

# Audit Quality Monitoring Report

1 July 2017 – 30 June 2018

# 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 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 2017 and 30 June 2018. It is for:

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

In this year's report, we highlight our expectations of directors and auditors of financial statements, and the key focus areas our stakeholders need to be aware of. We have also updated our [guidelines](#) for how directors can contribute to improving audit quality.

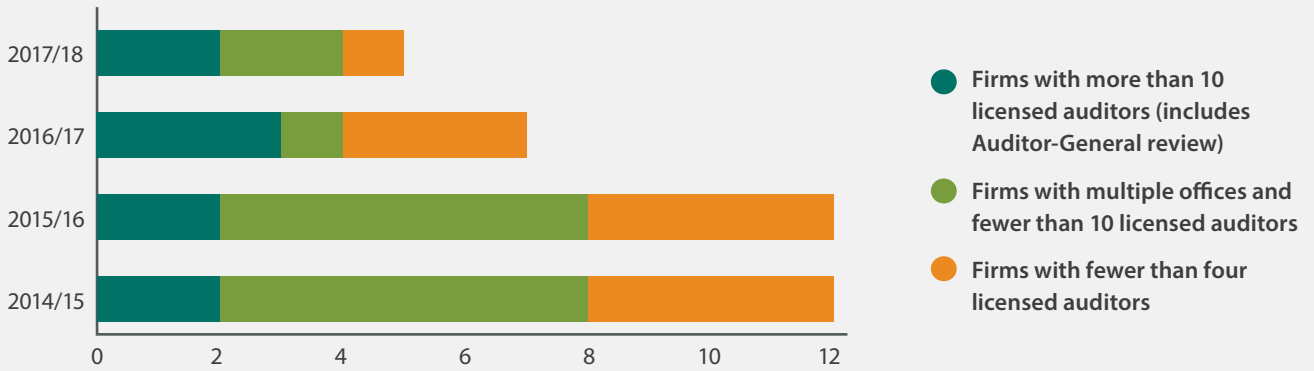
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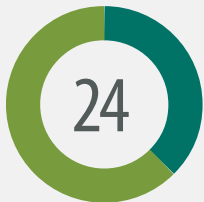
## Audit firms reviewed



## Audit quality reviews

2017/18

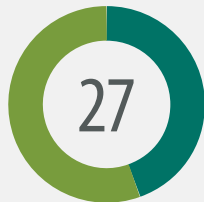
5 registered firms reviewed



audit files reviewed

2016/17

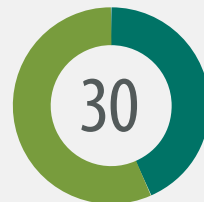
7 registered firms reviewed



audit files reviewed

2015/16

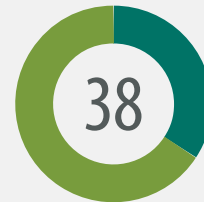
12 registered firms reviewed



audit files reviewed

2014/15

12 registered firms reviewed



audit files reviewed

● Listed companies ● Other companies

## Market snapshot

At 30 June 2018 there were...

138

domestic licensed auditors

19

domestic registered audit firms

190

NZX-listed companies

1,300

FMC audits

# What we've seen

Since we started reviewing audit firms, we have seen a noticeable improvement in the overall quality of audits. This indicates that actions taken by audit firms as a result of our feedback have been effective. However, inconsistencies in the quality of individual audits within the same audit firm continue to be a concern.

## Role of directors

Audit firms play a significant role in providing comfort on the quality and accuracy of financial statements. However, if an entity goes into liquidation, or requires restatement of its financial statements, that does not necessarily mean the audit was deficient.

Directors and management have primary responsibility for ensuring financial statements are compliant, and the quality of information they provide plays a big role in audit quality. We have observed that when poor-quality information is provided to auditors, there is a higher chance that possible shortcomings won't be identified through audit procedures. Therefore, our report not only focuses on areas of improvement for auditors, but also on the role management and directors play in audit quality.

## Our expectations

Audit firms need to consider why audit quality varies significantly across individual files even though the same policies and procedures are applied across all of the firm's audits.

We expect audit firms to invest more time to analyse the detail that underpins areas where we have found non-compliance. The outcomes of this analysis should be used to determine how to address our key findings most effectively.

We encourage audit firms to take note of all key findings detailed in this report, and also to look at the reports of international audit regulators to understand current trends in audit quality.

## Progress made

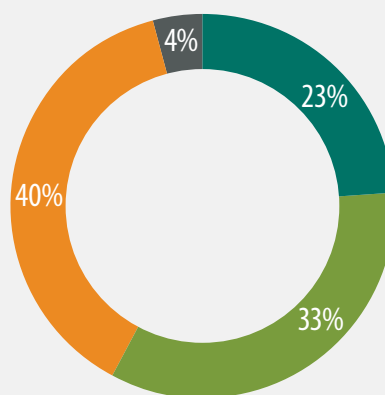
Following an audit review we ask the firm to provide us with a plan outlining how it will address our findings.

To measure the firm's progress on audit quality, in subsequent reviews we look at each area we noted for improvement, and assess whether the firm's plans and actions have resulted in better outcomes.

During the current review period, each audit firm we reviewed had made improvements in the areas where we previously highlighted issues. The level of improvement is shown below. In only 4% of the areas we highlighted we did not identify any subsequent improvements.

We expect audit firms to prioritise the issues raised in this report, and fully address these before the next review cycle.

Level of improvement in areas noted in review



- **Findings fully addressed**  
 Areas where firms implemented effective systems and procedures since our previous review
- **Significant improvement shown**  
 Areas where firms implemented changes based on our findings and improvements were noted on the majority of audit files but were not fully effective across all reviewed files
- **Some improvement shown**  
 Areas where firms implemented changes based on our findings, but improvements were only noted in some instances and were not fully effective across the majority of all reviewed files
- **No improvements found**  
 Areas where the planned system improvements to address our findings were not implemented or were ineffective

## Areas requiring additional attention

This report covers areas we consider contributed to deficient audits. Addressing these areas will therefore have the largest impact on improving audit quality.

These areas relate to:

- emphasising directors' responsibilities for audit quality
- improving auditor independence
- improving effectiveness of addressing key findings by audit firms
- improving audit procedures when assessing management experts
- auditing accounting estimates
- auditing of schemes and funds
- responding to risk and executing key audit procedures.

## International comparison

It is difficult to compare audit quality in New Zealand with other countries. Overseas regulators have differing mandates and, as our reviews don't cover all audit firms every year, the outcomes may vary year to year.

We can draw some comparisons through our membership of the International Forum of Independent Audit Regulators (IFIAR). Every year IFIAR compiles the [inspection findings](#) of various audit regulators for the six largest audit firms<sup>1</sup> for the audits of listed entities, including New Zealand. From this survey we have seen that our findings are similar to other regulators and that audit quality is not out of line with these jurisdictions.

## Changes in the auditor landscape

The number of registered audit firms has decreased from 40 to 19 since the introduction of audit oversight in 2011. This hasn't affected the number of licensed auditors, which has remained approximately 140 to 150. The main reason for the reduction in the number of registered audit firms is firms voluntarily cancelling their registration

due to an inability to comply with:

- the changes in assurance standards that require auditors to rotate off audit engagements on a more frequent basis
- the change in regulations that requires at least two licensed auditors to be involved in each FMC audit.

Some firms also merged to be able to accommodate these requirements. Additionally, the costs of compliance for audit firms with one or two licensed auditors (such as the cost of licensing and audit quality reviews) are relatively high compared to the income generated from the small number of FMC audits they perform.

Despite the decrease in registered audit firms, we haven't been alerted that FMC reporting entities are having difficulties finding suitable auditors. However, we continue to have regular contact with the Government regarding trends in auditor regulation and the potential impacts on overall financial markets.

## Disciplinary procedures

This year, the Disciplinary Tribunal of Chartered Accountants Australia and New Zealand (CA ANZ) concluded on one complaint involving a licensed auditor following a referral from the FMA. The auditor was censured. The auditor has voluntarily cancelled their licence and is prohibited from reapplying for a licence in the next two years. CA ANZ sought to recover the \$24,000 cost of these proceedings.

See page 21 for more information about the FMA's role in disciplinary procedures.

## Stakeholder perceptions of audit quality

The FMA is asking key stakeholders such as investors, fund managers, directors and management of FMC reporting entities, and auditors to provide insight on how each of these stakeholders value and perceive audit quality. We will be communicating separately on the outcomes of this survey and our proposed next steps.

<sup>1</sup> BDO, Deloitte, EY, Grant Thornton, KPMG and PwC

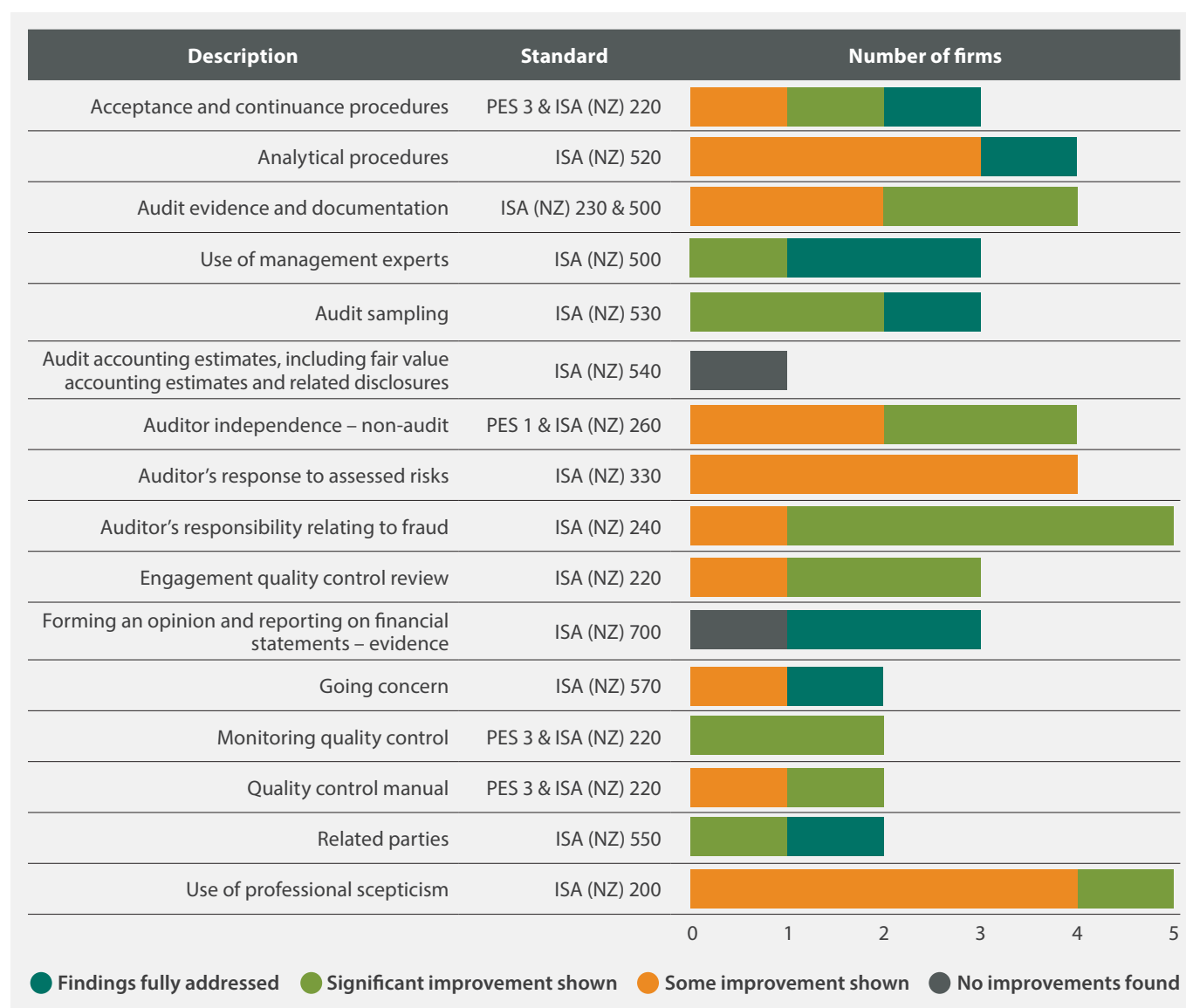
# Progress made

Each of the audit firms included in this report has been reviewed previously. Following these reviews, we asked firms to develop a plan showing how they would prevent any identified issues from reoccurring. To measure improvement, we tested the effectiveness of these plans by comparing the results of previous reviews with the results of our most recent reviews in the areas identified for improvement.

We found improvements in almost all of the areas. However, our main concern is that policies and procedures are not consistently applied across all audits within an audit firm. We want to see an increase in consistency of audit quality.

In this report we have highlighted key areas to help auditors turn their attention to where improvements will have the most impact and as a result will improve audit quality.

The table below shows how firms performed in the 15 most common areas identified for improvement.



# Directors' responsibility for audit quality

FMC reporting entities must have their own systems, processes and controls to produce compliant financial reports. Therefore, directors must not rely on the auditor to ensure that the financial statements comply with all financial reporting requirements. This would undermine the objective of an audit, which is to provide independent assurance.

Directors can help to improve audit quality by delivering quality financial information to the auditor. Directors should also ensure that the finance functions of the business are sufficiently resourced with the appropriate level of experience and knowledge.

Through our financial reporting and audit quality reviews, we have seen a direct link between the quality of an audit and the quality of the financial information provided by the entity. That is, in instances where the auditor has been given poor-quality financial information, we identified an increased chance that the audit file was classified as requiring significant improvements.

Examples of issues found in the quality of information provided by entities include the following:

- Not having appropriate systems to comply with accounting policies.
- Not having access to sufficiently qualified staff, resulting in poor-quality information.
- In instances of complex accounting treatments (including areas of accounting estimates), not providing the auditor with accounting papers that include sufficient support for the treatment chosen.
- Issues raised in management letters or audit committee reports not being addressed appropriately or in a timely manner.
- Financial statements not including key information that should be disclosed under the accounting standards.

## Our expectations

Even when an entity has provided poor-quality financial information, we expect auditors to take appropriate steps to fully comply with the Auditing Standards and the Professional and Ethical Standards. Auditors should clearly communicate to directors, in a timely manner, instances where the audit team had difficulties getting the appropriate information. Auditors should evaluate the impact of poor information on the audit opinion; this may ultimately lead to a modified opinion.

## What directors can do

Although it is the auditor's responsibility to deliver a quality audit, directors also make a key contribution to audit quality. Our [Directors' Guide to Audit Quality](#) provides directors with guidance on best practice. We also issue guidance on accounting treatments and disclosure matters that directors should familiarise themselves with, such as our [guidance on the disclosure of significant accounting estimates](#). We also expect directors to proactively engage with their auditor on how to improve the quality of the audit.

# Auditor independence

Our audit quality reviews in the last year continued to focus on auditors' compliance with the independence requirements when providing non-assurance services and other matters that could impact independence, such as longstanding association.

When performing our reviews, we look at audit firms' compliance with independence standards across all selected audit files. In large audit firms we select additional files to review for compliance with independence requirements. We focus on files where the firm provided extensive non-assurance services to the business being audited.

## Why independence is important

Auditors are required to be independent both in mind and in appearance when they perform audits of FMC reporting entities. What sets auditors apart from other professions is that their responsibility is not exclusively to satisfy the needs of an individual client (the FMC reporting entity) but also to take into account the investors' interests. Providing an independent opinion is therefore essential for overall trust in the audit profession.

## Improvements noted

Since we increased the emphasis on independence, the majority of firms have made significant improvements to their independence assessment. Areas where we have noted improvements include:

- Documentation on the audit file regarding the services provided by the audit firm, threats to the audit firm's independence and how the firm intends to mitigate the threats with appropriate safeguards
- Communicating the threat of conflict in relation to non-assurance services to directors in audit committee reports. This provides directors with sufficient information to question the firm on independence-related matters and to challenge whether steps for mitigation are appropriate and followed.

## Areas requiring improvement

Although progress has been made in auditor independence, we noted a few areas that require further work for both auditors and directors. These include:

- Disclosure of non-assurance services in financial statements and annual reports. Both auditors and directors should be responsible for ensuring investors have sufficient information in the financial statements to assess the audit firm's independence of mind and appearance. This requires better disclosure of the entity's policies and processes for determining auditor independence in the annual report, and better disclosure in the financial statements.
- Audit firms often identify threats to independence where the audit team reviews the work of another team from the audit firm. From our reviews we noted a number of instances where audit teams:
  - did not follow their planned approach to mitigate the threats to independence and therefore did not appropriately address the threat
  - did not review the work of other teams and therefore placed undue reliance on the other teams' work, leaving material balances unaudited.
- Although overall documentation of the assessment of independence on the audit file has improved, there is more work to do in documenting how independence in appearance is assessed. For example, we expect the documentation to illustrate that consideration has been given to issues such as the audit firm providing non-assurance services costing many times more than the audit fee, or the audited entity having one or more directors on their board that have been a partner at the audit firm.



## International developments

New Zealand follows the International Ethics Standards Board for Accountants' (IESBA) Code of Ethics to assess auditor independence. This code is principles-based and aims to cater for all types of audit, not just those of FMC reporting entities. The IESBA is currently consulting on the section of the standards that relates to non-assurance services and professional scepticism. We participate in discussions with international standard-setters by providing feedback on new standards through our memberships of the International Organization of Securities Commissions (IOSCO) and IFIAR. We also have discussions with our local standards-setter, the External Reporting Board (XRB), on specific New Zealand requirements.

We follow international developments both in Auditing Standards, and other laws and regulations in various jurisdictions that impact the independence of auditors.

### Our expectations

Not complying with the independence requirements of the professional standards is a serious breach of the Act. Auditors should approach independence with the highest integrity and, when in doubt, take a conservative approach. Auditor independence will continue to be one of our key areas of focus.

## What directors can do

Directors play a crucial role in managing the relationship with their audit firm and allowing the firm to be independent. Directors therefore need to think carefully before asking or allowing their audit firm to provide other services. The standard for auditor independence is built on the principle of viewing independence through the eyes of an objective, reasonable and informed third party. It is often difficult for investors to challenge auditor independence and therefore we expect directors to fulfil this role.

Directors should set clear rules for their audit committee to approve services and fees, and evaluate whether these processes are effective.

We encourage directors to provide better information in their financial statements and annual reports regarding auditor independence, so that investors have enough detail to assess whether sufficient steps were taken to maintain auditor independence. Directors should also challenge the audit firm on how threats to independence in the firm are mitigated, and if the firm takes adequate action to ensure mitigation procedures are effective.

Our [Directors' Guide to Audit Quality](#) provides useful guidance on the steps directors can take to maintain auditor independence.

# Audit firms' response to audit quality reviews

The purpose of auditor regulation is to improve audit quality. Through our audit quality reviews we are able to assess the quality of the policies, processes and procedures audit firms have in place to deliver compliant audits.

After each review, we provide the audit firm with a report setting out our findings. We also ask the audit firm to prepare the following:

- A remediation plan, to provide us with information on how the firm is addressing our key findings. Plans can include:
  - changes to the audit firm's systems, policies and procedures
  - changes to the audit procedures to address specific audit file findings
  - training to be provided to staff and audit partners.
- If required, we ask the firms for additional information to clarify their plans and how they believe these will be effective.
- A root cause analysis for any audit files that are rated as 'significant improvements required'. Root cause analysis is a process for identifying the causes of problems or events so that appropriate and achievable actions can be taken to prevent them from reoccurring. It can also be a means of identifying good practice as part of continuous improvement.

The effectiveness of these plans is assessed in our next review of the firm.

## What we have seen

In all of the firms we reviewed, we found areas for improvement, and each firm was required to prepare remedial plans and root cause analysis. When reviewing the plans and root cause analysis we noted areas that could be improved. Examples we noted across a number of firms include:

- While audit firms prepare plans and root cause analysis as required following our reviews, they do not use a similar approach following their own internal audit inspections. This may mean that issues noted during internal reviews are not addressed to the same standard.
- In some cases, the remediation plans do not include timeframes for when the remedial actions will be implemented, or how the effectiveness of the plan will be monitored and by whom.
- The root cause analysis often focuses on follow-up actions rather than examining why non-compliance occurred in the first place. This may be due to firms having inadequate processes to conduct the analysis. Examples that demonstrate this issue include:
  - the analysis has pre-populated drop-down boxes with possible causes, which limits options for complex problems
  - the team leading the analysis was not independent, which may result in biases when drawing conclusions
  - not all relevant staff involved in the non-compliant audit were part of the analysis, limiting the capacity to detect the reasons for non-compliance
  - the questions asked as part of the analysis were not appropriate to reveal the root causes.
- There is no clear link between the root cause analysis and the remedial action proposed in the plan.
- The remedial actions are similar to the firm's previous plan, but based on the outcome of the next year's review these actions did not seem to be effective.

## Our expectations

To improve audit quality, audit firms must understand why certain non-compliance occurs. Root cause analysis involves questioning why a problem arose until the cause is identified, so that improvement actions address the underlying cause rather than the symptoms.

We expect audit firms to focus on the following areas when evaluating and responding to quality reviews:

- Allocate appropriate resources and perform the analysis on a timely basis. Analyse findings from both the external audit quality review and the firm's internal monitoring process.
- Provide training and guidance to those performing the root cause analysis to ensure consistency.
- Develop a structured approach for interviewing the audit team so that underlying causes can be adequately identified and investigated. It is important that the audit team is involved not only in identifying the root causes but also in deciding how to improve audit quality.
- Develop a firm-wide action plan and monitor its effectiveness, to ensure all teams are dealing with the root causes. Actions may include an additional focus on coaching, support by central teams, project management, resource allocation and design-specific training programmes.
- Communicate the root causes to audit partners and staff. Explain inspection results and place more focus on good practice. This will increase awareness and influence the behaviours of auditors.

## What directors can do

- Ask auditors whether their audit file has been reviewed by the FMA or another regulator. Discuss the findings of these reports, focusing on causes of non-compliance and how the audit firm is planning to address these.
- Discuss with the firm more generally what it does to improve audit quality, including its own internal reviews and the lessons learnt from these.
- Ask what you can do to improve audit quality.

# Use of management experts

## Why experts are important

Accounting standards require businesses to value certain assets and liabilities at fair value. Businesses may use their own staff or a third-party expert for the valuations. Experts involved in these valuations may include actuaries, financial analysts and engineers.

Appropriate valuations are important because of their impact on financial results and the outlook of the company. The reports provided by these experts vary significantly in scope. In some cases, the third party may value the assets and liabilities based on market data; in others, all related information is provided by management. Additionally, these experts will perform different levels of work to verify the completeness, relevance and accuracy of the data used in their valuation. Given the complexity, valuations require significant auditor attention.

Expert reports may also contain disclaimers that affect the reliability of the report. When auditors rely on the work of experts, they are required to:

- evaluate their competence, capabilities and objectivity
- understand the scope of their work
- evaluate the appropriateness of their work as audit evidence for the relevant assertion.

The work of experts is often included in the scope of our audit file reviews.

## Improvements noted

We have noted improvements in how the work of management experts is assessed. Improvements include:

- Audit firms engaged third-party experts to assist them in instances where the audit firm did not have in-house expertise.
- More audit evidence in relation to key assumptions made by management experts.
- In many cases, the auditors have had more contact with the third-party expert engaged by the entity, to get a better understanding of the expert's work and to challenge certain assumptions.

## Areas requiring improvement

Although progress has been made in the use of management experts, we note a number of areas that require further work. These include:

- The audit team or auditor's experts failing to appropriately document the understanding of the expert's work. This includes identifying key data and assumptions that impact the overall valuation performed by the third-party expert. This may result in the auditor not sufficiently addressing the areas of highest risk.
- The auditor providing insufficient instructions to their own experts on what area should be covered by the auditor's expert's work. This results in an expectation gap between the auditor and the auditor's expert in terms of the work ultimately performed.
- The auditor not sufficiently addressing the impact of the management expert's disclaimers regarding completeness of information or reliability of data.
- The auditor failing to assess the competence and capabilities of the expert. In most cases, auditors confirmed whether an expert was independent and qualified. However, this doesn't always mean the expert has the expertise required.
- The auditor not testing the completeness, accuracy and reasonableness of significant source data used by the expert. This is especially the case where data is not necessarily relevant to other audit procedures.

## Our expectations

We expect to see improvements in auditors' consideration of the adequacy of experts' work. This is often difficult and challenging, and requires highly skilled staff.

Where FMC reporting entities have significant valuations that require industry expertise, we expect the audit firm to engage its own expert to assess the relevance and reasonableness of the key assumptions. This could be an appropriately qualified and knowledgeable in-house or external expert. If experts are not available in New Zealand, the auditor should use an overseas expert.

The engagement partner must be involved in planning and executing these procedures, and attend key meetings. The auditor's own expert should evaluate the relevance and reasonableness of assumptions underlying the valuation. It is also important that if the reliability, completeness and accuracy of data is tested by the audit team, the auditor's internal expert provides input to determine whether the data is appropriate for the purpose of the valuation.

We recognise that valuations rely on people to make judgments, and we expect audit teams to set appropriate thresholds within which they are comfortable with these judgments moving. However, it is important that auditors require the entity to provide disclosure in the financial statements about the impacts of even small movements in judgments on the overall valuation.

## What directors can do

- Ensure that external experts are sufficiently independent from management, and identify areas of management bias. Challenge management and experts on key assumptions that impact valuations.
- Disclose in financial statements the 'key' judgments and the impact of volatility on these.
- Where management or external experts include disclaimers in their valuation report, ensure you fully understand the effect of these disclaimers on the overall level of uncertainty of the valuation.
- Discuss the scope of the experts' work for material valuations with management, the expert and the auditor in the early stages of the audit.

# Accounting estimates

Accounting estimates in financial statements bring a range of complexities similar to those related to the use of management experts. Estimates include a level of judgment and consideration of uncertainties that require in-depth knowledge of the entity and its industry.

When we select audit files for review, we first look at the quality of the financial statement disclosure. Some recent reviews revealed a lack of disclosure in significant accounting estimates and assumptions, particularly those containing high levels of uncertainty. This poor disclosure is often a sign that the auditor found it challenging to audit these estimates.

To be effective in this area an auditor should have:

- a good understanding of the entity and the entity's historical ability to estimate reliably
- a good understanding of the market the entity operates in, and the challenges facing this market
- the ability to effectively apply professional scepticism
- a good understanding of management and director biases towards desired outcomes.

The area of auditing estimates has been identified by the standard-setters as requiring specific attention. It therefore has its own standard.

Financial statement areas that are often impacted by accounting estimates include:

- investments in unlisted entities
- assessment of the going concern of an entity
- complex valuation techniques for assets and liabilities
- impairment assessments on significant assets.

## What we have seen

Although the auditing standards are clear on the objectives and steps auditors should take to audit estimates, we note that auditors don't necessarily follow the requirements of the standard. The approach we often see is that auditors try to provide evidence to support management estimates. This is not the intention of the standard, which requires audit teams to develop a point estimate or a range of estimates to evaluate the reasonableness of the management estimate.

Examples of related issues include:

- Auditors not questioning or testing management assumptions such as significant growth assumptions and unrealistic budgets, even though other evidence in the audit file seemed to indicate there were significant concerns about the reliability of this information.
- Audit teams evaluating key assumptions and performing sensitivity analysis on the impact of each assumption, but not considering that multiple assumptions moving together could be a realistic scenario and would result in outcomes outside the auditors' acceptable ranges.
- Audit teams relying on management controls to prepare accounting estimates without testing the operating effectiveness of these controls.
- Auditors not involving staff with the appropriate specialist skills to assess and challenge management on key assumptions.
- Auditors not performing any audit procedures in relation to reliance on the work of a management expert, then stating in their response that the expert was sufficiently qualified and independent, and therefore no further audit work was required.

## Our expectations

Making improvements in this area may be more challenging, as audit work will often focus on future information as well as historical information. In executing audit work, we expect auditors to provide more information about how they determined their own range of possible outcomes on accounting estimates. This requires better documentation of each part of the Auditing Standard.

Applying sufficient professional scepticism should be demonstrated by taking into account all evidence obtained during the audit, not just the parts that support management's position. If an entity provides insufficient evidence in key judgment areas, the auditor should escalate these matters to the board at an early stage of the audit. Where the auditor cannot obtain 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.
- Ask how the auditor challenged management in the key judgment areas and how the auditor obtained comfort in these areas.
- Give a clear overview of performance-based incentives provided to management that may impact bias and management override.
- 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.
- Provide clear and concise disclosures in key judgment areas in the financial statements.

# Responding to risk and executing key audit procedures

When we review audit files we focus on higher-risk areas. This aligns with the audit approach of focusing on areas that are considered to be at higher risk of material misstatement, and that require additional audit procedures to reduce the risk to an appropriate level.

Key risk areas of audit files do not always relate to complex audit procedures; they often include the execution of basic audit procedures. Compliance with basic audit procedures provides insight into how well these procedures are executed across all audit files.

In this review period, failure to execute basic audit procedures in key areas accounted for 33% of audit files rated as requiring significant improvements. This is the same level as the previous review period, and is still an area for improvement across all audit firms.

## What we have seen

Audit firms' methodologies should address issues in the execution of basic audit procedures. Audit firms often addressed issues by providing additional training, but this training did not seem to be effective in resolving issues across all audit files. Audit firms should assess if other initiatives would have greater impact. Areas that we have identified for improvements are summarised below.

### Assessment of risk

The risk-assessment process of the audit enables audit teams to execute the audit approach correctly and effectively. Examples of incorrect execution include:

- The planned audit work not addressing all relevant financial statement assertions, resulting in relevant assertions not being supported by sufficient audit work.
- No detailed audit procedures planned or performed to address material account balances classified as lower risk.

- The audit approach remaining unchanged even though the risk changed during the audit. As a result, the audit lacked required procedures to address the changed risk profile.

### 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. We continue to find issues with the following:

- Auditors setting imprecise expectations that allow for errors that exceed materiality, making it unclear how these analytical procedures contributed to the overall audit evidence.
- The auditor explaining financial information variations between years without assessing if there was a plausible relationship between financial and non-financial data.
- Auditors using reports for substantive analytical procedures without checking aspects of reliability such as completeness and accuracy.
- Differences found as a result of these procedures not being supported by further audit evidence.

### Audit sampling and correction of errors

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 using target testing to test the entire population without performing any other audit procedures, leaving a material balance untested.
- Differences noted in the testing not followed up and not appropriately reported to directors.
- The audit team not documenting how the sample size was determined in testing of controls and detailed audit procedures.



## Our expectations

It is important that sufficient time is taken to plan the audit. Understanding the entity and its industry is key to getting the audit approach correct. Early involvement of all senior team members, such as the engagement leader and Engagement Quality Control Review (EQCR) partner, contributes to good planning. Although staff training is important for consistently achieving high-quality audits, it is also important that senior audit team members and audit partners have the skills and time to support and review work throughout the audit. This includes sufficient involvement in the planning, execution and final stages of the audit.

If important parts of an audit are performed by more junior staff, the firm must check whether they have appropriate training and expertise. Their work must be supervised and reviewed in a timely manner by a sufficiently experienced manager.

The EQCR partner also plays an important role in ensuring that sufficient audit evidence is obtained in the key risk areas, and that any concerns can be addressed in a timely manner by the audit team.

An EQCR review in the last couple of days of the audit may not be effective, as it limits the time audit teams have to address any issues found by the reviewer.

# Auditing schemes and funds

A large portion of FMC audits are audits of schemes and funds. These types of companies are an important part of financial markets. They often have a large number of smaller investors, and it can therefore have a big impact on market confidence if their financial information is misrepresented.

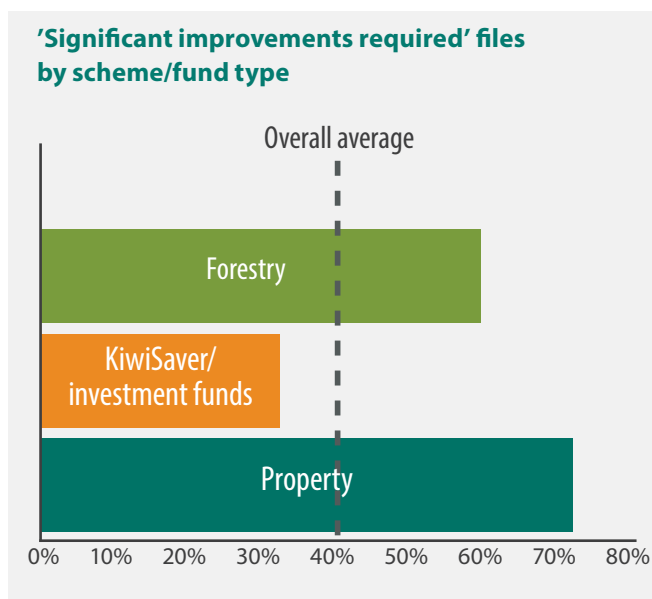
Schemes and funds are often managed by a related entity that has policies and procedures for preparing the financial statements of the individual schemes and funds. The audit firm may be the auditor for both the manager and the scheme. It is important that schemes and funds are approached as standalone audits, as each will have different investors.

Since the start of the audit oversight regime we have reviewed the audit files of many schemes and funds. Although these type of audits are often not complex, they still require specific attention and the application of sufficient professional scepticism.

Some auditors of forestry and property schemes believe that investors are mainly interested in the cash flows these entities generate, and therefore apply very high thresholds when assessing the valuation of assets. We believe this approach is incorrect. Knowing the value of assets helps investors to make informed decisions, and when units are sold, the basis for pricing is often the underlying value of the scheme’s asset.

## What we have seen

We saw inconsistencies in the audit approaches of schemes and funds. These inconsistencies are between different firms, and between different auditors at the same firm. Since the start of the audit oversight regime, the number of forestry and property schemes requiring significant improvements has been higher than other types of audits. The graph below shows the percentage of audit files reviewed between 2013 and 2018 requiring significant improvements for each different type of scheme or fund.



## Examples of deficient audits

During our audit quality reviews we saw a number of compliance issues in relation to the audits of schemes and funds, including the following:

- The audit team performing control procedures at the manager level, and only performing detailed audit procedures across a sample of funds and schemes. This means some individual audit opinions were not supported with audit evidence specific to that scheme or fund.
- For forestry schemes, audit teams assessing the forest manager's valuation on the basis that all forests in the scheme had the same characteristics (eg type of land, access, growth rate and condition of the forest) rather than assessing each individual forest on its own characteristics. This resulted in inaccurate valuations.
- For fund audits, some auditors relying solely on third-party confirmations to cover the existence, valuation and accuracy of investments, and also the completeness and accuracy of income from these investments, and not performing any further detailed audit work.
- Audit teams not obtaining the relevant control reports to ensure an appropriate compilation of third-party confirmations from fund managers or custodians when relying on these confirmations.
- When performing detailed testing on the valuation of investments, audit teams:
  - setting a threshold for the allowable differences that exceeded overall materiality
  - not extrapolating the difference in the sample to the entire population
  - not investigating any differences identified.

## Our expectations

When setting the audit risk, we expect auditors to take into account the interests of the investors of each scheme and fund. The audit work on these type of entities should be sufficient to support each individual audit opinion, and should take account of the following points:

- When assessing the value of more complex assets, we expect engagement leaders to assess the team's experience and evaluate if experts should be involved.
- For the audit of funds, auditors should not rely solely on third-party confirmations, and should perform sufficient audit work to independently verify the valuation of the assets and completeness of the income of these funds.
- For property schemes, we expect audit teams to critically assess valuation reports provided by management. In good audits, audit teams had in-depth discussions with the valuer or management expert, and challenged them on key assumptions. They pointed out errors and required these to be adjusted in the valuations. Some of these adjustments had a material impact on the overall valuation.
- Valuing forestry schemes often requires specific skills. Although some information is easy to verify, factors such as positioning and accessibility of the forest may be more difficult. It is important that auditors obtain sufficient audit evidence to challenge the more complex assumptions in the valuation.
- In good fund audits, auditors independently verified the valuation of listed investments covering the entire population. These auditors also performed detailed testing to cover the completeness and accuracy of income related to these investments. To ensure the existence of the investments, these teams relied on third-party confirmations supported by the necessary control reports of the manager or custodian.

# Changes to auditor reporting

The 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. The biggest changes are the communication of key audit matters and the disclosure of the name of the audit partner for FMC reporting entities with higher public accountability.

Key audit matters (KAMs) require the auditor to share the matters that, in the auditor's judgment, were of most significance in the audit. In the report the auditor explains why certain matters are KAMs, and provides information on how these were addressed with specific audit procedures. The specifics of the description are left to the judgment of the auditor. KAMs are intended to provide more specific, useful and relevant information about the entity's audit.

This new standard has been a focus of our reviews. Together with the XRB, we issued a [report](#) on our analysis of 168 audit reports. The report includes experiences of various stakeholders involved and interested in auditor reporting.

We looked at nine of these new reports in this review period, assessing them on:

- the process followed by the audit firm to conclude which matters were key audit matters
- consistency between the KAMs and the entity's disclosures in the financial statements about underlying judgments and assumptions
- whether the audit work performed fairly reflects what was disclosed in the audit report.

## What we have seen

Our reviews showed a high level of compliance in this area. Audit firms have allocated appropriate resources and engaged early with their clients on the change. A number of audit firms provided more information in their audit opinion than required under the new standard. This included the auditor explaining materiality and providing information about outcomes of the audit procedures performed. This provides investors with an additional level of insight about the auditor's work.

## Areas for improvement

We expect auditors to maintain the current quality of auditor reporting. As businesses change and audit approaches may differ from year to year, it is important to assess if previous reporting is still relevant. A change in audit partners or audit firms may also have an impact on the information disclosed in the audit report.

Matters that require ongoing auditor attention include:

- The audit partner and audit team should perform a final check that the audit work described in the auditor reporting fairly reflects the work documented in the audit file, especially when the audit opinion has been reviewed by several audit partners or specialists not involved in the audit.
- Ensuring that KAMs and disclosures are not concluded too early in the auditing process, as risks and audit approaches may change during the audit.

## What directors can do

It is not the directors' role to select or approve KAMs, but you can help by:

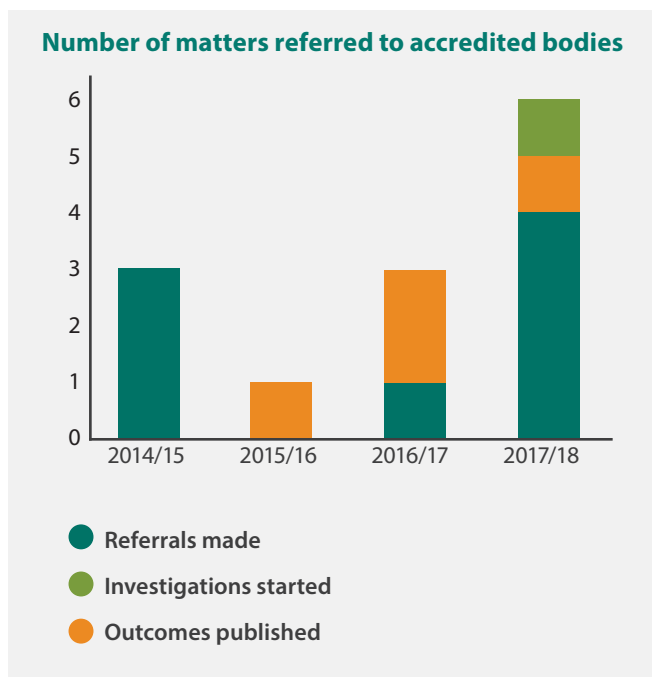
- engaging early with auditors about the audit
- encouraging auditors to disclose useful information beyond the minimum requirements of the standard
- ensuring that disclosures in the auditor reporting align with information in the financial statements or annual report.

# Disciplinary procedures

One of the functions of accredited bodies, as set out in the Act, is to take appropriate action against misconduct by licensed auditors. The FMA's role is to review whether the accredited bodies have appropriate systems, policies and procedures to meet the requirements for taking action against misconduct. In the most recent review we concluded that both accredited bodies are compliant with their obligations. We are only able to investigate matters that accredited bodies decide not to investigate, or that they ask us to investigate.

Following an audit quality review we may ask the relevant accredited body to assess if the auditor has breached the Auditing and Assurance Standards. These referrals are made if we believe the breaches have had a significant impact on audit outcomes, or where Professional and Ethical Standards have been breached. The graph opposite provides an overview of how many matters we have referred to accredited bodies following an audit quality review.

Outcomes of disciplinary procedures are documented on the audit register under the individual licensed auditor's name and on the accredited bodies' websites.



# Future focus

Our 2018/19 audit file selection for our quality review programme will continue to focus on the risks that the nature of the FMC reporting entity's business pose to investors, and will build on the results of our previous reviews. We will be looking for the successful implementation of audit firms' post-review plans, and improvement in the areas highlighted in this report.

At the end of the 2019 review cycle, a number of new accounting standards will come into effect. These include new standards for leasing, revenue, and financial instruments. We will be looking at entities that implement these new standards early and will be significantly affected by the changes.

More information on our key focus areas and how we conduct our reviews can be found in our [Auditor Regulation and Oversight Plan 2018-2021](#).

## New educational standard (IES 8)

The International Education Standard (IES) 8 (Revised) came into effect on 1 July 2016. The standard is mandatory for all licensed auditors. It focuses on the professional competence requirement for engagement partners who are responsible for FMC audits. It requires them to demonstrate compliance by providing a learning plan and learning outcomes, followed by a self-assessment of how they achieved them.

As part of our audit quality reviews we discuss the auditors' approach to implementing the new standard. We also reviewed this area in detail as part of our annual accredited body monitoring visits. Our review identified that licensed auditors and audit firms are still in the early implementation stage of the standard. We require the standard to be implemented immediately.

Audit partners should:

1. Consider their audit clients, particularly those with complex or specialist requirements, or how they see their audit client base developing.
2. Decide on the skills and knowledge levels needed to audit their clients effectively. These should be compared to existing skills and knowledge to help identify training and development needs.
3. Identify and plan CPD activities that are relevant to their role and will help to meet the training and development needs identified in step 2. CPD activities should fill the gaps identified above.
4. Record all CPD activity. Reflect on the learning outcome of each activity, decide if it has had an impact on skill or knowledge levels, and provide a brief statement to this effect. For each activity, explain what was involved and how this has achieved the learning outcomes. These learning outcomes should link back to IES 8 (Revised).

Learning plans should be prepared at the beginning of the year, and updated as circumstances change. The standard is not designed to follow the compulsory training prescribed by the audit partner's firm; training should be identified based on needs rather than what the firm offers. Compliance with this standard is one of the key licence conditions; non-compliance could lead to suspension or cancellation of a licence.

# 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 two years.

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 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 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<sup>2</sup> related to this 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 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:

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



- 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 that have 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 a previous review found an audit file did not meet the required standards, it is more likely we would review that auditor or audit file again in future.

## Auditor-General

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.

## File ratings

When we complete a review, we give each individual audit file a rating. The reviewer gives each finding a rating from low to high and propose a final file rating, which is moderated by AOC.

There are three categories of rating:

### 1. Good, or good with limited improvements required

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.

### 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
2018	3	3	3
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
2018	1	8	6
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 directly comparable with previous years. Our findings do provide insights in trends in the audit industry and highlight areas of improvements applicable for the majority of FMC audits.

## Possible post-review actions

Following an audit quality review we consider if further steps are required. Some of steps 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 misstatements.
- Doing 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.

# Appendix 2: Market data

	30 June 2018	30 June 2017	30 June 2016	30 June 2015
Domestic licensed auditors	138	141	146	150
Domestic registered firms	19 <sup>3</sup>	21 <sup>4</sup>	24 <sup>5</sup>	29 <sup>6</sup>
NZX-listed companies	190	195	186	162
FMC audits	1,300	1,300	1,700	1,700
New licences issued to domestic auditors	5	7	8	10
Domestic auditor licences cancelled	8	12	12	1
Domestic auditor registrations cancelled or expired	2	3	4	0
Firms reviewed	5	7	12	12
Audit files reviewed	24	27	30	38

3. This includes four firms that have separate firm registrations, but operate under one brand name.

4. This includes five firms that have separate firm registrations, but operate under one brand name.

5. This includes five firms that have separate firm registrations, but operate under one brand name.

6. This includes nine firms that have separate firm registrations, but operate under two brand names.

# Glossary

<b>Accounting standards / NZIFRS</b>	The New Zealand equivalent to International Financial Reporting Standard issued by the External Reporting Board
<b>Act</b>	Auditor Regulation Act 2011
<b>AOC (Auditor Oversight Committee)</b>	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-audit partners, company directors, and other people with relevant experience.
<b>Audit firm</b>	Registered audit firm as defined by the Act
<b>Auditing and Assurance Standards</b>	The auditing and assurance standards issued by the External Reporting Board
<b>Auditing standards</b>	International Standard on Auditing (New Zealand) to be applied in conducting audits of historical financial information as issued by the External Reporting Board
<b>Auditor</b>	Licensed auditor as defined by the Act
<b>CA ANZ</b>	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.
<b>EQCR</b>	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.
<b>EQCR partner</b>	Licensed auditor who performs the EQCR. This may be a licensed auditor who is not a partner in the audit firm.
<b>Financial statements assertions</b>	When auditing accounting balances in the financial statements, the auditor should ensure the following assertions are covered: existence/occurrence, rights and obligations, completeness, accuracy, valuation, presentation/classification.
<b>FMC audit</b>	Has the same meaning as in section 6 of the Auditor Regulation Act 2011
<b>FMC reporting entity</b>	Has the same meaning as in section 6 of the Auditor Regulation Act 2011

<b>Going concern</b>	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.
<b>IFIAR</b>	International Forum of Independent Audit Regulators
<b>ISA (NZ)</b>	International Standard on Auditing (New Zealand) issued by the External Reporting Board
<b>Materiality</b>	Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
<b>Non-assurance service</b>	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".
<b>PES</b>	Professional and Ethical Standards issued by the External Reporting Board
<b>Professional scepticism</b>	An attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
<b>Quality review</b>	A review of an audit firm as defined by the Act



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