NOVEMBER 2022

Audit Quality Monitoring Report

1 July 2021 – 30 June 2022

FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Purpose of this report

The Auditor Regulation Act 2011 (the AR Act) requires the Financial Markets Authority – Te Mana Tātai Hokohoko (FMA) to report each year on the outcomes of the audit quality reviews we performed on the systems, policies and procedures of registered audit firms and licensed auditors in the preceding financial year. The report also sets out the FMA's expectations for how directors and auditors of financial statements can improve and maintain audit quality.

Building on previous years, this year's report emphasises that high-quality audits are vital to ensuring investors can make active choices based on clear, concise, and effective information.

Audit quality

Audit quality is a key priority for the FMA, as it is a cornerstone of market integrity and investor confidence. Investors rely on audited financial statements and need to have confidence that they present a true and fair reflection of a company's financial position and performance.

The elements of audit quality

Provides investors and stakeholders with assurance that financial statements give a true and fair view

Ensures audits are performed in accordance with the regulations and standards

Driven by a robust risk assessment and thorough understanding of the entity and its environment

Supported by an independent process and audit evidence, and involves the exercise of professional judgement and scepticism

Challenges management effectively and obtains sufficient audit evidence for the conclusions reached

Reports unambiguously on the auditor's conclusion on the financial statements

Contents

Executive summary

2022 market snapshot

As at 30 June 2022 there were:

135 domestic licensed auditors
(Prior year: 138)

185 NZX-listed companies
(Prior year: 186)

13 domestic registered audit firms
(Prior year: 14)

1050 FMC audits
(Prior year: 1130)

Our reviews

2021/22

2 small firms, 2 medium firms, 3 large firms

25 audit files* including
9 listed companies
16 other FMC reporting entities

2020/21

1 small firm, 2 medium firms, 2 large firms

21 audit files including
11 listed companies
10 other FMC reporting entities

2019/20

1 small firm, 1 medium firm, 2 large firms

26 audit files including
13 listed companies
7 other FMC reporting entities

2018/19

2 small firms, 1 medium firm, 3 large firms

27 audit files including
9 listed companies
18 other FMC reporting entities

Small firms: fewer than four licensed auditors; medium firms: multiple offices and fewer than 10 licensed auditors; large firms: more than 10 licensed auditors (including Audit New Zealand).

* During the year, we also performed a re-review on specific areas of concern in one individual audit file. We did not rate that file and the result of that re-review is not reflected in our report.

What we have seen

While audit firms have made improvements since our previous reviews, audit quality remains inconsistent between audit firms, and in some instances inconsistent between audits within the same firm.

We have seen increased documentation relating to accounting estimates and how auditors applied professional scepticism, continuing the trend from previous years. We also found auditors have performed more work in areas with higher risk, especially areas of management judgement and where auditors were required to apply professional scepticism.

The rate of 'non-compliant' audit files remained relatively consistent with last year, although this year we reviewed more audit files: 25, compared to 21 in the 2020/21 year.

The audit firms and audit files that we review are different year to year, and therefore a straight comparison cannot be made.

The audits we reviewed were mainly performed remotely by audit firms through various COVID-19 lockdowns. This did not appear to have any significant impact on the audit process and quality of the audits, likely due to the experience gained from earlier lockdowns. Our audit quality reviews were also performed remotely during this review cycle.

Where our reviews note significant misconduct, we refer these matters to the appropriate disciplinary bodies. We did not have to make any referrals this year. An overview of disciplinary actions taken over the previous years can be found on page 24.

Focus areas

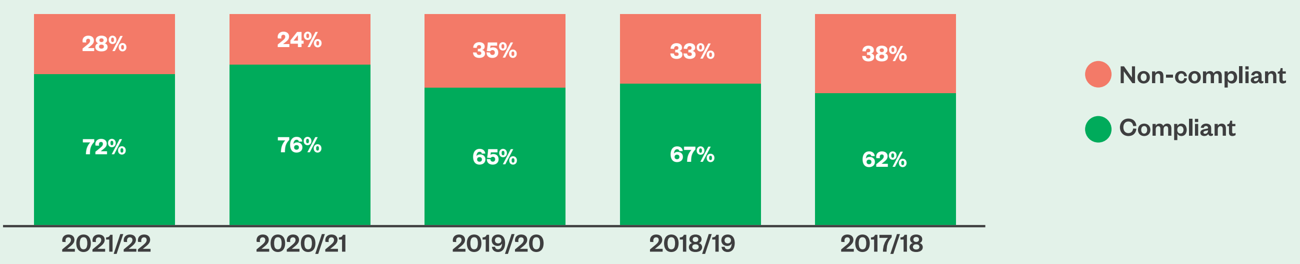
Firms are making significant investments in their audit quality functions and audit software. Despite the increase in the extent of audit work and investment in new tools, there are still several areas where improvements are required, notably in relation to auditors not documenting their work and the evidence to support their conclusions.

From our reviews this year, we have identified the following areas we want audit firms to focus on:

- Documentation of audit evidence
- Professional judgement and scepticism
- Audit procedures in the following key audit areas:
  - Going concern
  - Revenue
  - Related parties
  - Fraud and risk of management override of control

In this report we also highlight two areas for the audit industry and directors of FMC reporting entities to take note of: the auditor shortage; and the impact of climate risk on audits of financial statements.

Compliance of audit files reviewed



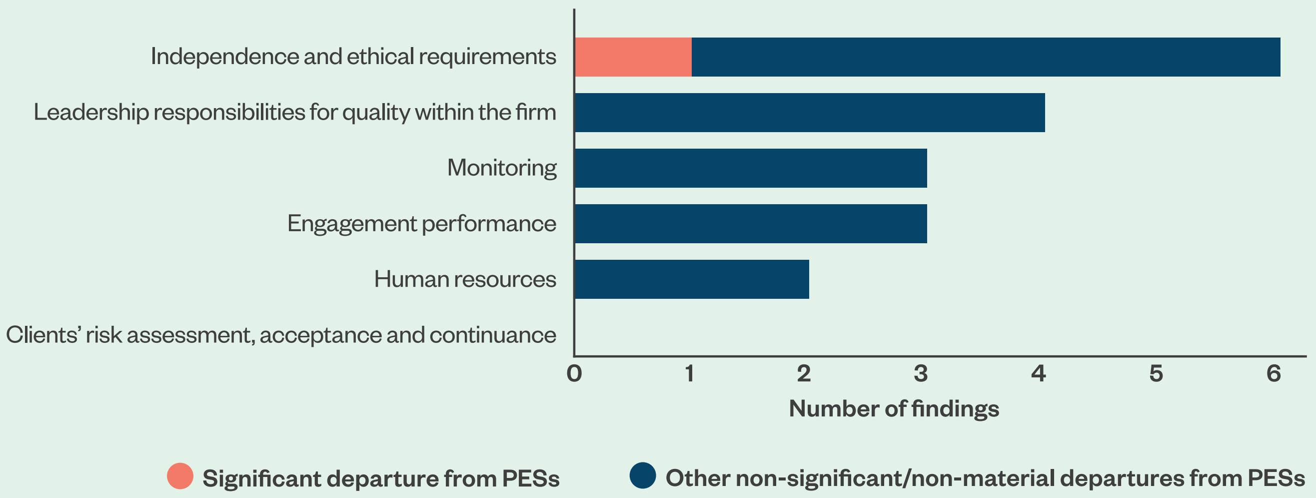
Audit firm quality control systems

As part of our audit quality reviews, we assess the controls audit firms have in place to perform audits to an adequate standard, and whether these comply with the relevant Professional and Ethical Standards (PESs). The firms we reviewed generally had control systems of appropriate quality to support performance of high-quality audits. We identified some departures from standards, including one significant enough to potentially adversely affect the firm's audit quality. Audit firms are required to immediately address high-level findings in the remediation plans they provide to us. We assess these plans on reasonableness and follow up on implementation.

The table below shows the number of findings raised in each of the six elements of the quality control standard, identified as significant departures, or other areas where the audit firm did not comply with all the requirements.

At the end of 2022 audit firms need to comply with a revised quality control standard. The new standard puts more focus on internal control procedures and reviews the firm must perform to ensure their quality control is effective. We will focus on this standard in our 2023/2024 review cycle and assess implementation across all registered audit firms.

Quality control system findings



Audit quality review findings

This year we reviewed 7 audit firms and 25 audit files. We also followed up on one audit file from the prior year to see if the audit firm had addressed our findings. In this section, we provide details from our reviews of the audit firms' quality control systems and, for the audit files reviewed, we provide background on areas of non-compliance, including whether these were systematic across other audit files we reviewed.

Quality control systems

As part of our reviews, we assess the adequacy and effectiveness of the firm's control policies and procedures, and whether their systems comply with the relevant Professional and Ethical Standards. Our assessment includes the review of:

- the governance structure of the audit firm and the culture modelled by its leadership
- the adequacy and appropriateness of the firm's monitoring process, including a follow up on any matters the firm identifies from these processes
- the results from any internal and external audit quality reviews of the audit firm
- how audit quality is considered in the performance assessment of staff and leaders
- how the audit firm conducts root cause analysis when assessing the underlying cause of audit quality findings
- the audit firm's plans to address findings from internal and external reviews, and how it monitors effective implementation of its remedial plans.

In this year's reviews we assessed only one finding as significant, where the audit firm, through its internal monitoring process, identified exceptions in its annual independence declaration process. Some staff indicated they held financial interests in restricted entities, which is prohibited by the firm's independence policy. Although the firm detected the non-compliance, these breaches should not have occurred. The firm should ensure its staff fully understand its policies and the consequences of breaching them. At the time of the review, the quality control team was dealing with the breaches.

Although not assessed as significant, we identified other deficiencies which, if not corrected, may impact the quality of the firm's work. These included:

- no clear structure for who is responsible and accountable for audit quality
- remuneration not linked to audit quality
- incomplete list of prohibited entities
- an identified breach of rotation of key audit partners and engagement quality reviewers (EQR)
- no clear evidence of regular messaging to staff to promote quality
- not performing checks to confirm the accuracy and completeness of annual independence declarations.

Our expectations for audit firms

- Audit firms are finalising their plans to implement the requirements of the new quality control standards or implement new quality control systems[1] coming into effect in December 2022. Some firms will be leveraging their global resources to assist with the design, implementation, and monitoring of these new requirements. Firms should note they remain responsible for monitoring of their own quality management system locally, and cannot discharge responsibilities elsewhere. Firms should ensure they can evidence how they have complied with the standards.
- To assist firms with managing quality, the new quality standards will require the firm to implement monitoring procedures additional to their existing quality management systems. To ensure that quality management teams can adequately manage quality, we encourage firms to monitor resource levels, to ensure they can maintain their current level of service and have the necessary capacity to meet the new requirements.

FMA focus

- To provide firms with adequate time to ensure the new standards are implemented, compliant and operating effectively, we do not intend to thoroughly review quality management systems during the 2022/2023 review cycle but will focus only on whether the firm performed certain monitoring processes. For the 2023/2024 review cycle, we plan to perform specific reviews of all audit firms' implementation of the new standards. We aim to issue a separate report summarising our findings from these reviews. For subsequent review cycles, the assessment of quality management systems will become part of the regular audit quality reviews.
- Other significant changes to auditing standards, for example ISA (NZ) 315, will be covered in our audit file reviews.
- As part of our 2021/22 review cycle, we assessed root cause analysis and remedial plans that firms put together to address issues we raised in our reviews. We focused on the appropriateness of the root causes identified and whether the remedial actions are appropriate to ensure the issues do not reoccur. Going forward we will place more emphasis on the process used to identify root causes and related remedial actions, to ensure remedial plans are effective.

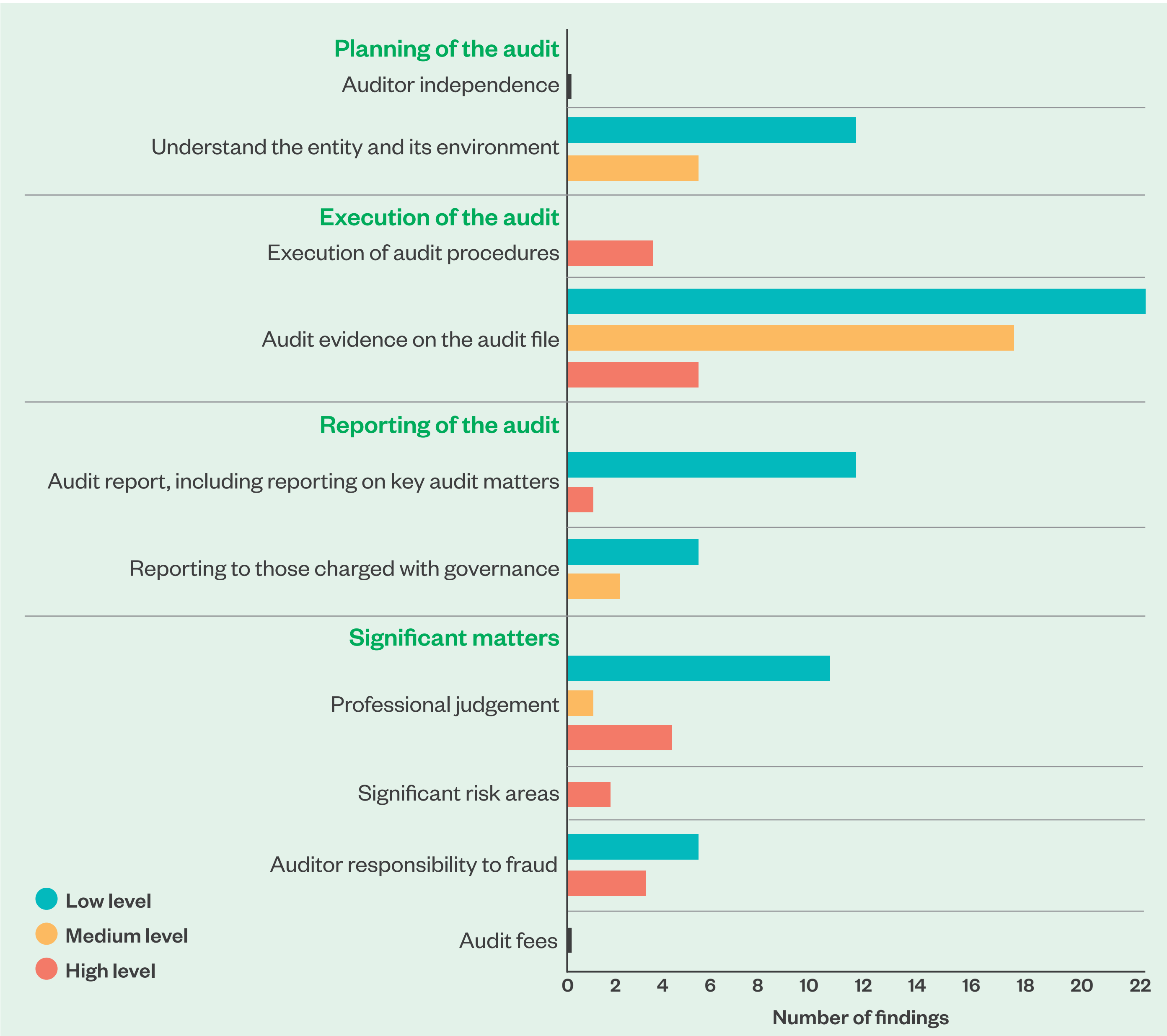
1: PES 3: Quality Management for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance or Related Services Engagements; PES 4: Engagement Quality Reviews; and ISA (NZ) 220 (Revised): Quality Control for an Audit of Financial Statements

Individual file reviews

Findings in key focus areas

As set out in our annual Auditor Regulation and Oversight Plan, we continue to focus on key areas of the audit, common findings from our previous reviews, and common findings identified by international audit regulators.

The chart below shows the number and level of findings identified in the 2021/2022 review cycle in the four key audit areas.



Analysis of individual file reviews

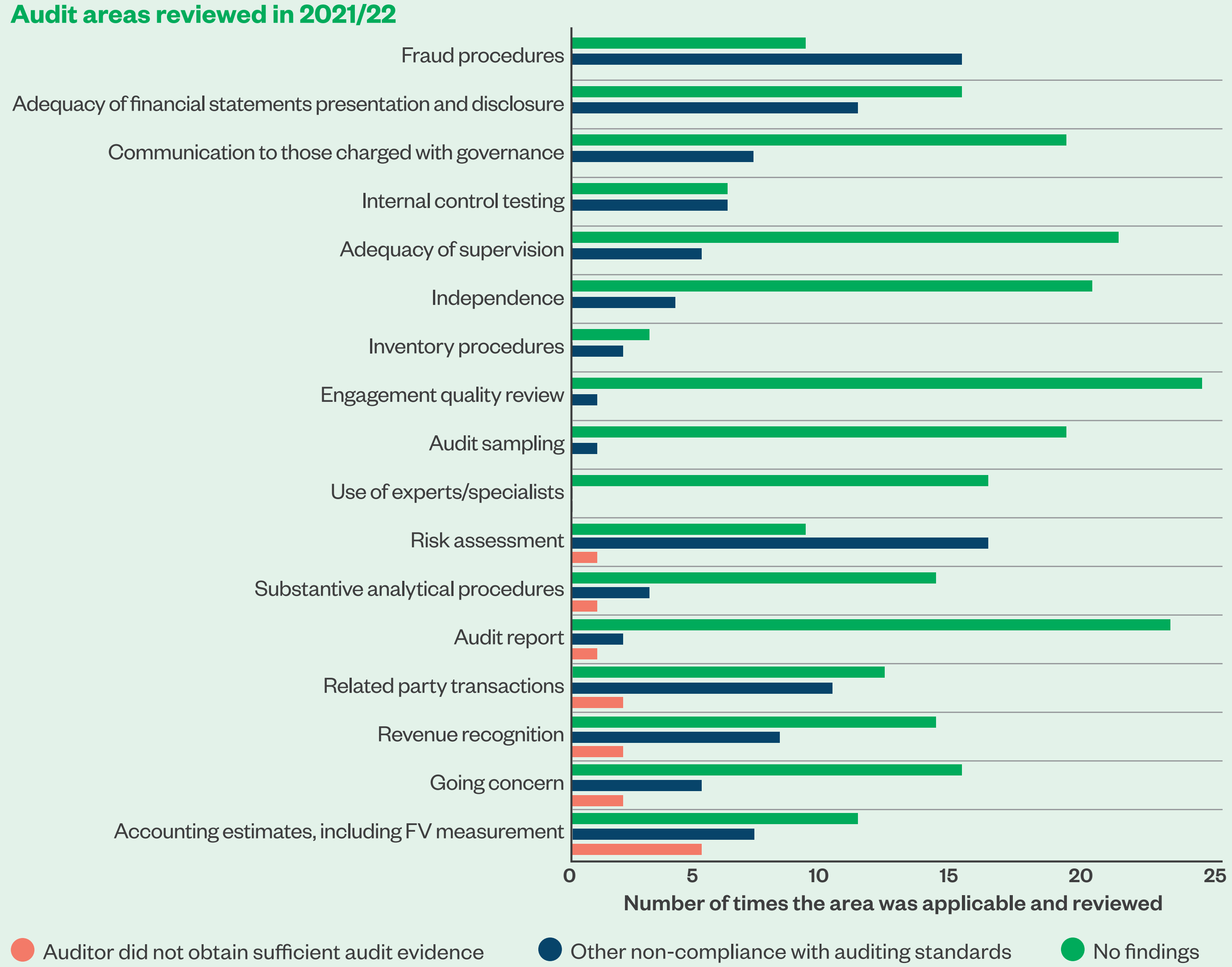
When reviewing audit files, we assess whether the auditor complied with the Assurance Standards, and otherwise exercised reasonable care, diligence, and skill in carrying out the audit.

Our reviews focus on key areas rather than the entire audit file. The areas we look at are either:

- fundamental to overall audit integrity, such as auditor independence, and sufficient oversight by the engagement leader and EQR partner; or
- selected based on the potential risks they pose – for example, they may be significant to the entity's financial statements, include complex issues for the auditor, and/or involve significant judgements.

The table below shows how many times we reviewed these key areas across the 25 audit files in our sample, and how frequently we noted issues. We identified 7 audit files that were non-compliant. Across these files, there were 9 areas where the auditor did not obtain sufficient audit evidence and one area that included a material misstatement.

Audit areas reviewed in 2021/22



Audit file compliance

We noted an increase in the level of documentation for areas of accounting estimates and where auditors had to apply professional scepticism, which is positive. However, we identified instances where the auditors did not obtain sufficient audit evidence, or did not sufficiently document the work they performed. We have also seen auditors use new technologies to replace or supplement audit procedures, which contributes to the enhancement of audit quality.

The rate of non-compliant audit files was 28%, up slightly from 24% last year. While the audit firms and files we review are different each year, this is an encouraging result. We expect firms to apply the learnings from past review cycles going forward, to help continue the downward trend.

We rate a file as non-compliant if the audit or parts of the audit were not performed in accordance with the Auditing and Assurance Standards and where insufficient audit evidence was obtained in at least one key risk area. Other reasons we rate a file as non-compliant are:

- the auditor failed to identify a material misstatement in the financial statements
- the auditor breached independence requirements
- an incorrect audit opinion was issued.

The table below shows the number of areas in which the auditor did not obtain sufficient evidence in files that were non-compliant from our last two review cycles.

Number of areas reviewed in which files were non-compliant

When we rate an audit file as 'non-compliant' we can take several actions. Depending on the nature of the findings and the timing of our review, we assess the best approach to remediation, which may involve contacting the entity to enquire about the accounting treatments. In the table below we set out what we found:

Results from non-compliant audit files[2]	Number of files 2021/22	Number of files 2020/21
Financial statements are materially misstated	1	2
Insufficient evidence available to make a reliable assessment of material misstatement	4	2
Insufficient evidence, additional audit work required, impact to be assessed	2	1
Investigate or referral to the disciplinary bodies	0	0

For the audit files where we concluded insufficient evidence was obtained in a significant risk area, the areas impacted were:

- going concern and the impairment of joint venture investments and loan balances
- arm's length and completeness of related party transactions
- completeness of revenue and the risk of management override
- impairment of intangible assets.

In one instance additional audit work was required where the audit team did not assess the accounting treatment for the change in percent ownership in an investment. After our review, the audit team performed additional remedial work and the financial statements did not require restatement.

2: Where we rate an audit as 'non-compliant', it does not necessarily mean the financial statements do not show a true and fair view or require restatement. Equally, where we rate an audit as 'good' or 'compliant' this is not an endorsement that the financial statements are free from misstatement.

International comparison and developments

We continue to track our observations in New Zealand against those reported by the International Forum of Independent Audit Regulators (IFIAR). IFIAR provides an overview of the findings of various audit regulators, including the FMA, from reviews of listed entity audits by the six largest audit firms[3]. The overview provides key trends, review findings, and the overall percentage of non-compliant audit files.

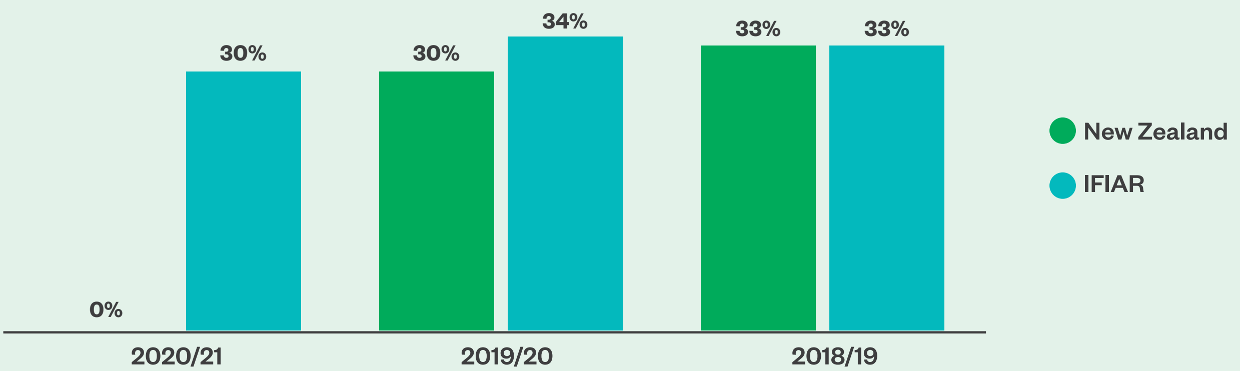
The graph below compares our 'non-compliant' file ratings with those in the IFIAR report[4].

As we only review 8 to 15 listed audits each year, and 2 to 3 of the Big 6 firms, the New Zealand percentages may fluctuate significantly between years. In 2020/21 we reviewed nine listed files audited by the large network firms and rated all these as compliant. The IFIAR percentage includes the results of 42 countries, and in 267 of the 893 reviews they concluded that the audit file was not compliant. In 2022, one audit by a top-six firm that we reviewed was non-compliant (10%). The IFIAR number for 2022 was not available at the time this report was published.

Throughout the pandemic we have continued to be actively involved with IFIAR. We chair IFIAR's Emerging Regulators Group, which gives us an opportunity to engage with the leadership of large audit networks, to help us address issues at a local level. We also provided webinars on key topics such as climate change disclosures and our enforcement process. All meetings of the Global Audit Quality working group, which we attend as observers, were held remotely.

We continue to assess international developments and enquiries, especially in the UK and Australia, to identify potential changes that would be applicable in the New Zealand audit market.

Percentage of non-compliant audit files of listed entities performed by the Big 6



3: The 'Big 6' – BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC

4: We apply the same file rating standards as IFIAR in our audit quality reviews.

Common findings and themes

In this section we provide more detail on the common themes we identified in our reviews, and our expectations for auditors and directors to ensure issues do not reoccur. In most instances, our findings were not isolated to certain files, firms or partners, but rather themes identified throughout the review sample

Audit evidence on the audit file

Audit evidence is one of the cornerstones of an audit; lack of evidence impacts the quality of an audit. The standards require an auditor to obtain sufficient and appropriate evidence to support their opinion. An auditor should base their opinion on evidence gathered during the audit. The evidence should be sufficient and should cover all material areas of the financial statements. Evidence can be in various forms and can be obtained from various sources including the documentation of the work performed by the auditor.

We have seen an improvement in the quality of evidence obtained and the way it has been documented on audit files. However, there are areas that require further improvement. Below are some examples of poor practice we observed in our reviews.

Evidence obtained in the prior year relevant to the current year

- The auditor relied on evidence obtained in the prior year but did not roll forward the evidence to the current year file.
- The auditor rolled the evidence forward from the prior year but did not perform any audit procedures to confirm the evidence is still relevant.
- Audit procedures were performed in the prior year to assess relevance of laws and regulations on the audit, but no procedures were performed in the current year to confirm the assessment is still appropriate.
- The auditor performed an assessment on whether a specific accounting treatment is appropriate in the prior year, but that assessment was not rolled forward, and circumstances had changed since the prior year.

Work of experts

- The auditor did not provide evidence of consultation with the technical team (internal experts) or documented feedback from the technical team to support the conclusion reached on the audit file. In most instances the auditor only documented the specific matter that was consulted on, but not other key areas of the experts' work.
- There was insufficient documentation of the reliance on the work of experts and the auditor's evaluation of assumptions and inputs used in the fair value assessment.
- The auditor did not evidence communication with management's expert and/or the auditor's expert, including the agreed scope of work.
- In many instances the auditor engaged their corporate finance team to assist with verifying the appropriateness and reasonableness of assumptions used in cashflow projections used in fair value or going concern assessments. Although the auditor obtained confirmation from the corporate finance team that the assumptions may be appropriate and reasonable, the auditor failed to evaluate the appropriateness of that team's work, and therefore did not have sufficient and appropriate evidence on the audit file to support the auditor's conclusion.

Clarity of documentation

- The auditor did not clearly describe the incentives and opportunities related to fraud; they documented the risks that existed but did not elaborate as to what those specific risks were in relation to the entity. Additionally, we did not see documentation showing how they concluded that risks were 'low'.

- Where audit firms have software with auditing programmes and templates designed to enable the auditor to perform procedures, the auditors did not complete the templates and procedures appropriately, and only answered "completed", without further details on what evidence was obtained.
- The audit file did not contain enough detail to reflect the discussions held during the internal planning meeting, meetings with management and those charged with governance, and the impact these meetings had on the audit.
- Where the audit firm audited related entities, the auditor did not include sufficient evidence of each individual audit file to support the individual audit opinion.

Consistency of documentation

- During the audit, the auditor revised their risk assessment, but this was not updated on the audit file. As a result, the work performed and evidence gathered were not in line with the risk assessment documented on the audit file.
- In the key audit matters section of the auditor's report, the auditor stated that the controls were tested or assessed for operating effectiveness. However, the auditor performed only a walkthrough of the entity's processes and controls, and did not formally test any controls. We also noted several instances where auditors document that their approach is to test the functional effectiveness of the controls, while they were only assessing the controls for design effectiveness.

Our expectations for auditors

- The documentation on the audit file should be clear and detailed enough to demonstrate the procedures performed by the audit team, the evidence obtained, and the conclusion reached.
- All working papers and evidence prepared in prior years that may support the auditor's conclusion should be brought forward and retained on the current audit file with an assessment by the auditor of whether there have been any changes to the circumstance and whether the working papers are still relevant.
- In instances where the auditor intends to rely on work performed by internal experts, the auditor should ensure the detailed workings to support the expert's opinion are retained on the audit file. The auditor should further ensure those working papers have been reviewed by the auditors, and provide comments and conclusions as to why the work performed and conclusion reached by the internal expert are appropriate to support the auditor's opinion.
- Where the auditor has made changes to their planned approach or risk assessment, they need to ensure those changes and the reasons for those changes are clearly documented in the audit file.
- The auditor needs to ensure that all working papers are appropriately reviewed to ensure they are accurate and provide appropriate sufficient audit evidence to support the auditor's opinion.
- Where the auditor attends a meeting (internally, or with management, those charged with governance and/or an external expert), they may want to ensure that detailed minutes are included on the audit file to clearly evidence what was discussed, any risks identified, and decisions made that may impact the audit or the audit approach.
- Auditors should not disclose references to controls in their key audit matters if these haven't been tested and relied on as part of their audit evidence.

Professional judgement and scepticism

The exercise of professional judgement is critical in any audit, and a fundamental requirement of the auditing standards. The need for professional judgement may be more obvious in areas such as risk assessment, fair value, going concern, interpretations of accounting standards, or the assessment of the sufficiency and appropriateness of evidence. However, professional judgement is also critical in deciding how an audit is conducted more generally, including making sure that the right specialist skills or knowledge is available.

When professional judgement is not exercised effectively, audit quality may suffer. Below we highlight some findings related to the application of the auditor's professional judgement and scepticism, including assessment and testing of key assumptions used in fair value and going concern assessment. Although we have seen an improvement in the extent of work auditors do around areas requiring good judgement, it remains an area where auditors need to ensure the evidence they gather is sufficient and appropriate to support their conclusions.

Agreements and terms of the transaction

- When reviewing the change in an investment and considering whether the accounting treatment remained appropriate, the auditor did not evaluate all available information, such as relevant agreements and terms of the transaction. This resulted in the arrangement being incorrectly classified and accounted for in the financial statements.

Forecasts

- The auditor did not obtain evidence to verify the validity and accuracy of short-term and long-term revenue forecasts utilised in management's impairment assessment.
- The auditor did not obtain sufficient evidence to corroborate management's position on their ability to obtain additional funding through the issue of shares.
- The auditor did not obtain any evidence to corroborate if the current value of collateral was sufficient to ensure the recoverability of the loan in the case of a default.
- We did not find any evidence the auditor challenged management's assessment of the indicators of impairment or corroborated the assessment provided by management with relevant evidence.

Discount rates and terminal growth rates

- The auditor did not assess the reasonableness of the discount rate and the terminal growth rate used for cashflow projections.
- The auditor developed their own discount rate to assess the reasonableness of the discount rate used by management in their impairment assessment but did not document their rationale for how they determined their own rate.

Disclosure

- The significant assumptions detailed in the audit workpaper were not consistent with the assumptions disclosed in the financial statements.

Requirements of the accounting and auditing standards

- The auditor did not evidence the review of management's assessment of the accounting treatment.
- The audit file did not contain any consideration of the entity's compliance with the accounting standards.

Our expectations for auditors

- Auditors should be sceptical when assessing management estimates and be able to demonstrate through their audit documentation how they challenged management on the appropriateness of their key assumptions used, such as substantial revenue growth rates, discount rates or terminal growth.
- Appropriate and sufficient audit evidence should be obtained to support the significant judgements made by management.

Our expectations for directors

- Financial statements must fully comply with IFRS, and disclosures must be clear, concise, and effective[5]. This includes disclosing key assumptions made by management in their accounting decisions.
- Ensure the entity has policies and procedures to support preparation of high-quality financial statements that capture all transactions and disclosures.
- Accounting records should be accessible and support the accounting treatment made by management.
- For unusual or more complex transactions, entities should prepare accounting papers to support their decisions and treatment. Where the accounting team has insufficient experience, the entity should obtain independent accounting advice.
- Board minutes should record key decisions and discussions on the key accounting estimates made by directors.

5: See our 2018 report Improving financial statements

Significant risk areas

When selecting parts of the audit file to review, we focus on financial statement areas that are significant in terms of value or disclosure. These often align with the auditor's assessment of significant risks and key audit matters.

During our reviews, we identified several issues related to these significant risk areas. Below we highlight some of these findings, which often relate to auditors not performing the necessary procedures to obtain sufficient and appropriate evidence.

Related parties and related party transactions are still an area where auditors need to improve, in relation to both the extent and quality of the procedures performed, to ensure the disclosures are both accurate and complete.

Going concern

- It was not clear what audit procedures were performed on the projected cashflows to determine whether the entity would be able to continue as a going concern. The auditor did not obtain sufficient and appropriate audit evidence to support their specific considerations (including assumptions and judgements) and conclusion.
- The auditor did not ask management to extend its assessment to at least 12 months from the date of issuing the auditor's report, as required by the standard.
- The disclosures in the financial statements did not clearly disclose the events or conditions that cast significant doubt on the entity's ability to continue as a going concern.

Revenue

- It was not clear from the documentation where the auditor obtained an understanding of the entity's control environment, including the identification of relevant controls, and whether the auditor assessed the controls for the design, implementation, and operating effectiveness.
- There was no evidence that the completeness of revenue was tested. The test performed traced recorded revenue to a bank statement but did not address other assertions such as occurrence and completeness.
- Where the auditor rebutted the risk associated with the recognition of revenue due to fraud, they did not document this assessment.

Related parties

- The auditor did not evidence how they had tested the arm's-length assertion of related party transactions as disclosed in the financial statements.
- The auditor did not perform sufficient and appropriate procedures to address the level of risk associated with the related party transactions.
- The auditor did not evidence audit procedures carried out to address the completeness and occurrence of transactions with related party entities identified at the planning stage.

Fraud and the risk of management override

- The auditor rebutted the risk of fraud relating to management override of controls, which is not allowed by the auditing standards.
- There was no evidence of the discussions held between the auditor and the rest of the audit team with regards to the risk of material misstatements due to fraud. It was not clear what fraud risk factors the audit team considered and what the conclusions were regarding the risk of material misstatement due to fraud.
- The auditor did not assess all identified risky journal entries. There was also no documentation on file to confirm the validity or authority of the preparers identified by the firm's analytical tool.

Our expectations for auditors

- The auditor should obtain a thorough understanding of the business processes related to significant risks, including the identification and assessment of relevant controls and whether the controls are at least designed effectively.
- The auditor should clearly document the areas of significant risk and what procedures they will perform to address this. Any changes made during the audit should be reflected in this assessment.
- The audit plan should set out the audit procedures that address the significant risks of material misstatement.
    - We expect the auditor to obtain more persuasive audit evidence where the risk has been assessed as being higher.
    - We expect the auditor to design and perform audit procedures whose nature, timing, and extent are based on and responsive to the assessed risks of material misstatement at the assertion level.
- Auditors should remain alert and revise the risk assessment if new or other information comes to the auditor's attention that differs significantly from information on which the risk assessment was based.

Our expectations for directors

- Directors should lead the relationship with their auditor and proactively engage in conversations with the auditors to produce effective and high-quality information.
- Directors should ensure significant issues with management are discussed, resolved in a timely manner, and appropriately addressed.
- Information provided to the auditor should be checked for completeness and accuracy.
- Processes should be evaluated for the risk of error, fraud, and management override of controls.
- For related party transactions, directors should assess the entity's monitoring systems to verify the completeness and accuracy of relationships and transactions.

Current developments in auditing

One of the key objectives of audit oversight is to promote quality, expertise, and the integrity of the audit profession in relation to FMC audits. With major growth in retail investing in recent years, we are seeing more Kiwis entrusting their wealth to the sharemarket, or otherwise indirect investments in FMC reporting entities through managed investment funds or KiwiSaver. The audits of these entities provide the necessary trust and comfort that the financial information of the entities is robust.

In our monitoring of audits and audit firms we focus not only on compliance with audit standards, but also developments and trends in the audit market that could impact the quality of audits or require additional focus.

Auditor shortages

Our audit quality reviews are focused on ensuring the quality of information provided to investors is not compromised due to a lack of well-executed audit procedures. Audit quality is impacted by the systems audit firms have in place, and the capabilities of their auditors.

Over the years audit firms have made significant investments in their audit quality systems, and the number of our findings in this area has been low. Audit quality is more impacted by the execution of the audit procedures by individual auditors. Therefore, it is important to have sufficient auditors with the right skill sets.

Through our financial reporting surveillance, we noted a shortage of experienced auditors, impacting the timely completion of audited financial information for investors and stakeholders. The shortage has been exacerbated by challenges in attracting and retaining talent. Overseas secondments and immigration stopped during COVID-19 border closures, which limited the inflow of experienced auditors, while new graduates and other audit staff are finding a broader range of options in the tight labour market, especially with the current lack of international students.

Professional services firms with audit functions have continued to grow both in revenue and staff numbers, even during the pandemic. Based on this it seems the problem isn't attracting staff to such firms, just attracting staff to their audit functions.

As the pandemic eases and some measures have been taken to attract overseas auditors, we are as likely to lose local auditors to overseas and corporate opportunities as we are to gain auditors from offshore. The shortage looks likely to continue for some time, and solving it will require a collective effort by the audit profession.

Steps have been taken to alleviate the pressure of the shortage locally, with the FMA granting some reporting deadline extensions for businesses and auditors impacted by shortages and COVID-related absence. Providing timely information to investors is important, and therefore we ask entities to work with their auditor to make robust plans to avoid breaching filing deadlines. Going forward, we will consider extensions on a case-by-case basis, but expect FMC reporting entities to be sufficiently organised to meet the filing requirements.

Audit firms play a crucial role in maintaining the integrity of our financial system and therefore we expect the profession to increase its focus on creating a sustainable future that can resist disruptions. It is essential that firms focus not only on filling vacancies, but on attracting the right talent.

From a regulation perspective, the shortage risks impairing audit quality over time if excessive workloads continue and knowledge gaps are not filled. Where possible we revisit policy and procedures to ensure competent auditors from different jurisdictions can become licensed auditors.

To ensure that audits of our most important entities are performed to required standards, we have set out steps directors, audit firms and professional bodies can take.

Directors

- In a constrained market, audit firms need to make choices about what work to take on, and what clients to engage with. Therefore directors should provide an environment that facilitates delivery of high-quality information to auditors, including having robust internal control processes and procedures.
- Directors and management can minimise the risk of delay and breaches in their financial reporting obligations by having a robust plan, to ensure required information is available for their auditors in a timely manner.
- Directors are expected to engage in a timely manner on any external accounting advice from other accounting firms so audit timeframes are not impacted.
- Directors should be willing to pay a reasonable fee to ensure their auditor has sufficient time and resources to perform a compliant audit, rather than focus overly on driving down the audit fee.
- When issues arise regarding filing deadlines, contact the FMA early with plans for how to complete the audit as soon as possible.

Auditors and professional bodies

- A recent CA ANZ discussion document, Attracting and retaining talent in the audit profession, points to evidence young auditors are looking for meaning in their work. The profession should explore how to better articulate the purpose of an audit and the benefits an audit has for investors and other stakeholders, to align better with the sense of purpose and value employees are looking for.
- As part of the planning and completion of the audit, have open discussions with directors of entities about the quality of the information provided by management and their attitude towards the audit. Selecting the right clients can impact staff retention and attraction rates.
- Becoming an auditor has followed traditional pathways. The profession should look at ways to accommodate more flexibility in professional development and career progression. With the current need for specialist skill sets, such as expertise in technology and science in relation to developments in climate-related disclosure, traditional pathways may not be as suitable.

Climate-related risks

The introduction of mandatory climate-related disclosures in New Zealand adds a new regulated service for auditors and other assurance providers. Approximately 200 entities will be classed as Climate Reporting Entities (CREs), and required to prepare climate statements from 2024. However, all FMC reporting entities, regardless of whether they are a CRE, are already required by existing accounting standards to assess if climate change has an impact on their financial statements.

To respond to climate change risks in the audit of financial statements, auditors should have a good understanding of:

- laws and regulations regarding climate change
- how climate risk is impacting certain entities and industries
- how climate risks impact accounting.

Existing expectations for directors and management

Directors and management are responsible for ensuring financial statements comply with the accounting standards. We strongly recommend management and directors consider climate risks throughout their risk assessment process, covering the impact on financial statements as well as the new required disclosures.

The accounting standards do not refer explicitly to climate-related matters. However, entities must consider climate-related matters when they are material to the financial statements. The IFRS Foundation has issued a useful guidance document on assessing the impact of climate-related matters when preparing financial statements.

When preparing financial statements, entities should focus on providing information in a clear, concise, and effective way, so material information is not lost in lengthy explanations of the circumstances and the impact on numbers. This is also relevant to the impact of climate change on disclosures.

Existing expectations for auditors

In the audit of financial statements, the auditor's objective is to obtain reasonable assurance about whether the financial statements are free from material misstatement, and to report on whether the financial statements are prepared, in all material respects, in accordance with the financial reporting framework. If climate change impacts the entity, the auditor needs to consider whether the financial statements appropriately reflect this.

As part of an audit, the auditor should consider the potential risk of material misstatement of the financial statements due to climate change. Where auditors identify risks, they must determine an appropriate audit response to assess if the risks have a material impact on the financial statements.

In October 2020, the IAASB issued a Staff Audit Practice Alert setting out some of the more significant areas that may need to be considered in relation to risk assessment and responses to assessed risks, audit evidence, communication with those charged with governance, and auditor reporting.

The FMA issued expectations for disclosures on audit files in relation to climate risk earlier this year.

New expectations under the Climate Related Disclosures (CRD) regime

The CRD regime also introduces mandatory assurance over greenhouse gasses. Both audit firms and other assurance providers will be able to perform these services based on the standards set by the XRB.

Providing assurance over non-financial information is becoming more important to maintain trust in the financial markets. Therefore it is important the systems and process followed for providing these services are robust and of the same quality as for audits of financial statements.

XRB has issued the draft Standard for Climate Disclosure, which will become effective by December 2022. The FMA will provide information on our expectations for keeping the appropriate records and how we are monitoring the regime. The FMA's website is regularly updated with new content on CRD.

FMA's focus on climate risks

- We will provide information to all stakeholders of our monitoring approach and expectations for CREs. We will also focus on the development of the assurance regime for these new disclosures.
- Over the coming years we expect our monitoring of audit files will include consideration of climate risks where they have a material impact on financial statements.
- In our reviews of financial statements, we will consider if climate change risks have an impact on business models, cashflows, financial positions, and the performance of entities. We will also look at statements made by the entity on climate issues outside of the financial statements, and how these are considered as part of their accounting.

Appendix 1 – Audit oversight regime

Oversight of FMC auditors

The Ministry of Business, Innovation and Employment (MBIE) sets the policies for the oversight of auditors of FMC reporting entities. The regulations are set out in two key pieces of legislation:

- the Financial Markets Conduct Act 2013 (FMC Act), which establishes which entities require their financial statements to be audited by a licensed auditor/ registered audit firm
- the Auditor Regulation Act 2011 (AR Act), which sets out the rules regarding the licensing and oversight of auditors of FMC reporting entities.

What are FMC reporting entities?

The FMC Act defines an FMC reporting entity as:

- an issuer of a regulated financial product (for example managed investment schemes and other registered schemes)
- listed entities
- registered banks and licensed insurers
- credit unions and building societies
- a number of other licensed entities under the FMC Act.

Financial Markets Authority

The FMA is the Crown entity responsible for enforcing securities, financial reporting and company laws as they apply to financial services and financial markets. This includes the regulation of auditors of FMC reporting entities, and the accreditation and monitoring[6] of professional bodies. The FMA also licenses and registers overseas auditors and audit firms.

External Reporting Board

The External Reporting Board (XRB) is an independent Crown entity responsible for standards related to auditing in New Zealand. In relation to FMC reporting entities, the XRB has issued the following standards:

- Accounting Standards, which each FMC reporting entity must comply with
- Auditing and Assurance Standards, which all auditors must comply with when auditing FMC audits.

The standards are based on international standards, being the International Financial Reporting Standards (IFRS), International Auditing Standards (IAS) and the various standards issued by the International Ethics Standards Board for Accountants (IESBA).

Professional bodies

Two professional bodies in New Zealand are accredited by the FMA: Chartered Accountants Australia and New Zealand and CPA Australia. To be accredited, these bodies are required to have adequate and effective systems, policies and procedures in place to perform the following functions:

- licensing domestic auditors and registering domestic audit firms using the standards set by the FMA
- monitoring those auditors and registered audit firms
- promoting and monitoring the competence of these members
- taking action against misconduct.

All licensed auditors can be found on the Auditors Register.

Disciplinary proceedings

Accredited bodies have the primary responsibility for investigating potential auditor misconduct. The FMA can investigate only those matters that accredited bodies have referred to us or decided not to investigate.

We may refer a matter to the relevant accredited body for further investigation following an audit quality review, a complaint, or any other intelligence obtained by the FMA. These referrals are made if we believe the issue

6: CA ANZ accredited body reports; CPA Australia accredited body reports had a significant impact on the audit's outcome, or where Professional Ethical Standards may have been breached.

The graph below provides an overview of how many matters we referred to accredited bodies or investigated ourselves.

As at the date of this report, there are three ongoing investigations of referrals made by the FMA between 2017 and 2022 that are in various stages of the disciplinary process. These cases may involve several licensed auditors and could take several years to conclude, depending on the complexity.

Monitoring audit quality

The FMA issues an annual Auditor and Regulation Oversight Plan. This plan helps licensed auditors, registered audit firms and accredited bodies to understand how we will approach auditor regulation and which areas we will focus on during our reviews.

We report annually on our findings in the Audit Quality Monitoring Report (this report), and provide additional guidance in Audit Quality: A director's guide.

Quality review methodology

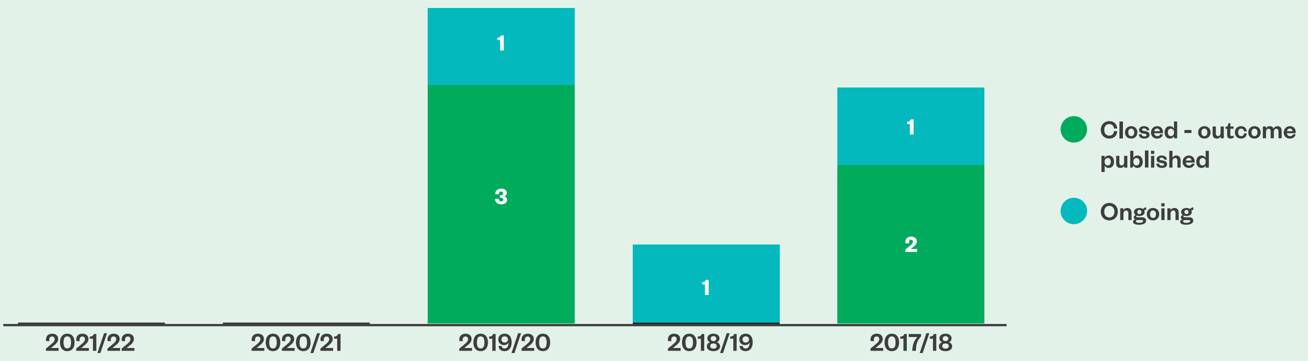
We assess an audit firm's compliance with the standards and the requirements of the AR Act by:

- looking at the audit firm's overall quality control systems for performing compliant FMC audits
- reviewing a selection of individual FMC audit engagement files to see if a file complies with the above systems and the Auditing and Assurance Standards issued by the XRB.

We review the 'Big Four' firms every two years, and all other audit firms every three years. As a result of our Memorandum of Understanding (MOU) with the Auditor-General, we may review audits of FMC reporting entities carried out by private audit firms on behalf of the Auditor-General. The results of these reviews are included in this report and our findings are communicated directly to the Auditor-General.

All our reviews undergo a robust moderation process. Each audit quality review assessment report is peer-reviewed by a reviewer not involved in the initial review. Our final report goes to the Auditor Oversight Committee (AOC) for consideration. The AOC provides an independent forum to review the consistency and fairness of all quality review reports. The AOC comprises a diverse group of professionals including former auditors, company directors, and others with relevant experience who are independent of the audit profession.

Number of matters referred to accredited bodies - disciplinary proceedings and investigations



Quality control framework

The requirements of a quality control system are set out in the Professional and Ethical Standards, and Auditing Standards. Our assessment of an audit firm's quality control system focuses on whether:

- the system complies with the relevant standards
- the system's policies and procedures are followed
- the system contributes to high-quality FMC audits.

We also evaluate whether the audit firm's internal monitoring of its audit quality control system is effective. This internal monitoring includes the audit firm performing an engagement quality control review (EQCR) on each audit file. The EQCR process is designed to provide an objective evaluation of the significant judgements the audit team has made, and the conclusions reached in the auditor's report.

We have prescribed additional requirements[7] for the EQCR given its importance to the audit process. We expect the EQCR partner to be suitably qualified and have relevant experience to enable them to give an objective evaluation, and therefore require the EQCR to be licensed.

Individual file reviews

We carry out individual audit file reviews to check the auditor has complied with Auditing and Assurance Standards, and exercised reasonable care, diligence and skill in carrying out the audit.

Key attributes of audit quality are:

- an independent audit is carried out by a licensed auditor
- the auditor demonstrates appropriate levels of professional scepticism
- adequate and appropriate audit evidence is obtained
- the auditing and assurance standards are followed
- an appropriate audit opinion is issued.

Risk-based file selection

The number of audit files we select for each audit firm is determined by the number of licensed auditors at the audit firm, the number of FMC audits completed and the results of the audit firm's previous review. We choose audit files to review at random, as well as selecting audits from higher-risk sectors and industries.

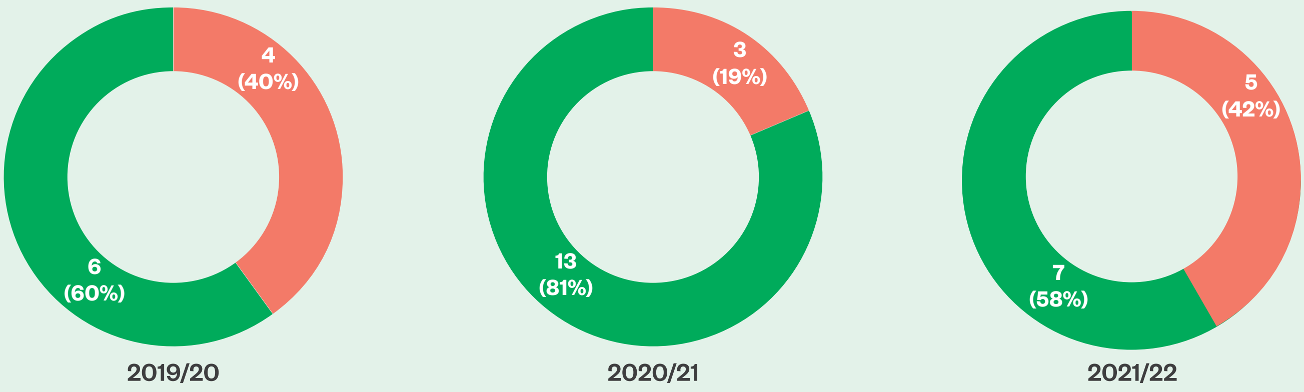
- Risk-based selections include businesses that are more vulnerable to risks from existing and emerging market conditions, such as businesses that are newly listed, experiencing significant growth, or other higher-risk businesses that have compliance issues such as qualified audit reports. This may include:
  - businesses of significant public interest, given the value of financial products issued to the public (such as KiwiSaver schemes, banks, insurance companies and businesses listed on the NZX)
  - businesses and industries that are more vulnerable to risks from existing and emerging market conditions, such as newly listed businesses, or businesses that experienced significant growth
  - other businesses considered higher risk, such as finance companies, or businesses that have non-compliance issues such as qualified audit reports, or that have not complied with laws and regulations
  - businesses where our previous review found an audit file did not meet the required standards.
- Non-risk-based selections include audit files selected to cover auditors previously not reviewed, or to provide sufficient coverage of the audit firm's work.

7: Paragraph 8(1)(f) of the Auditor Regulation Act (Prescribed Minimum Standards and Conditions for Licensed Auditors and Registered Audit Firms) Notice 2012

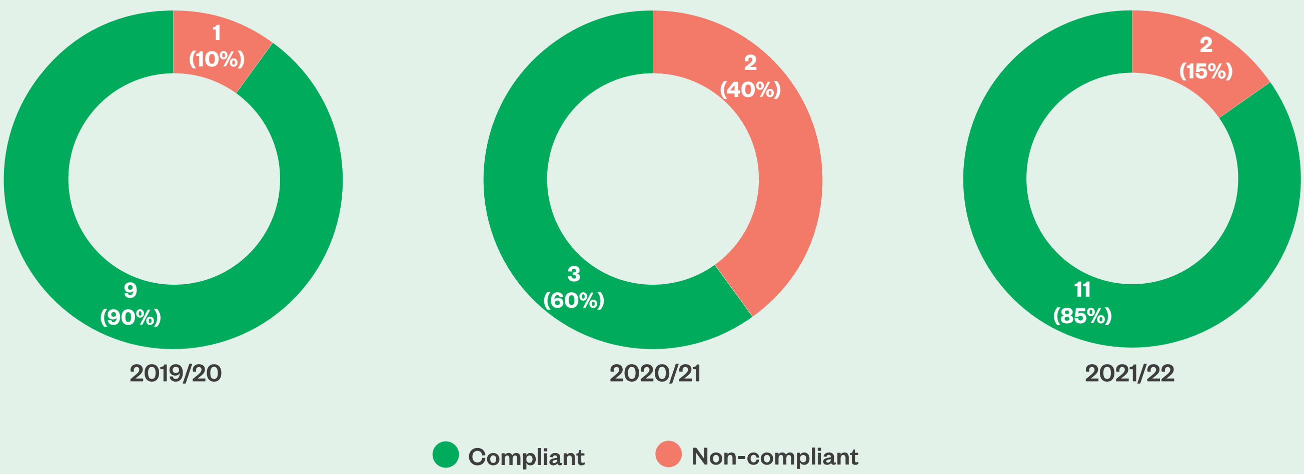
The audit firms and audit files we review change each year, so it is difficult to compare year-on-year results. Trends in audit quality should be analysed over several years to better understand what progress has been made. Due to the small sample sizes and the selection approach, the result may not be indicative of the overall quality of audit firms reviewed.

Audit files selected on a risk basis are often more complex and, therefore, have a higher chance of being non-compliant than those selected at random. Historically, our risk-based selections have had a higher level of non-compliant files. The tables below show the split between risk-based and non-risk-based sampling, and the number of files we have rated non-compliant.

Number of audit files from risk-based selection



Number of audit files from non risk-based selection



File ratings

When we complete a file review, the reviewer gives each individual finding on that file a rating from low to high, and proposes a final overall file rating from the categories below:

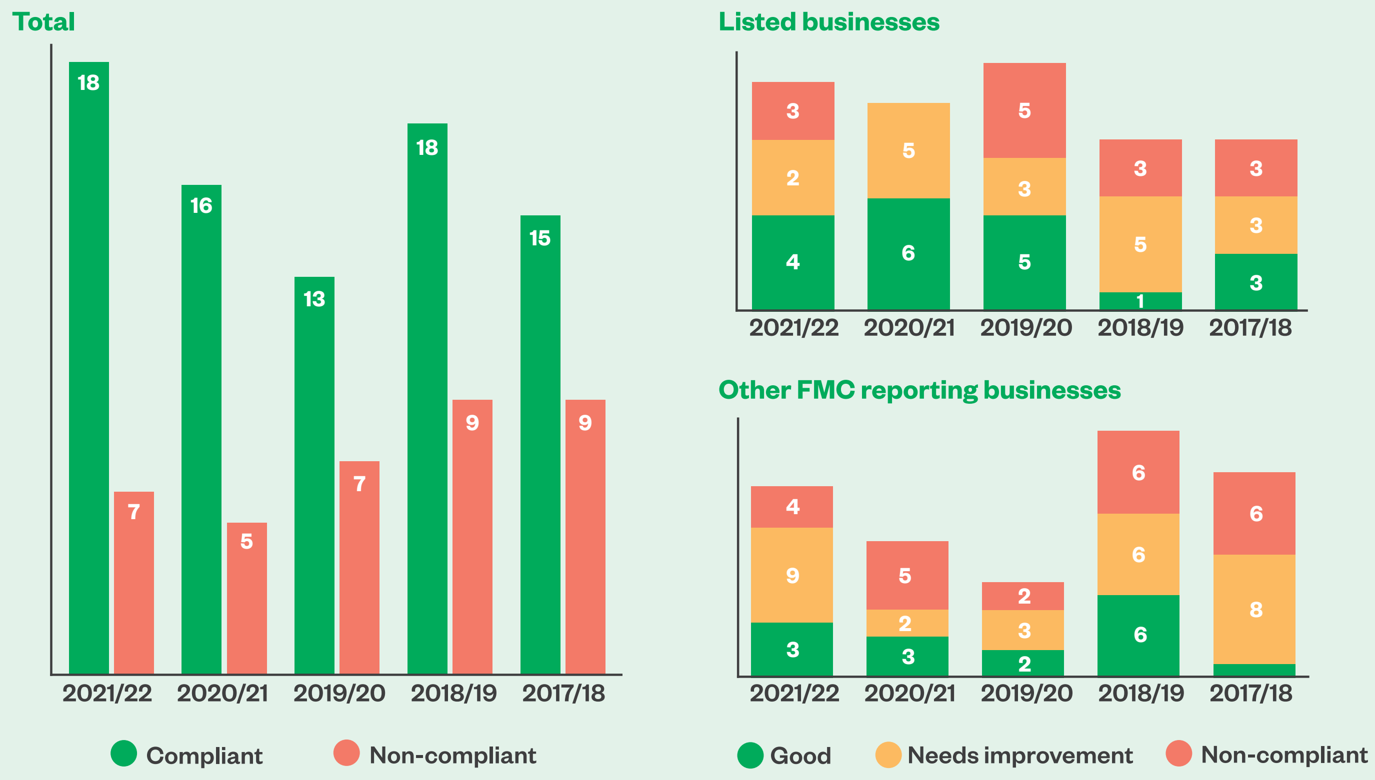
- Good – we either had no findings or the findings relate to improving some documentation or minor non-compliance with the auditing standards. The reviewer is satisfied that all audit procedures have been performed around key risk areas and sufficient audit evidence was obtained.
- Compliant, but improvements needed – we identified several areas in the file where the audit wasn't performed in accordance with the audit standards. However, the reviewer found that overall, there was sufficient and appropriate audit evidence obtained in the key risk areas.
- Non-compliant – the file showed several areas where the audit wasn't performed in accordance with the standards. The reviewer found insufficient or inappropriate audit evidence obtained in at least one key risk area of the audit, or the review showed a material misstatement that required restatement of the financial statements and/or the audit opinion.

The ratings are moderated by the AOC.

Summary of review ratings

The graph below provides an overview of how we rated the individual audit files reviewed over the last eight years. This is broken down further between listed and other businesses

Number of audit files reviewed



Background to our rating criteria

Our reviews focus on audit processes and procedures, and do not assess whether the underlying audited information is correct. Where we rate an audit as non-compliant, it does not necessarily mean that the financial statements do not show a true and fair view or require restatement. Equally, where we rate an audit as good or compliant this is not an endorsement that the financial statements are free from misstatement.

Our reviews cover different audit firms each year and files are selected on a risk basis. The sample is therefore not statistically representative, and the summary of results needs to be interpreted cautiously. Our findings do, however, provide insights in trends in audit quality and highlight areas for improvement applicable for most FMC audits.

Possible post-review actions

Following an audit quality review, we consider if further action is required. Actions we could take include:

- Requiring an audit firm to perform additional work to address our findings.
- Requiring an entity to restate the financial statements if we find material misstatements.
- Completing a follow-up review within 12 to 18 months of the previous review to ensure the audit firm has taken appropriate action to address our findings.
- Issuing directions to remediate any findings.
- Referring complaints to the professional body to be dealt with under its disciplinary procedures.

Appendix 2 – Market data

	30 June 2022	30 June 2021	30 June 2020	30 June 2019	30 June 2018
Domestic licensed auditors	135	138	135	132	138
New licences issued to domestic auditors	4	9	10	11	5
Domestic auditor licences cancelled	7	6	7	8	8
Domestic registered audit firms[8]	14	14	14	14	15
Domestic audit firms licensed	0	0	1	0	0
Domestic audit firms' registrations cancelled or expired	0	0	1	1	2
NZX-listed companies	185	186	178	205	190
FMC audits	1,050	1,130	1,200	1,250	1,300
Firms reviewed	7	5	4	6	5
Audit files reviewed	25	21	20	27	24

8: This includes two brand names with six individual licences. We have included these as 2 registrations as we combine the reviews of this individual licences. This disclosure has changed from previous year where they were disclosed as separate firms.

Glossary

Accounting standards /NZ IFRS	The New Zealand equivalent to International Financial Reporting Standard issued by the External Reporting Board
AR Act	Auditor Regulation Act 2011
AOC	This is the Audit Oversight Committee established by the FMA that provides an independent forum to review the consistency and fairness of all quality review reports. The members of AOC are a diverse group of professionals including former auditors' partners, company directors, and other people with relevant experience.
Audit firm	Registered audit firm as defined by the AR Act
Auditing and Assurance Standards	The auditing and assurance standards issued by the External Reporting Board
Auditing standards	International Standard on Auditing (New Zealand) to be applied in conducting audits of historical financial information as issued by the External Reporting Board
Auditor	Licensed auditor as defined by the AR Act
Culture	A reflection of shared beliefs and one of the most important factors in explaining motivation, commitment, and decision-making. It is an intangible factor that explains why larger groups of people do similar things, talk in similar ways and why they use similar tools to achieve an outcome.
EQR	Engagement Quality Review. This is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team has made and the conclusions it has reached in formulating the auditor's report.
EQR partner	Licensed auditor who performs the EQR. This may be a licensed auditor who is not a partner in the audit firm
Going concern	Under the going concern assumption, a business is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless those charged with governance plan to liquidate their business, cease operations, or have no alternative than to stop doing business.

IFIAR	International Forum of Independent Audit Regulators
ISA (NZ)	International Standard on Auditing (New Zealand) issued by the External Reporting Board
FMC reporting entity	Has the same meaning as in section 6 of the AR Act
FMC audit	Has the same meaning as in section 6 of the Auditor Regulation AR Act
Materiality	Information is material if its omission or misstatement could influence the economic decisions of users taken based on the financial statements.
NZICA	NZICA and the Institute of Chartered Accountants of Australia (ICAA) formally amalgamated on 1 January 2015 to form the Chartered Accountants Australia and New Zealand (CA ANZ). After the amalgamation, NZICA continues to regulate the accountancy profession for Chartered Accountants ANZ members who remain resident in New Zealand (and by virtue of their residence continue to be NZICA members) according to the NZICA Act 1996, and the terms of the amalgamation agreement. For the audit oversight regime, NZICA continues to be the accredited body.
PES	Professional and Ethical Standards issued by the External Reporting Board
QCS	An audit firm's quality control systems
Quality review	A review of an audit firm as defined by the AR Act

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

WELLINGTON – Level 2 | 1 Grey Street | PO Box 1179 | Wellington 6140