

June 2018

# Auditor regulation and oversight plan 2018-2021

This report is for:

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

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# Executive summary

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## Our role

Our main statutory objective is to promote and encourage the development of fair, efficient and transparent financial markets. Our *Strategic Risk Outlook 2017* outlines what we believe are the current and main drivers of risk to fair, efficient and transparent financial markets. Based on the drivers of risk identified, we have seven strategic priorities that will guide our activities over the next three years. Two of these priorities are particularly relevant to auditors' work.

They are:

- investor decision-making — we want to see capable, confident and well-informed investors
- frontline regulators — we want to see frontline regulators who contribute to well-regulated financial markets.

Audited financial statements are a key resource which investors rely on. Their confidence in the financial statements is dependent on the perceived quality of the audits. Auditor regulation and oversight helps to ensure the businesses we regulate (known as FMC reporting entities) have access to competent auditors, and these audits (known as FMC audits) are of a high standard.

To achieve this, we:

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

## What we intend to do

Over the next three years to 30 June 2021, we will focus on three main areas:

- **Improving audit quality** — we aim to perform audit quality reviews of registered audit firms once every three years. We will also ensure our key stakeholders, including audit firms, are informed about developments in audit quality, and what can be improved. There has been no significant change in our current review's focus compared with previous years. Our reviews are aligned with what audit regulators are doing internationally.
- **Monitoring changes** — In 2017 we incorporated the new auditor reporting requirements into our monitoring program. For the upcoming years we will be paying specific attention to this new area for listed entities. We aim to report on this specific area at the end of the 2019 review cycle. A number of new accounting standards will become effective in the next few years. These include new standards for leasing, revenue, and financial instruments. Our focus will be on entities that implement these new standards and will be significantly affected by these standards.
- **Monitoring accredited bodies** — we are required to monitor the accredited bodies and their regulatory role.

# The purpose of auditor regulation

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Investor confidence is key to successful financial markets. This confidence depends on investors having access to credible and reliable financial information. Audits of FMC reporting entities' financial statements aim to enhance investor confidence. The audits ensure these statements comply with financial reporting standards and give a true and fair view of the financial position of the business.

Auditor regulation supports the quality and integrity of audits of FMC reporting entities. By maintaining high auditing standards we aim to:

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

## Increasing investor confidence

The Auditor Regulation Act 2011 (the Act) regulates auditors' performance of financial statement audits of FMC reporting entities. The Act recognises this is a specialist job that cannot necessarily be performed by any qualified accountant.

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

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

## Recognition of New Zealand auditors overseas

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

The list below shows some of our initiatives to raise global recognition of our audit oversight and improve international investors' confidence in our capital markets.

- In October 2017, the Swiss Government recognised New Zealand's oversight regime. This means New Zealand auditors can continue to audit the financial statements of businesses listed in the Swiss stock exchange, without needing a licence. The Swiss government's announcement concludes that the New Zealand system's audit oversight of audit firms and auditors are equivalent to those in Switzerland.
- In July 2016, the European Union (EU) recognised New Zealand's oversight regime. This means New Zealand auditors can continue to audit the financial statements of businesses listed in the EU markets. The European recognition also confirms New Zealand's regulatory structure is robust, and gives investors confidence that New Zealand auditors meet international standards. The recognition means we are now able to share information with the EU audit oversight authorities, and can rely on each other's work in the supervision of auditors and audit firms.
- In December 2014, we joined the International Forum of Independent Audit Regulators (IFIAR). Our IFIAR membership gives us access to international knowledge on auditor regulation. It also gives us greater influence with the six largest international audit firms. On 4 April 2017, we signed IFIAR's Multilateral Memorandum of Understanding (MMOU) together with 21 other IFIAR members. This MMOU contributes to the effective regulation of audit firms by improving information exchange and cooperation among members.

- Our IFIAR membership allows us to learn from the experiences and methodologies of other regulators, and provides important training for our staff and reviewers. We are also involved in IFIAR's smaller regulators taskforce. As a member of the taskforce we have the opportunity to share insights, achieve our objectives to maintain and increase international recognition, and improve our audit oversight.

## Improving audit quality

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Audits of FMC reporting entities' financial statements are aimed at increasing investor confidence. One way we ensure these audits are done well is by reviewing the audits done by registered audit firms. We explain the results of our reviews to each audit firm so they understand any issues identified, and can improve their higher-risk audits.

### How we review audit quality

The Act requires us to perform an audit quality review of each registered audit firm at least once every four years. However, we will aim to keep our review cycle consistent with the EU's three-year cycle, to stay aligned internationally. The frequency of our inspections varies. We inspect larger firms every 18 to 24 months, while other firms are generally inspected once every three years. These reviews are carried out by FMA staff and contractors, including staff from other overseas' audit oversight bodies.

We review the systems, policies and procedures of audit firms against the Act's and the Auditing and Assurance Standards' compliance. Audit firms must also use reasonable care, diligence and skill in their FMC audits. We test this by reviewing individual audit files.

Our audit quality review process is outlined below.

#### Planning

- We produce an annual schedule of the audit firms we will review.
- We communicate early with the relevant audit firm to agree on suitable review dates.
- We select files to inspect, based on the risk the audited business poses to investors. These businesses may include listed companies, financial institutions and large investment schemes. Audit files are checked for compliance with the Auditing and Assurance Standards.
- We select the key focus areas for each of the audit file we review.

#### Onsite visit to audit firms

- The reviewers perform the onsite review in line with our standard methodology and procedures which include the minimum requirements of Section 68 of the Act covering audit quality reviews.
- The findings of the individual file reviewed are discussed with the team that performed the audit. When necessary, the team can provide further evidence and explanations.

#### Reporting

- We provide the audit firm with a draft report of our key findings of both the systems, policies and procedures of the audit firms, and the individual audit files. The firm has the opportunity to comment and provide us with further evidence about how they complied with the Auditing and Assurance Standards.
- Following the audit firm's comments, we prepare a final draft quality review report which is provided to our Audit Oversight Committee (AOC). The AOC gives an independent review of the consistency and fairness of all quality review reports. It is made up of a diverse group of professionals, including ex-auditors, partners, company directors, and others with relevant experience.
- We provide the audit firm with a final report which contains our findings and recommendations for remediation.

- We require audit firms to provide details of how they will mitigate the key findings of the final report. We may ask the audit firm to clarify if its response is insufficient.

### **Are you interested in becoming a reviewer?**

We would like to hear from auditors with more than 10 years of significant audit experience who have recently left the audit industry and are interested in becoming a reviewer for the FMA. For more information, please contact [Jacco Moison](#).

## **Areas of focus**

During our audit quality reviews, we assess:

- the audit firm's internal quality control
- the quality of individual audit files.

We decide our focus areas at the start of a three-year audit cycle. We are currently in the second year of the second three-year cycle. The focus areas are chosen based on issues identified by international audit regulators and our own findings from most-recent reviews<sup>1</sup>.

### **The new audit report**

In our review of the new auditor reporting, we focus on:

- the process followed by the audit firms to determine key audit matters
- the quality of information in the audit report
- whether the audit work establishing key audit matters is appropriate.

We will help audit firms to provide clearer and better audit reports that give investors and other users of financial statements the most relevant information.

### **Auditor independence**

An important part of an auditor's role is to act in the interests of investors, as well as the client. Auditors also need to effectively identify and assess any threats to their independence. They must apply appropriate safeguards to protect their independence, and report these properly to audit committees or directors.

In our reviews, we will focus on audit firms that provide significant non-audit services to the FMC reporting entities they audit. We will review whether they have appropriately identified threats to their independence, whether those threats were addressed sufficiently by the controls put in place, and the audit work performed. We will also verify whether all aspects of the non-audit services were reported to the board of directors, and are appropriately disclosed in the financial statements and the audit. Auditors should approach independence with the highest integrity and, when in doubt, take a conservative approach. If we 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.

### **Audit quality control systems and supervision**

We will focus on the adequacy and effectiveness of the audit firm's own control policies and procedures, especially where our reviews find something the firm's own quality review procedures did not pick up.

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

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<sup>1</sup> See our Audit Quality Review Report 2017

## **Professional scepticism**

We expect an appropriate level of professional scepticism to be maintained during every audit. In the audit documentation, we expect to see sufficient audit evidence demonstrating that appropriate professional scepticism has been applied by the partners and quality control reviewers engaged, and by the staff.

We will focus on whether there is sufficient documentation of professional scepticism in these areas:

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

## **Audit evidence**

We will review whether licensed auditors have appropriate audit evidence to determine whether the FMC reporting entities' financial statements had no material misstatements.

Our focus on audit evidence will be on whether audit firms have obtained sufficient evidence in these areas:

- a company's going concern
- revenue recognition, including the assumptions of fraud and management override
- key risks identified by the audit team for each of their audit file.

## **Understanding the issuer and its environment**

We expect auditors to have an adequate understanding of an FMC reporting entity's business model. This should be reflected in the auditor's risk assessment to ensure that all key risk areas are included in the audit strategy. The audit procedures should be backed by sufficient audit evidence covering all the key risks identified.

We will focus on whether:

- the risks have been properly identified
- the review of the audit procedures have been properly executed
- there is sufficient evidence to back the procedures.

## **The auditor's responsibilities relating to fraud**

One of the auditor's objectives is to identify and assess the risks of material misstatement of the financial statements because of fraud. We will review the auditors' assessment of this risk, and see if they used the correct procedures to address it. We will continue to review the areas of journal entries and other specific fraud procedures.

## **Use of an auditor's expert**

If financial reports are complex or include matters requiring specialist knowledge, such as valuations of certain assets and liabilities, the FMC reporting entities may use the advice of external or internal experts. We expect auditors relying on the work of other auditors or experts, to check their competence and objectivity. Auditors should evaluate the quality of the experts' work, their independence, their key assumptions, and the valuation methods used. We will review whether the auditor has engaged an independent expert where there is a lack of in-house expertise to challenge the work of a company's expert.

## **Audit fees and audit performance**

We observe some audit fees have decreased or remained flat for several years. While we are keen to see companies get value for money from their audits, we would be concerned if the reduced fees result in inappropriate time pressures which affect the quality of the audit work. To assess whether sufficient audit work has been completed, we will focus on FMC audits with very low audit fees, or where the audit fees did not reflect the complex nature of the business.

## **Execution of audit procedures**

In our reviews, we often look at significant account balances and transactions. These areas may not necessarily be identified as key risk areas by the audit team. We will focus on the execution of the audit procedures for these significant account balances and transactions.



## Education and communication

Our audit quality reviews will, most likely, reveal breaches of auditing standards or identify areas for improvement. We will ensure our key stakeholders, including audit firms, are told of issues we have with the audit quality, and are kept up to date about any key developments in audit quality.

Many stakeholders play a role in improving the quality of FMC audits. Our communication about the audit oversight regime is designed to help these stakeholders contribute to higher quality audits in New Zealand.

Our communication for the next three years may include:

- The auditor oversight plan which tells our stakeholders what our monitoring process will focus on. The Act requires us to update this plan annually on a rolling three-year basis.
- Quality review assessment reports for audit firms after an audit quality review. These reports contain the findings of reviews and our recommendations for remediation.
- Presentations at audit firms of what we found during their individual audit quality review, and how to improve their overall audit quality.
- Presentations or reports addressed to other stakeholders about the audit oversight regime, and how other businesses and professionals can contribute to audit quality.
- An ongoing dialogue with accredited bodies of our audit quality review findings and other trends in the audit industry. The aim is to improve the joint monitoring of licensed auditors, and address education issues.
- Annual reports of audit quality reviews which summarise the findings for the year. These reports include recommendations, to both auditors and other stakeholders, on how to improve audit quality. This enables auditors to willingly comply with our compliance expectations and the standards and legislative requirements.
- Letters to directors and audit committees about the quality of information provided to the audit firms or other non-compliance with Accounting Standards identified during our audit quality reviews.
- We will work with the External Reporting Board (XRB) to find areas for improvement so the XRB can use this information to influence international accounting standards where needed.

## The role of accredited bodies

While we carry out some areas of the auditor oversight regime directly, accredited bodies also have important responsibilities as frontline regulators. We monitor how well they perform this role, and expect them to significantly contribute to achieving the Act's objectives.

## The accreditation process

Professional bodies need the appropriate systems, policies and procedures in place to perform their regulatory functions. Our accreditation process evaluates how robust the professional bodies' procedures are, and indicates whether policies or processes need to be changed to meet standards.

The requirements can be found on our website, in this document, *Policies and guidance for the assessment of applications to be an accredited body*. Currently, there are two accredited bodies: the New Zealand Institute of Chartered Accountants (NZICA)<sup>2</sup> and CPA Australia.

Regulatory functions	How they work	How we monitor them
Licensing domestic auditors and registering domestic audit firms.	We issue the prescribed minimum standards that audit firms have to meet.  Accredited bodies have to notify us about licensing and registration approvals and failures.	We review a sample of licences and registrations assessed by accredited bodies to confirm whether the applicants have met the minimum standards. We also provide recommendations to improve accredited bodies' systems and policies, if and when required.
Monitoring licensed auditors and registered audit firms.	We review the policies and procedures accredited bodies have in place for monitoring licensed auditors and registered audit firms. We can request information about their monitoring at any time.	We review the effectiveness of accredited bodies' monitoring procedures. We also provide recommendations to improve accredited bodies' systems and policies, if and when required.
Promoting and monitoring competence.	Licensed auditors must comply with the minimum standards we set for professional development and ongoing competence.	We review the availability of training provided by accredited bodies.

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<sup>2</sup> NZICA amalgamated on 1 January 2015 to form the Chartered Accountants Australia and New Zealand, however NZICA continues to be the accredited body

Taking action against misconduct.

We review accredited bodies' policies and procedures for dealing with misconduct of licensed auditors or registered audit firms. Accredited bodies must report any complaints received about licensed auditors or registered audit firms to us. We also have the power to start or take over investigations of misconduct and to take direct disciplinary action.

We review any complaints about a licensed auditor to see if accredited bodies' policies and procedures were followed. We recommend improvements to accredited bodies' systems and policies, where necessary.

## How we monitor accredited bodies

We review whether accredited bodies have adequate and effective regulatory systems to be effective frontline regulators. We will regularly liaise with accredited bodies about their reports or notifications and, where appropriate, share intelligence with them. We expect accredited bodies to use their full range of regulatory tools. We will work closely with accredited bodies to coordinate these tasks to ensure there are no gaps or possible duplication of work, and that appropriate action is taken when an issue is identified.

The table below sets out the regulatory functions accredited bodies carry out, how they ensure these are appropriate and effective, and how we monitor them.

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

At the end of each year, we report on our monitoring of the New Zealand Institute of Chartered Accountants and CPA Australia. These reports provide information on the effectiveness of the accredited body's policies and processes in each of the areas tabled above. The accredited body also needs to provide an annual report detailing its relevant systems and processes, and how it has performed its regulatory functions.

# How we will measure our performance

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Our Statement of Intent 2017-2020 outlines how we will measure our performance against our objectives. The following measures, directly or indirectly, reflect the objectives of the auditor oversight regime.

<b>Measure:</b> Investors believe that frontline regulators contribute to well-regulated New Zealand financial markets.
<b>Explanation:</b> We work closely with accredited bodies, in their capacity as frontline regulators, to ensure they have effective regulatory arrangements. We also ensure their regulatory efforts are focused on issues that licensed auditors and registered audit firms need to address.

<b>Measure:</b> The FMA stakeholders and consumers of New Zealand financial services believe that FMA's actions help raise standards of market conduct and integrity .
<b>Explanation:</b> Through our audit quality reviews we monitor auditors' compliance with their legal obligations. Where we see technical non-compliance with the standards, we make recommendations to help improve audit firms' systems and processes. Where we see serious non-compliance we may require auditors to perform additional audit work and may refer auditors to the disciplinary tribunal of their professional body. We survey investors and other stakeholders to understand whether we are perceived to be having an impact on market conduct and integrity.

<b>Measure:</b> Investors believe financial product information given to them helped them to make an informed decision.
<b>Explanation:</b> Audited financial information is an important part of financial product offer information. The new audit report will also help investors to make informed decisions about which companies to invest in. Over time, we expect to see an increase in the number of investors who find this information helpful. We will survey investors to understand if they did find it helpful to them.

The outcome of these performance measurements will be included in our annual report.

## Appendix: Regulatory responsibilities

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

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