detailing their relevant systems and processes, and how they have performed their regulatory functions.

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.

| Activities | What accredited bodies do | What we do |
|---|--|--|
| Licensing of auditors and registration of audit firms. | 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. |
| 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 firms 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. We also share details of our findings and recommendations on how audit quality can be improved. |
| Investigations | 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. |
| 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. |