Audit Quality Monitoring Report

1 July 2016 – 30 June 2017

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

Purpose

Under the Auditor Regulation Act 2011 (the Act) we must carry out a quality review of the systems, policies and procedures of registered audit firms and licensed auditors at least once every four years.

We are also required to prepare a report each year on the quality reviews we completed in the preceding financial year.

Our quality reviews help improve audit quality standards and ensure audit opinions are reliable. These reviews also help us to achieve our strategic goal of ensuring that investors have access to resources that help them make better-informed financial decisions.

This report summarises our findings from the quality reviews we carried out between 1 July 2016 and 30 June 2017. It is for:

- accredited bodies
- auditors
- chartered accountants
- company directors
- investors
- issuers.

In this year's report, we draw attention to our expectations of directors and auditors of financial statements and the key focus areas our stakeholders need to be aware of. We have also published a separate **Directors' Guide to Audit Quality** to outline how directors can contribute to improving audit quality.

Contents

Key trends

Market snapshot

At 30 June 2017 there were...

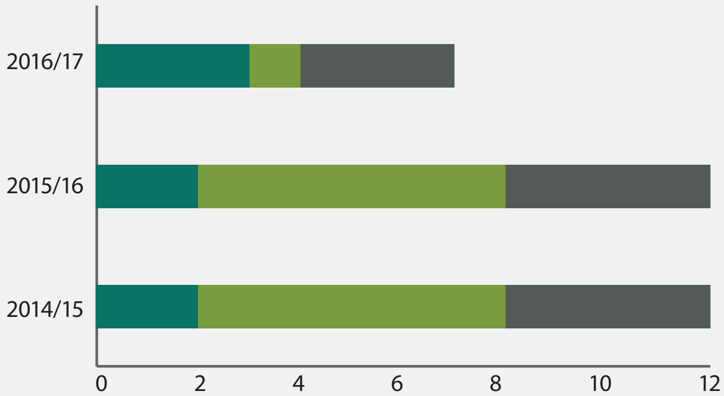
141
domestic licensed auditors

21
domestic registered audit firms

195
NZX-listed companies

1,300
FMC audits

Audit firms reviewed 2014-2017



- Firms with more than 10 auditors (includes Auditor-General review)
- Firms with multiple offices and fewer than 10 auditors
- Firms with fewer than four auditors

Audit quality reviews

2016/17

7 registered firms reviewed

audit files reviewed

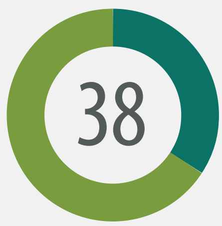
2015/16

12 registered firms reviewed

audit files reviewed

2014/15

12 registered firms reviewed



audit files reviewed

Listed companies   Other companies

Executive summary

We have seen improvements in audit quality since we started our audit firm reviews in 2013. The majority of audit firms have successfully implemented plans to address our previous review findings. However, while all audit firms now have appropriate systems and policies in place to deliver high-quality audits, we still see inconsistencies in the quality of individual audits.

Our approach

We are currently in the second three-year audit review cycle, which means we have reviewed each firm included in this report at least once before[1].

Between 1 July 2016 and 30 June 2017, we reviewed seven audit firms and 27 audit files. We continue to use a risk-based, targeted approach to select audit files for review. This means we focus on entities where audit failure would have a significant impact on the New Zealand capital markets as a whole. We also look at businesses with complex audit or accounting issues where it is more difficult to ensure investors are receiving appropriate disclosure.

As a result of this approach, the audits we review do not represent the audit environment as a whole. We therefore don't necessarily focus on the audit file ratings[2] as a key indicator of progress made by the audit firms, but measure the progress made since their last review.

Our expectations

Audit firms should continue their efforts to deliver quality audits on a consistent level. Firms need to understand why audit quality can vary significantly within a firm even though the same policies and procedures are applied. Audit firms should perform root-cause analysis for the more significant matters raised in our reviews to understand the underlying issues that resulted in non-compliance. This will provide the information necessary to implement effective plans that will prevent these issues from reoccurring.

We encourage audit firms to take notice of our key findings as well as their individual firm review reports. Audit firms should also look at the reports of international audit regulators, including the International Forum of Independent Audit Regulators, to understand current trends in audit quality.

While audit firms play a role in improving audit quality, directors also have key responsibilities for ensuring a quality audit has been performed. We have published a separate Directors' Guide to Audit Quality with key messages for directors.

International developments

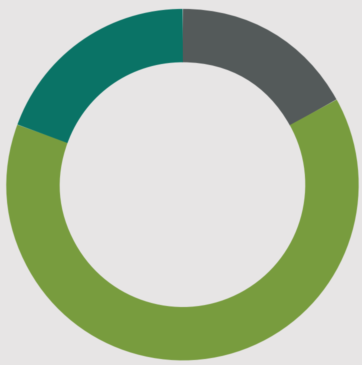
In 2014, we joined the International Forum of Independent Audit Regulators (IFIAR). IFIAR provides a forum to exchange information about the audit environment, including experiences and insights from their inspections of auditors, and enforcement practices.

The majority of New Zealand audit firms are part of a larger international network of

Progress made

Following an audit review we ask the firm to provide us with a plan outlining how they will address our findings. As part of this year's review we looked at whether the firms made improvements in the areas we highlighted for attention during the previous review cycle.

Improvements were made in the majority of areas where we previously had findings. This shows the initiatives implemented by firms are working. However, it will take time for firms to fully implement the necessary changes into their policies and procedures, and for us to see these applied consistently to all audits. We expect it may take multiple review cycles before the more complex matters are addressed.



Fully addressed our findings
Firms implemented effective systems and procedures since our previous review (20%)

Improvement shown
Firms implemented changes based on our findings, but improvements are not fully effective across all reviewed files (63%)

No improvements found
The planned system improvements to address our findings were not implemented or were ineffective (17%)

1 Except Audit New Zealand, which we reviewed for the first time this year – see page 4.
2 More information about our approach and file ratings is included in Appendix 1 on page 18.

firms. Through IFIAR's annual survey of inspection findings we can compare New Zealand audit firms' performance with its international counterparts. The findings reported in the annual survey are consistent with the findings in our audit quality reports.

On 4 April 2017, we signed a Multilateral Memorandum of Understanding with 21 other IFIAR members. This facilitates better information exchange between these independent audit regulators and should ensure more effective regulation of audit firms both internationally and locally.

Disciplinary procedures

This year, the Disciplinary Tribunal of Chartered Accountants Australia and New Zealand (CA ANZ) concluded on two complaints involving licensed auditors.

These cases followed an initial referral we had made after a quality review. As part of this remedial process, CA ANZ reviewed an additional FMC audit deemed to be deficient as it failed to detect a material misstatement in the financial statements of the FMC reporting entity. The auditor was censured and is prohibited from performing certain FMC audits, including listed entities, banks, insurance and finance companies, for the next two years.

The engagement quality control review (EQCR) partner of this audit file was censured for their involvement in not detecting the misstatement. CA ANZ sought to recover the costs of these proceedings of $109,228.

Currently, the Professional Conduct Committee, Disciplinary Tribunal and Appeals Council of CA ANZ have three ongoing complaints following our referrals. Outcomes

Key improvement areas

In this report we provide detailed information for audit firms to help them assess and improve audit quality. We selected a number of key areas based on findings we believe have the largest impact on improving audit quality.

These are:

- auditor independence
- internal review of audit quality
- use and documentation of professional scepticism
- audit of revenue
- executing key audit procedures.

This year we also provide findings on the audits of banks and finance companies, as these audits have specific risks and challenges not relevant to other audits.

of disciplinary procedures are documented on the audit register under the individual licensed auditor's name.

Auditor reporting

A new standard for auditor reports was introduced in 2016, covering New Zealand-listed companies with a reporting period ending on or after 15 December 2016. It provides users of financial statements with previously unavailable information on the key aspects of the audit. During the year, we reviewed two FMC audits that applied the new auditor reporting. We have not included findings in this report as we believe the sample is insufficient to show any useful trends.

Since its introduction, we have collected data about the new auditor report. Together with the External Reporting Board we will issue a separate report in November 2017 that sets out our observations from the first year.

Auditor-General

In July 2016, we entered into a Memorandum of Understanding (MOU) with the Auditor-General. Under the MOU, the Auditor-General has agreed we can undertake audit quality reviews of audits of FMC reporting entities that private audit firms and Audit New Zealand carry out on behalf of the Auditor-General. During this financial year we completed our first review of FMC audits by Audit New Zealand. We have incorporated these findings into this report.

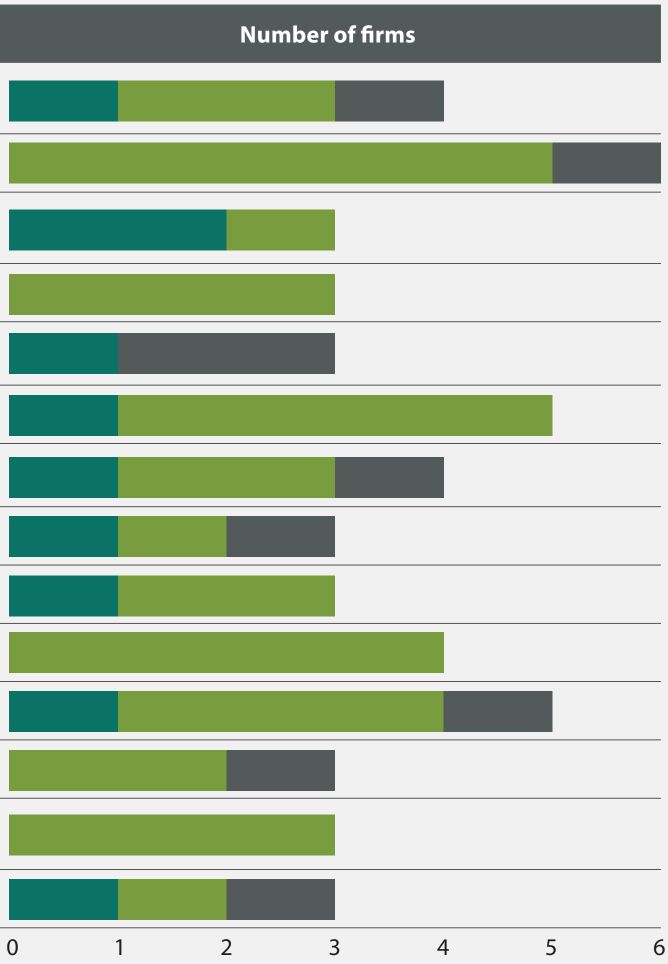
Progress made

The audit firms reviewed for this report have been reviewed previously[3]. In the first reviews we classified the areas that required improvement into 18 categories. Following these first reviews, we asked firms to outline a plan showing how they would prevent any identified issues from reoccurring. When reviewing the firms again, we tested the effectiveness of these plans. Although we found improvements in many areas, firms still have some work to do to ensure changes made to policies and procedures are consistently applied across all audit files.

We understand it will take time for firms to fully integrate these changes. We have highlighted key areas throughout this report to help auditors turn their attention to where improvements need to be made.

The table below shows how firms did in the 14 most common areas for improvement.

Description	Standard
Acceptance and continuance procedures	PES 3 & ISA (NZ) 220
Audit evidence and documentation	ISA (NZ) 230 & 500
Auditor independence – non-audit services	PES 1 & ISA (NZ) 260
Auditor independence – other	PES 3 & ISA (NZ) 220
Communications with those charged with governance	ISA (NZ) 260
Engagement quality control review	ISA (NZ) 220
Forming an opinion and reporting on financial statements – evidence	ISA (NZ) 700
Going concern	ISA (NZ) 570
Monitoring quality control	PES 3 & ISA (NZ) 220
Quality control manual	PES 3 & ISA (NZ) 220
Related parties	ISA (NZ) 550
Auditor's response to assessed risks	ISA (NZ) 330
Auditor's responsibility relating to fraud	ISA (NZ) 240
Use of professional scepticism	ISA (NZ) 200



- Effective systems and procedures implemented following our review
- Changes implemented based on our findings, but some improvements not fully effective across all reviewed files
- Planned improvements to systems ineffective or not implemented

3 Audit New Zealand has not been reviewed previously, so no progress data is included for this firm.

Key findings

Auditor independence

Our reviews continued to focus on auditors' compliance with the independence requirements for non-assurance services and other matters that could impact independence, such as longstanding association.

In large audit firms, we looked at independence across the files selected for a full review. We also selected an additional 10 files to review where the firm provided extensive non-assurance services to the business being audited – the cost of which was sometimes in excess of five times the audit fee.

Since increasing the emphasis on independence, the majority of firms have improved documentation for disclosing their assessment of threats to their independence, the application of appropriate safeguards, and the proper reporting of these to audit committees or directors.

The Professional and Ethical Standards are built on the principle of viewing independence through the eyes of an objective, reasonable and informed third party. However, this principle is often not documented in audit files.

It is also difficult for investors to challenge auditor independence, as little information about the nature of the services provided is publicly available. For example, one firm disclosed that advisory services provided by the audit firm included financial due diligence. However, neither the audit firm nor the business disclosed that this due diligence work formed the basis of the auditor's assessment of the business's going concern assumption and goodwill impairment. We believe auditors and directors should provide more detail to investors on the non-assurance services provided.

Key findings

Our reviews continue to show some areas of non-compliance with the Professional and Ethical Standards, including the following examples.

- No documentation on the audit file regarding non-assurance services provided.
- The audit firm did not disclose in the audit opinion all of the services they provided.
- The appearance of independence was not appropriately considered in accepting non-assurance services. For example, where the auditor provided non-assurance services costing many times more than the audit fee, the audit file did not record any consideration of whether the appearance of independence could have been compromised.
- No documentation regarding the evaluation of threats to the firm's independence and no appropriate safeguards put in place to mitigate these threats.
- Proposed procedures to remediate a threat were not performed.
- Failure to follow the rotation rules as set out in the auditing standards.
- The audit team did not report to the board:
  - all non-assurance services provided
  - threats to the audit firm's independence and how these were mitigated.

International developments

Most countries with established auditor regulators follow the International Ethics Standards Board for Accountants (IESBA) Code of Ethics.

This code is principles-based and aims to cater for all types of audits, not only those of FMC reporting entities. IESBA is in the process of revising parts of the standard.

A large number of regulators, including IOSCO, IFIAR and the Office of the Auditor-General, questioned the standard-setter about the effectiveness of the threats and safeguards requirements in the standard[4].

Their concerns included the following.

- If the provision of a service creates a threat to the auditor's independence, they don't believe using different teams within the firm provides an effective safeguard. The main concern is that the firm performed the service for its audit client and may be incentivised to make judgments that protect the economics and other interests of the firm rather than public interest and needs of investors. The threat to independence relates to an entire firm (or network of firms). Therefore, other safeguards outside the firm would be more effective at mitigating any independence risk in those circumstances.
- The code includes subjective language that may not be enforced. This means regulators are reluctant to challenge auditors' judgments.

We are a member of IOSCO and IFIAR, and are able to provide input on these submissions, and show support for the concerns raised.

A number of local laws and regulations around the world override parts of this code. These include requiring mandatory

4 See the IFIAR website for the concerns these regulators have

audit firm rotation and prohibiting non-assurance services based on value and nature of the services. We don't have these restrictions in New Zealand, and they are not currently our preferred solution to issues concerning auditor independence. However, we will consider pushing for such changes if we do not see improvements in auditor independence.

As well as focusing on audit firms, we expect directors to play a crucial role in protecting the best interests of investors by acting conservatively in the area of auditor independence. See our Directors' Guide to Audit Quality for details of what they should look for in an auditor.

Our expectations

We expect audit firms to:

- improve their assessment of independence threats
- look at the safeguards they have in place to mitigate these threats
- actively review their audit work to ensure mitigation is successful.

We also expect audit firms to place more emphasis on the conceptual principles of independence, and not just consider each non-assurance service in isolation. Auditors need to clearly communicate to directors the impact of non-assurance services at the start and completion of each relevant audit. Due to the significance of independence issues, there needs to be a review by both the engagement partner and the EQCR partner.

Not complying with the independence requirements of the professional standards is a serious breach of the Act. To date we have referred three auditors to their disciplinary body for breaching independence requirements (among other non-compliance issues). We believe breaching auditor independence could significantly damage the credibility of the audit profession as a whole.

Auditors should approach independence with the highest integrity and, when in doubt, take a conservative approach. If we continue to see non-compliance we will increase enforcement and seek clarification on what is considered acceptable under the New Zealand Professional and Ethical Standards.

What directors can do

- Approve all audit and non-audit services and fees, and not delegate this to management.
- Have an internal policy to approve non-assurance services from their auditor. The policy should consider:
  - setting an appropriate threshold for non-assurance services at a level that, in the director's opinion, doesn't impact the appearance of independence
  - the nature of services being provided and their impact on auditor independence
  - when it is appropriate to get another firm to carry out non-assurance services.
- Provide investors with detailed information on the business's policies regarding auditor independence in their annual report.
- Provide detailed disclosures in the financial statements regarding the types of services provided by their auditor, so investors can make an informed decision about the auditor's independence[5].
- Ensure audit committees assess auditors' independence objectively and don't rely solely on the auditors to confirm it.
- Ask auditors for a detailed assessment of identified threats from non-assurance services and how the firm will tackle this, especially in complex and subjective areas.

5 Refer to our report on disclosure of audit fees

Audit quality control

Plans to improve quality have proved effective in the majority of areas we have previously raised issues. Following our reviews, firms have provided additional training to staff, and have amended policies and procedures. However, we still note differences in quality when evaluating individual audit files. We expect audit firms to improve the consistency with which they deliver audits by evaluating their own quality control systems and policies.

Internal quality control procedures

Audit firms are required to have robust internal audit quality reviews. Our assessment of firms' internal quality control programmes showed differences between large firms and smaller firms with fewer than three licensed auditors. In some smaller firms, we found the quality control procedures did not meet the requirements of the standards. None of these internal reviews indicated that audit teams did not obtain sufficient audit evidence in accordance with the auditing standards; these results don't match our observations.

Key findings

The following are examples of concerns we raised during some reviews.

- Internal audit quality reviews failed to include an evaluation of the firm's quality control systems.
- Quality reviews were performed by non-auditors, bringing into question whether these reviewers had the appropriate knowledge.
- The majority of reports did not identify any key areas for improvement, which may indicate these reviews are not effective.
- The outcomes of the reviews were not always discussed with audit staff, or the firms' board or management, resulting in issues not being addressed in subsequent audits.

Consultation

Audit firms often have policies and procedures to consult with other audit partners or specialists, such as valuation or technical accounting specialists. We saw better audit quality where the auditor had consulted, either internally or externally, than when there was no consultation.

Mandatory consultation is often required when auditors issue a modified audit opinion. We would like to see mandatory consultation for unmodified opinions where significant judgment is applied in areas of going concern.

Smaller firms often have difficulty finding appropriately qualified experts in areas where specialist audit expertise is required, which may impact overall audit quality.

EQCR partner involvement

The engagement quality control review (EQCR) partner also plays an important role in ensuring audit quality on an engagement level. Therefore, the prescribed minimum standards require the involvement of an EQCR partner who is also a licensed auditor. Where audit files did not meet the minimum standards, insufficient EQCR was often a contributing factor.

The following findings raise concerns about EQCR's effectiveness.

- The length of time the EQCR partner was involved was not always sufficient to address all requirements of the standard.
- The EQCR partner was not involved in a timely manner. In some cases the majority of requirements were reviewed on the last day of the audit before the opinion was issued. This raises concerns about the effectiveness of the EQCR process, as the team may not have the time to address issues.
- The EQCR partner did not detect significant non-compliance with the Assurance Standards in the areas reviewed. This, combined with a lack of evidence of what the EQCR had considered in the key risk areas of the audit file, raised concerns about the effectiveness of these reviews.

The EQCR process is an important aspect of the audit regime. It is designed to ensure the audit partner has obtained significant evidence in the key risk areas. It should not be approached as a 'tick-the-box' requirement.

Where we identified significant non-compliance in audit files we generally referred both the lead engagement partner and the EQCR partner to the disciplinary body, as they are both responsible for ensuring a high-quality audit process.

Our expectations

We expect audit firms to:

- proactively review their internal quality control measures
- continue to invest in their quality control functions, rather than relying solely on regulators' audit reviews
- perform independent self-assessment of the files our reviews identified as needing significant improvement
- for smaller audit firms that have difficulty finding appropriate experts to assess internal control issues, or struggle to find audit and accounting experts, seek support from their international networks or other qualified independent experts with current audit knowledge
- take action where licensed auditors have delivered poor-quality audits
- reward staff and partners who deliver high-quality audits and make this a key indicator in performance reviews
- following an internal review, take action to address the matters in their individual audit files and avoid those issues arising in other files
- be aware of issues noted by their network following reviews in other jurisdictions.

What directors can do

- Make sure their business has appropriate policies and procedures in place to address complex accounting issues or business transactions, and seek independent advice when necessary. They should not rely solely on their auditor to address these issues.
- Ask auditors whether their audit file has been reviewed by the FMA or another regulator.
- Discuss the lessons learnt from the audit review with their auditors.
- Ask their auditors how they could further contribute to audit quality.
- Make sure audit tender proposals provide information about external reviews by regulators, and other factors such as relevant experience of audit staff and how senior members of the audit team will be used.
- Choose an audit firm based on quality of work, rather than solely on cost. We note that directors keep asking auditors for greater efficiency when performing audits. We are concerned about these expectations, as audit requirements are increasing and we note little room for the improvement of efficiency. Therefore, reducing audit fees may impact the quality of the audit.

Professional scepticism

Together with independence, professional scepticism is a key factor in delivering high-quality audits. Professional scepticism is an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to error or fraud, and critical assessment of audit evidence.

Professional scepticism is difficult to address as it is a requirement that affects all aspects of the audit, and every team member involved. The level of scepticism can be affected by certain conditions and pressures during an audit, and also by the skill and expertise of the audit team.

We continue to find issues in certain audits where an insufficient level of professional scepticism is applied. This is especially concerning if it relates to the assessment of a business's going concern or areas of significant management judgment.

New Zealand is not unique in its need to address this area of professional judgment and scepticism in audits. It is an ongoing concern for audit regulators internationally. It is also an area audit firms focus on in their annual training programmes.

Key findings

Our reviews found the following examples where the auditor's professional scepticism could have been improved.

- Management assumptions such as significant growth assumptions and unrealistic budgets weren't questioned or tested, while other evidence in the audit file seemed to indicate there were significant concerns about the reliability of this information.
- In key judgment areas, valuations or fair value measurements, audit teams often document the main assumptions and judgments based on management discussions. However, there is often no evidence that the auditor reviewed the underlying agreements or documents that form the basis of the key assumptions.
- Undue reliance placed on work performed by other non-assurance departments of the audit firm, such as tax or corporate finance, without audit teams performing the required procedures.
- Auditors did not perform any audit procedures in relation to reliance on the work of a management expert. The auditors stated in their response that the expert was sufficiently qualified and independent, and therefore no further audit work was required.
- The audit team relied on IT-generated reports such as sales data or inventory data, without testing the reliability of these reports for accuracy and completeness.
- Third-party confirmations:
  - did not include evidence of who provided the confirmation to the auditor
  - were not signed appropriately.

It was also unclear how the auditor maintained control over the confirmation process.

- The audit teams did not consider or document potential impairment indicators in relation to the business's key assets. We also did not see any evidence of why the auditor concluded there was no indication of impairment and therefore that no further audit work was required.
- Audit teams not appropriately considering fraud risk (including financial reporting fraud) and management override in the audit.
- A lack of documentation of the engagement quality control review. This brings into question the professional scepticism of the EQCR when the above matters were either not raised by the EQCR or not followed up by the audit team.

Our expectations

We want to see better documentation of engagement partners' and EQCR partners' involvement in the planning and key areas of the audit. We also expect auditors to be particularly alert when businesses are under significant financial pressure, including periods of fast growth or below-expectation performance.

Making improvements in this area may be more difficult than other areas. This should be an area of ongoing and extensive training for audit staff and engagement partners at every level. Less-experienced staff should be supported by experienced managers, engagement partners and EQCR partners, and by a robust and timely review of the work, onsite at the audit client.

We also expect EQCR partners to critically assess the quality and sufficiency of evidence obtained by the audit team in key areas of the audit, and to better document their involvement.

If businesses provide insufficient evidence in key judgment areas, the auditor should evaluate whether they are able to obtain other sufficient and appropriate audit evidence to mitigate the risks. Where the auditor cannot obtain such evidence, we expect to see documentation in the audit file explaining how this has affected the audit opinion.

What directors can do

- Challenge auditors' understanding of the business and its risks, and make sure they understand the relevant laws and regulations.
- Ask the auditor to explain any contentious issues, and issues requiring significant judgment that were resolved by management and the auditor.
- Ask how the auditor challenged management in the key judgment areas and how the auditor obtained audit comfort in these areas.
- Provide a clear overview of performance-based incentives provided to management that may impact bias and management override.
- Provide clear and concise disclosures in key judgment areas in the financial statements.
- If the auditor and management had different views, understand how they resolved their differences and how the auditor supported their views with appropriate evidence.
- Facilitate an open dialogue where the auditor can discuss challenges with the audit committee and management during the audit.

Audit of revenue

Auditors are responsible for getting reasonable assurance that financial statements taken as a whole are free from material misstatement caused by fraud or error. Revenue has been identified in the auditing standard as an area that has heightened risks due to management override of controls and risk of fraud.

Revenue is typically a material balance, often involving significant risks that require special audit consideration. Because of the importance of auditing revenue, this is included as an area of focus in our review.

We continue to see instances where auditor performance relating to revenue is not sufficient – this accounted for 33% of the failed audit files (40% in the previous year).

Key findings

We have identified the following concerns.

- Failure to identify specific revenue risks, including rebutting the risk of fraud without documenting an appropriate reason.
- Relying on effectiveness of controls without testing or noting errors that impact effectiveness. This was not mitigated by performing additional audit work.
- Not clearly documenting identified fraud risk and how it was addressed in the audit work for each of the financial statement assertions.
- The audit team only tested high-level monitoring reviews by management. The audit team did not obtain evidence of how these reports were generated, what thresholds were established by management to investigate, and whether these procedures were appropriate to address the relevant financial statement assertions.
- Audit procedures did not address risks appropriately. The most common issues were noted in:
  - **completeness** – audit teams tested only recorded revenue in the next reporting period after year-end, rather than considering other audit procedures such as testing of shipping documents or evidence that services or goods had been delivered
  - **cut-off** – the procedures did not cover the appropriate period or did not take into account the risk of the transactions, and therefore were ineffective.
- Testing journal entries to address the risk of fraud and management override of controls was not executed appropriately. Examples include:
  - not testing journal entries back to supporting documentation
  - the audit team declared 'risky' journal entries out of scope. This resulted in the auditor not testing any journal entries
  - selecting sample sizes for journal entries that did not meet the standard for audit sampling.
- Audit teams did not always test IT-generated reports for completeness and accuracy. This means they would not have been reliable enough to be used in other procedures such as analytics or for selecting samples for detailed testing.
- Substantive analytic procedures were not performed in accordance with the standard, so they did not provide the level of comfort required by the auditor.

Our expectations

We expect auditors to continue their focus on the appropriate identification of revenue risks. The risk assessment should clearly cover:

- fraud risk indicators
- possibility of management override of controls
- complexity of revenue streams
- how these risks will be addressed in the audit procedures for each financial statement assertion.

The engagement partner should lead the discussion regarding these topics. The procedures performed by the audit team also require appropriate supervision and review by senior audit staff and the engagement partner. These senior members must make sure audit procedures are appropriately designed and executed. We also expect the EQCR partner to identify whether insufficient or inappropriate audit evidence was obtained in key risk areas.

What directors can do

- Challenge auditors' understanding of the business and its risks in relation to each material revenue stream.
- Ask auditors to explain their approach and outcomes for auditing revenue, especially their approach to fraud risks and the possibility of management override of controls.
- We expect audit committees to discuss fraud risk factors with their auditor, as well as the controls the business has in place to mitigate the risk of material misstatement in the financial statements due to fraud.
- Make sure that auditors understand the complexity of the different revenue streams and the incentives provided to management to meet performance-based bonuses that may impact the risk of management override of controls.

Execution of key audit procedures

When reviewing key areas of audit files we often review material balances that are not necessarily complex account balances or transaction streams. These key areas of the audit often require the execution of basic audit procedures and provide insight into how well these procedures are executed across all audit files. Failure to execute audit procedures in these key areas accounted for 33% of failed audit files in the review period (47% in previous review period).

Some common areas of non-compliance

Substantive analytical procedures

Substantive analytical procedures were not performed in accordance with the standard and therefore did not provide the comfort intended by the audit team. Examples of areas that were poorly executed included the following.

- Auditors setting imprecise expectations that allowed for errors that exceeded materiality, making it unclear how these analytical procedures contributed to the overall audit evidence.
- The audit team setting incorrect expectations.
- Auditors using reports for substantive analytical procedures without checking their reliability, such as completeness and accuracy.
- Differences found as a result of these procedures weren't supported by further audit evidence.

Audit sampling

The sample chosen by the audit team did not provide sufficient comfort in relation to the key audit balance tested. We noted the following examples of non-compliance.

- The audit team used target testing to test the entire population, without performing any audit work, leaving a material balance untested.
- Differences noted in the testing were explained away and no further audit work was undertaken to address the impact of these differences.
- When using audit sampling, differences were not extrapolated to the entire population.
- The audit team did not document how the sample size was determined and how it reduced sampling risk to an acceptable level.

Related party transactions

Auditing of related-party transactions requires further improvement, especially for the following.

- Testing the completeness and accuracy of the disclosed related-party transactions.
- Testing the terms and conditions of these transactions, especially when the business discloses that these transactions are on an 'arm's-length basis'.

Our expectations

Adequate training and supervision of audit staff is essential to achieve consistently high-quality audits. Senior audit team members must make sure audit procedures are appropriately designed and executed.

If important parts of an audit are performed by more junior staff, the firm must check whether these staff members have appropriate training and expertise. Their work must be supervised and reviewed by an experienced manager. Senior staff and engagement partners need to allocate sufficient time to perform these reviews, and do so in a timely manner.

Audit of banks and finance companies

The quality of audits of financial institutions like banks and finance companies is an important part of our mandate to promote fair, efficient and transparent financial markets. Since the start of the audit oversight regime we have reviewed the audit files of many finance companies and banks, as these audits are complex and significant for investors. These types of audits also have specific risks and challenges not relevant to other audits.

Our reviews of the audit files of these financial institutions focused on a number of key areas, including:

- loan provisions, including both the collective provisions of the retail loan book and the specific provisioning of the corporate lending
- reliance placed on controls in the loan provisioning and interest expenses area
- bank IT systems and the testing of these systems by the firms' IT specialists
- loan provisioning of smaller finance companies
- valuation of financial instruments such as foreign exchange contracts and interest rate swaps.

In our reviews we raised certain issues regarding:

- consistency in the quality of audit testing, in the area of controls testing and performance of substantive testing in loan provisioning
- audits of other non-significant but material balances.

In some cases the impact of the individual findings was not significant to the audit itself, but these issues demonstrate that auditors are not applying a sufficient degree of challenge and/or scepticism at all times. Combining a number of these findings raises concerns over whether sufficient audit evidence was obtained to detect material misstatements.

Key findings

We have identified the following types of concerns.

- Where the audit teams relied on management controls, we questioned whether the audit team had done enough to rely on this work around loan loss provisioning.
- When testing specific provisions, audit teams mainly corroborate management's views rather than challenging the provision or why management's scenario was the most appropriate based on the evidence obtained.
- IT control deficiencies identified by IT specialists were not sufficiently or appropriately followed up and evaluated by audit teams.
- Detailed testing regarding the valuation of financial instruments revealed that:
  - the threshold set for the allowable differences exceeded overall materiality
  - the audit team did not extrapolate the sample to the entire population. If extrapolated, the difference exceeded materiality
  - differences identified were not investigated further.
- Other material balances were supported by incorrectly performed substantive analytical procedures. These procedures did not include:
  - setting appropriate expectations that were both plausible and predictable
  - testing the reliability of data used in the analytics.
- For smaller finance companies we noted that audit firms did not obtain sufficient evidence about loan provisioning. Audit teams often applied a fully substantive audit approach without testing any controls. Examples include:
  - valuations of securities were out of date and were not appropriately tested by the audit teams
  - relying on reports prepared by management without testing the data, such as payment profiles
  - not assessing whether loans had rolled over into new loans without repayment or an assessment of potential repayment
  - no documentation of the scepticism applied by the audit team when auditing loan loss provisions. Often we saw only that the audit team corroborated management's views based on discussions rather than obtaining any independent audit evidence
  - failure to document the basis of key judgments adequately.

Financial institutions reviewed 2013-2017

Our expectations

Audit firms must ensure that teams performing bank audits have the specific skills and expertise required. We therefore expect firms to:

- have mandatory sector training for partners and staff who perform bank audits. This training should focus on benchmarking, data analytics when assessing loan loss provisions, and the wider regulatory and market risks facing banks. Where a firm audits subsidiaries of Australian banks we expect combined training of the audit teams
- ensure appropriate supervision and review by senior staff and the engagement partner for procedures performed by the audit team in key areas such as loan provisioning and valuation of financial instruments. These reviews should make sure audit procedures are appropriately designed and executed, and cover the appropriate risk. We also expect the EQCR partner to challenge the team's approach and execution of audit procedures in these key risk areas
- ensure IT specialists are appropriately integrated into the audit team. Both auditors and IT specialists must have an appropriate understanding of the business's control environment to avoid findings by both teams not being addressed appropriately
- perform root-cause analysis for issues identified by external and internal reviews. This should incorporate lessons learnt internationally as regulators find similar issues across jurisdictions
- ensure audit teams apply an appropriate degree of challenge and professional scepticism in the audit of loan loss provisions, rather than seeking to corroborate management's views.

What directors can do

- Discuss with auditors the areas of concern raised here and how the audit team addressed these areas in the audit.
- Seek assurance that the audit teams have:
  - appropriate local knowledge
  - sector expertise
  - competence and experience in auditing financial institutions.
- Together with auditors, evaluate the effectiveness of the business's relevant internal controls, and the extent to which the auditors review them and are able to place reliance on them.
- Ensure auditors are provided with the appropriate data on a sufficiently aggregated level to perform their analytics in support of the audit of the financial statements.
- Make sure auditors understand the complexity of the different financial products provided and the impact these have on the risk assessment.
- Provide a clear overview of performance-based bonuses for management or incentives that may impact the risk of management override of controls within the business.
- Ensure management assesses the impact of current and emerging issues on a timely basis and that the auditor and the business jointly understand how these issues affect the assessment of significant risk.

Future focus

Our quality review programme in 2017/18 will continue to focus on the risks that FMC reporting entities pose to investors, building on the results of our previous quality reviews.

Our reviews focus on the successful implementation of the plans we ask audit firms to provide, together with their ongoing compliance with the Auditing and Assurance Standards. As documentation of audit files improves, we have an opportunity to review certain areas in more depth.

Audit Oversight Plan

More information on our key focus areas and how we conduct our reviews can be found in our Auditor Regulation and Oversight Plan 2017-2020.

Possible post-review actions

Following our quality reviews, we have required or can require licensed auditors to take the following actions.

- An auditor is required to perform additional work to address our findings.
- A business is required to restate the financial statements, if we find misstatements.
- We do a follow-up review within 12 to 18 months of the previous review to ensure the firm has taken appropriate action to address our findings.
- Issuing directions to remediate any findings.
- Referring complaints to the licensed auditors' professional body to be dealt with under its disciplinary procedures.

Auditor-General

As a result of the MOU with the Auditor-General, (see page 4), we may review some audits of FMC reporting entities carried out by private audit firms on behalf of the Auditor-General in the upcoming review cycles.

Appendix 1 – Quality review framework

Quality review methodology

The purpose of an audit quality review is to make sure the systems, policies and procedures of audit firms comply with the Auditing and Assurance Standards and other relevant legislation. Audit firms must also carry out FMC audits with reasonable care, diligence and skill.

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

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

We review each registered audit firm on a three-year cycle – except the large national network firms, which we review every 18 months.

All of our reviews undergo a robust moderation process. Each of our audit quality review assessment reports is peer-reviewed by a reviewer not involved in the initial review. Our final report goes to the Audit 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 ex-auditors, company directors, and others with relevant experience who are independent of the audit profession.

Quality control framework

Audit firms must have systems, policies and procedures (a quality control system) in place to provide a robust framework to underpin FMC audits.

The requirement of a quality control system is 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 how effective the firm's internal monitoring of the audit quality control system is. Another important aspect of quality control is performing an engagement quality control review (EQCR) on each FMC audit file.

The EQCR 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 reached in the auditor's report.

We have issued additional requirements[6] related to the EQCR, as we see this as a key part of the audit process. We expect the EQCR partner to be suitably qualified, with relevant experience to give an objective evaluation. They should also be involved in key decision-making to make sure the audit has an efficient process.

Individual file reviews

We carry out individual audit file reviews to make sure that the auditor has complied with auditing and assurance standards. The audit file review also checks if the licensed auditor has exercised reasonable care, diligence and skill in carrying out FMC audits.

Key attributes of audit quality are:

- an independent audit carried out by a licensed auditor
- appropriate levels of professional scepticism applied by the auditor
- reliable audit opinion issued
- enough appropriate audit evidence obtained
- auditing and assurance standards followed.

File selection and ratings for individual audit files

The number of audit files we select for each audit firm takes into account the number of licensed auditors at the firm, the number of FMC audits and the results of the firm's previous review.

When we select FMC audit files for review, we take into account:

- businesses of significant public interest based on the value of securities 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 higher-risk businesses such as finance companies, or businesses with non-compliance issues such as qualified audit reports or non-compliance with laws and regulations
- a cross-section of different licensed auditors in each registered firm.

If our review finds that an audit file did not meet the required standards, it is more likely we would review that auditor or audit file again in future.

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

File ratings

When we complete a review, we give each individual audit file a rating. The reviewer gives the file a proposed rating, which is moderated by AOC.

There are three categories of rating:

1. Good, or good with limited improvements required

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.

2. Compliant, but improvements needed

We identified areas in the file where the audit wasn't performed in accordance with the audit standards. However, overall the reviewer found there was sufficient and appropriate audit evidence obtained in the key risk areas.

3. Significant improvements required

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.

Summary of review ratings

Listed businesses

Year	Good	Compliant	Significant improvements
2017	2	8	2
2016	-	6	7
2015	5	6	2
2014	1	9	4
2013	2	2	3

Other FMC reporting businesses

Year	Good	Compliant	Significant improvements
2017	4	6	5
2016	-	9	8
2015	2	8	15
2014	2	24	16
2013	3	7	16

Background to our rating criteria

Our reviews do not assess whether audited information was reported correctly. Where an audit required significant improvements, it does not necessarily mean the audit opinion was inappropriate, or the financial statements were inaccurately prepared or did not show a true and fair view. Equally, where we rated an audit as good or compliant this doesn't imply the financial statements did not contain any inaccuracy or misrepresentation.

Our reviews cover different audit firms each year and files are not selected randomly. Due to this targeted approach, the audit files inspected do not represent the market as a whole. The summary of our review needs to be interpreted cautiously, as results in any one year are not comparable directly with previous years.

Appendix 2 – Market data

	30 June 2017	30 June 2016	30 June 2015
Domestic licensed auditors	141	146	150
Domestic registered firms	21[7]	24[7]	29[8]
NZX-listed companies	195	186	162
FMC audits	1,300	1,700	1,700
New licences issued to domestic auditors	7	8	10
Domestic auditor licences cancelled	12	12	1
Domestic auditor registrations cancelled or expired[9]	3	4	0
Firms reviewed	7	12	12
Audit files reviewed	27	30	38

7 Includes five firms that have separate firm registrations, but operate under one brand name
8 Includes nine firms that have separate firm registrations, but operate under two brand names
9 A number of audit firms merged or voluntarily cancelled licenses

Glossary

Accounting standards / NZIFRS	The New Zealand equivalent to International Financial Reporting Standard issued by the External Reporting Board.
Act	Auditor Regulation Act 2011
AOC	This is a 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 ex-auditors partners, company directors, and other people with relevant experience.
Audit firm	Registered audit firm as defined by the 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 Act.
CA ANZ	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 purpose of the audit oversight regime, NZICA continues to be the accredited body.
EQCR	Engagement Quality Control 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.
EQCR partner	Licensed auditor who performs the EQCR. This may be a licensed auditor who is not a partner in the audit firm.
Financial statements assertions	When auditing accounting balance in the financial statements, the auditor should ensure the following assertions are covered: existence/occurrence, rights and obligations, completeness, accuracy, valuation, presentation/classification.
FMA	Financial Markets Authority
FMC audit	Has the same meaning as in section 6 of the Auditor Regulation Act 2011.
FMC reporting entity	Has the same meaning as in section 6 of the Auditor Regulation Act 2011.

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 either plan to liquidate their business, cease operations, or have no other alternative but to stop doing business.
IFIAR	International Forum of Independent Audit Regulators
ISA (NZ)	International Standard on Auditing (New Zealand)
Materiality	Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
Non-assurance service	Any engagement provided by the audit firm that doesn't meet the definition of "an engagement in which an assurance practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria".
PES	Professional and Ethical Standards
Professional scepticism	An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
Quality review	A review of an audit firm as defined in the Auditor Regulation Act 2011.
Revenue recognition	Incorporating the gross inflow of economic benefits (cash, receivables, and other assets) arising from the ordinary operating activities of a business (such as sales of goods, sales of services, interest, royalties, and dividends) in the income statement when it meets the following criteria: • it is probable that any future economic benefit associated with the item of revenue will flow to the business • the amount of revenue can be measured with reliability.

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND

AUCKLAND

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

Phone: +64 9 300 0400 Fax: +64 9 300 0499

WELLINGTON

Level 2, 1 Grey Street
PO Box 1179, Wellington 6140

Phone: +64 4 472 9830 Fax: +64 4 472 8076