NOVEMBER 2024

Trends in audit quality

Audit Quality Monitoring Report
1 July 2023 – 30 June 2024

Our annual audit quality monitoring report provides findings from our reviews of the systems, policies and procedures of registered audit firms and licensed auditors, along with information about good practice to help company directors and auditors of financial statements improve audit quality.

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Purpose of this report

The Auditor Regulation Act 2011 (the Act) requires the Financial Markets Authority – Te Mana Tātai Hokohoko (FMA) to prepare an annual report on the outcomes of the audit quality reviews we performed on the systems, policies and procedures of registered audit firms and licensed auditors in the preceding financial year.

As well as providing a snapshot of the performance of registered audit firms during the period 1 July 2023 to 30 June 2024, this report provides information for directors and auditors to assist with achieving and maintaining excellent audit quality.

This report continues to emphasise that high-quality audits are vital to ensuring investors can make well-informed choices based on clear, concise, and effective information. An overview of the audit oversight regime and market data can be found in the appendices.

Elements of audit quality and desired outcomes

Reports unambiguously the auditor's conclusion on the financial statements	Audit is performed in accordance with the regulations and standards	Driven by a robust risk assessment and thorough understanding of the entity and its environment
Supported by an independent process and audit evidence, and involves the exercise of professional judgement and scepticism	Challenges management effectively and obtains sufficient audit evidence for the conclusions reached	Provides investors and stakeholders with assurance that financial statements give a true and fair view

Contents

Summary of audit file quality reviews

2024 market snapshot

At 30 June 2024 there were:

133 domestic licensed auditors (Prior year: 135)

201 NZX-listed issuers (Prior year: 203)

12 domestic registered audit firms (Prior year: 12)

1,230 FMC audits conducted in the preceding 12 months (Prior year: 1,190)

Our reviews

2023/24

2 small firm, 3 medium firm, 4 large firms

19 audit files including 10 listed companies, 9 other FMC reporting entities

2022/23

1 small firm, 1 medium firm, 2 large firms

19 audit files including 9 listed companies, 10 other FMC reporting entities

2021/22

2 small firms, 2 medium firms, 3 large firms

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

2020/21

1 small firm, 2 medium firms, 2 large firms

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

Small firms are firms with fewer than four licensed auditors.

Medium firms are firms with multiple offices and fewer than 10 licensed auditors.

Large firms are firms with more than 10 licensed auditors (including Audit New Zealand).

Foreword

This year we changed our overall approach to how we monitor registered audit firms. We have gone from reviewing audit firms once every two or three years, to an annual review for most firms. Although we visit each firm more frequently, the total number of audit files we review remains consistent.

The reason for this change is to be able to provide more timely feedback and to compare practices over the same time period for all audit firms. The change also allows us to do more effective thematic reviews across industries and audit firms.

This year we looked at how firms implemented Professional and Ethical Standard 3: Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements. The new standard puts more focus on internal control procedures and reviews of the controls that firms must perform to ensure quality management is effective.

We are pleased to see that audit firms have successfully transitioned to the new standard, and found limited areas that require improvement. Next year our focus will be on whether firms have appropriately designed and performed procedures and testing for the effectiveness of their quality management systems.

While we saw a decrease in the overall number of findings per audit file during our reviews, there was a slight increase in the number of significant findings compared to last year. Two key areas we identified for further improvement, where we see both auditors and directors of reporting entities as part of the solution, are risks related to fraud and going concern. It is important to have these topics front of mind throughout the audit process, as they are fundamental for promoting the integrity of financial statements and the quality, expertise and integrity of the audit profession.

We also want auditors to focus on ensuring they have a good understanding of both the business they are auditing and the risks they assess as part of the audit. We have often found that standard audit procedures are either not appropriately scoped, due to lack of understanding of the business or not executing audit procedures as intended. The reasons why such oversights happen often relate to either insufficient time or insufficient review by senior audit staff.

We encourage auditors to continue to focus on these areas so that audits are consistently executed at a high standard.

The FMA continued monitoring activities of overseas auditors. During this reporting year we started an investigation into an overseas auditor for their work on a New Zealand incorporated entity.

We continue to evaluate the effectiveness of our audit oversight and consider where improvements can be made. Our overall objective is to improve audit quality across FMC audits. Our audit quality reviews play an important role in identifying areas for improvement, and we continue to engage with auditors and audit firms to identify any other risks. Directors also play an important role in the audit process and can contribute to audit quality. We welcome their input.

Jacco Moison
FMA Head of Audit, Financial Reporting and Climate Related Disclosures

2023/24 audit quality overview

What we have seen

Audit quality remains strong in New Zealand. However, inconsistencies in execution are holding back the ability to produce stronger evidence and support for audit opinions. This year's reviews identified five non-compliant files compared to three last year, with the number of files reviewed (19) remaining consistent.

One of the goals with our more frequent reviews of each registered audit firm is to enable better comparison of results. However, identifying trends is more complex than comparing year-on-year results, as the combination of risk-based and random selections in our sample of audit files can impact the outcomes of the review. The number of audit firms reviewed (9 this year, compared to 4 in 2022/23) may also impact the overall outcomes.

Although the number of non-compliant files is higher than last year, the total number of findings is similar – 26, compared to 28 reported in 2022/23. The non-compliance rate of 26% is below the international non-compliance rate of 32%.

Focus areas

Our reviews this year focused on the implementation of two new audit and assurance standards:

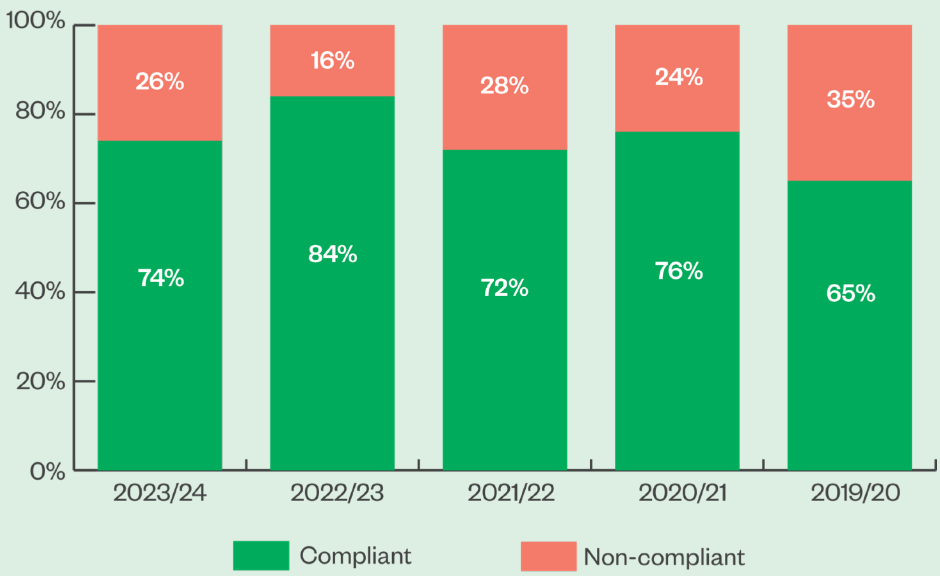
- Professional and Ethical Standard 3: Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements
- ISA (NZ) 315 (Revised 2019) : Identifying and Assessing the Risks of Material Misstatement

We are satisfied with how firms have approached and implemented these new requirements, identifying only a few low-level issues. We will continue to focus on these standards in future reviews.

This year's report also highlights the following areas where we identified common or more significant findings, to ensure they are a focus for firms during their audits:

- Risks of fraud and the entity's going concern assessment

Percentage of compliant and non-compliant audit files reviewed



- Accounting estimates, including the use of experts
- Revenue recognition and the use of service organisations.

Our reviews highlighted some key principles that audit firms should consider to further enhance the quality of audits in New Zealand. These principles include:

- **Appropriate assessment and consideration of evidence obtained from third-party service providers:** Where the auditor relies on information from third-party organisations as audit evidence, they should determine if these third parties are classified as a service organisation in accordance with ISA (NZ) 402. The auditor should clearly document their approach to relying on information from third parties as audit evidence and obtain sufficient evidence to support their conclusions.
- **Assessing the risk of fraud in audits of financial statements:** Auditors who involve multiple levels of governance and leadership at the entity will be better placed to identify and assess indicators of fraud risk. The auditor's understanding of the entity and management incentives will contribute to a robust framework to identify risks of fraud. We encourage auditors to carefully consider whether their procedures are appropriate to mitigate the fraud risks identified.
- **Going concern assessment:** Professional scepticism is important when evaluating financial forecasts used for a going concern assessment. The disclosures and assumptions made by management and directors should be supported by sufficient audit evidence.

International comparison and developments

We continue to track our year-on-year results against those reported by the International Forum of Independent Audit Regulators (IFIAR). IFIAR surveys various audit regulators, including the FMA, about reviews of listed issuer audits performed by the six largest audit firms (Big 6)[1]. Last year 51 jurisdictions were included in IFIAR's survey.

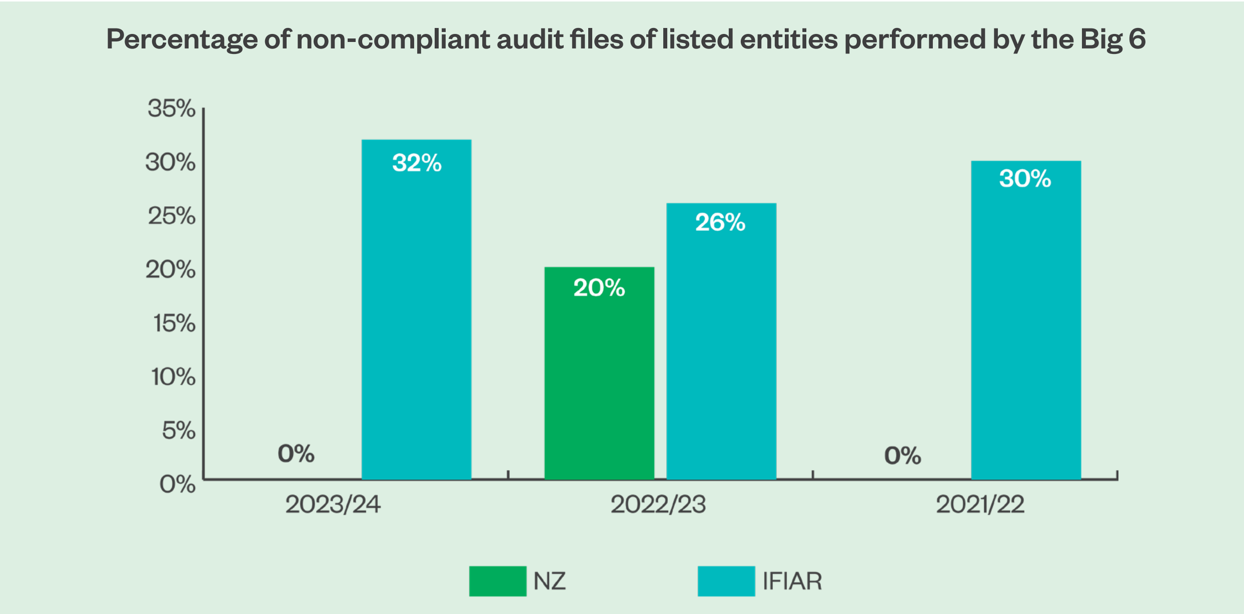
The survey provides key trends, review findings, and the overall percentage of non-compliant audit files[2]. The New Zealand percentages can fluctuate significantly between years as we review a limited number of listed issuer audit files from the Big 6, and may select FMC audits that are not listed issuers.

Our involvement with IFIAR and our international regulatory relationships are important for the purposes of the Act, to promote recognition of the professional status of New Zealand auditors in overseas jurisdictions.

We continue to contribute to and learn from international developments and share our experiences and knowledge with fellow audit regulators on audit-related topics and developing trends (such as climate-related assurance), and suggested reforms for regulation of the audit profession.

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

2 We apply the same file rating standards as IFIAR in our audit quality reviews


Percentage of non-compliant audit files of listed entities performed by the Big 6
35%
30%
25%
20%
15%
10%
5%
0%
0%
32%
20%
26%
0%
30%
2023/24
2022/23
2021/22
NZ
IFIAR

Trends and analysis from our audit file reviews

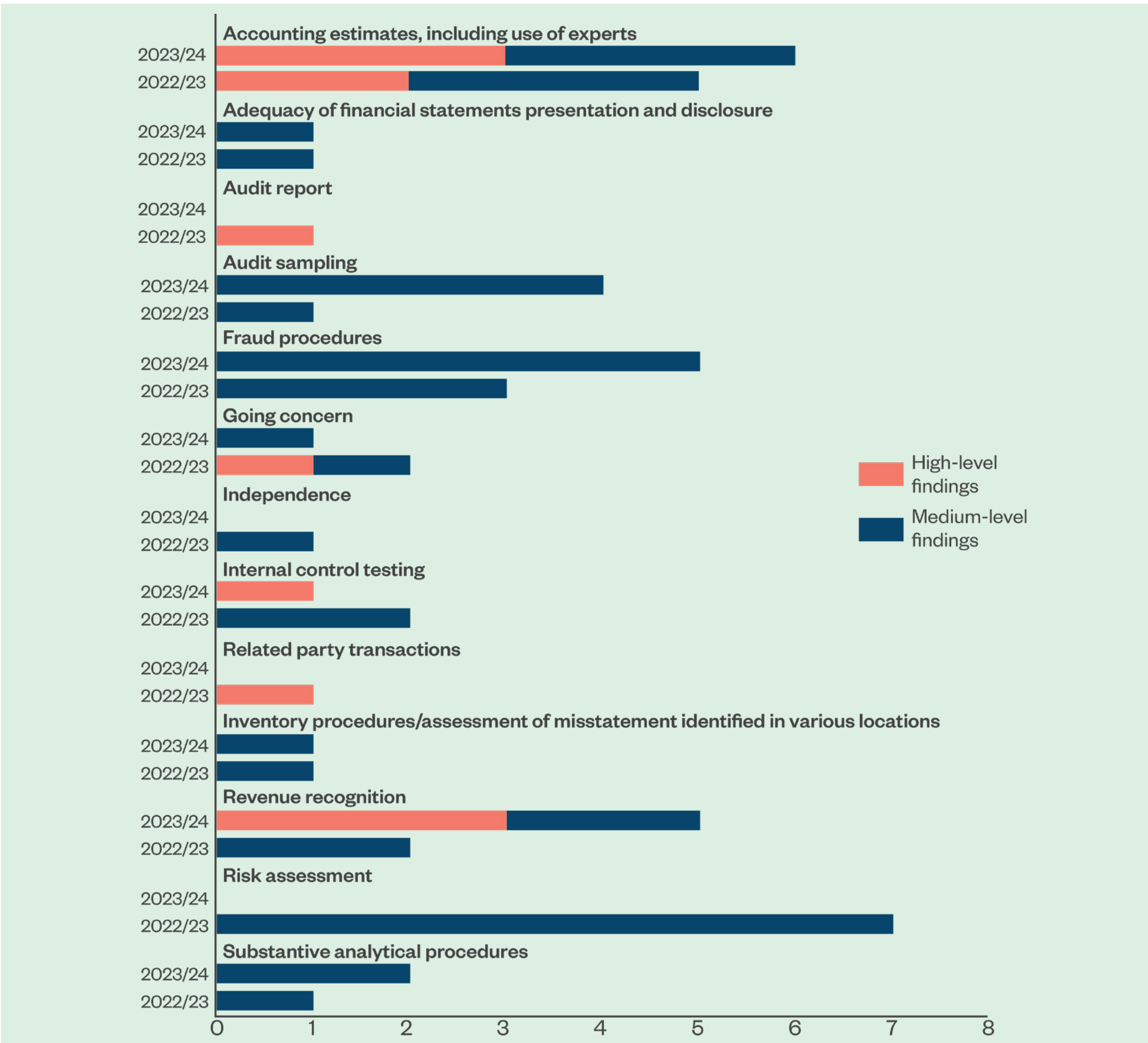
When reviewing audit files, we assess whether the auditor complied with the Auditing and Assurance Standards, and otherwise exercised reasonable care, diligence, and skill in carrying out the audit.

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

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

More information about our areas of focus can be found in our annual Auditor Regulation and Oversight Plan.

The table below shows the total number of high- and medium-level findings we have identified in the key areas, across the 19 audit files we reviewed. Although there were two more high-level findings compared to the previous year, the total number of findings was lower – 26, compared to 28 in 2022/23.



Follow-up on non-compliant audit files

When we rate an audit file as 'non-compliant' we can take several actions. Depending on the nature of the findings and the timing of our review, we assess the best approach to remediation. We require the audit firm to perform a root cause analysis and prepare a remediation plan to address findings we have rated as 'high' or 'medium'. Where our findings indicate that the auditor did not perform appropriate procedures to obtain sufficient evidence, we instruct the auditor to improve procedures to ensure our findings are addressed in the next audit.

Results from non-compliant audit files[3]	Number of files 2023/24	Number of files 2022/23
Financial statements materially misstated	0	1
Insufficient evidence available to make a reliable assessment of material misstatement	4	1
Insufficient evidence, additional audit work required, impact to be assessed	1	1
Investigate or refer to disciplinary body	0	0

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

Going concern and fraud

In the aftermath of global corporate collapses, questions are raised about what more could have been done by auditors in relation to the going concern assessment and, where applicable, the work performed around fraud as part of the audit of financial statements.

A common theme in both going concern and fraud issues is the gap between what users of financial statements expect from auditors, and what auditors are required to do in accordance with the Auditing Standards. It is challenging to address this gap, as expectations are subjective, and concerns generally only arise after an issue is identified.

We have been giving this topic due consideration for some time, and more detail on closing the expectation gap can be found in the Association of Chartered Certified Accountants report in collaboration with Chartered Accountants Australia & New Zealand "Closing the expectation gap in audit – the way forward on fraud and going concern".

The going concern assessment and fraud are not primarily the responsibility of auditors: all parties in the reporting system play an important role in ensuring these are addressed as part of preparing financial statements. Management has a responsibility to ensure sufficient systems and processes are in place to address the risk of fraud, and to prepare a robust assessment of the going concern position of the entity. The directors should challenge management on whether all risks are identified and mitigations put in place are sufficient to address the risk of fraud. The entity's going concern disclosures in the financial statements should contain all required information and be supportable.

We recognise that as a regulator we have an important role to play. While we cannot narrow the expectation gap alone, this report provides insight to better understand the collective responsibility and the FMA's role.

Auditors' responsibilities

Material misstatements due to fraud in an audit of financial statements

The directors are responsible on behalf of the entity for the preparation and fair presentation of the financial statements in accordance with NZ IFRS, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

The auditors are responsible for performing certain procedures to address the risk of material misstatement due to fraud in the audit of financial statements. These include but are not limited to:

- Holding discussions with management and directors about the risks of fraud.
- Holding a separate discussion with the audit engagement team members covering how and where the entity's financial statements may be susceptible to material misstatement due to fraud.
- Assessing the risks of fraud in revenue recognition and management override of controls.
- Testing the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

Further, the auditor makes materiality assessments about the potential fraud risk factors and considers if further procedures are required. However, the auditor is not responsible for seeking out or fully investigating suspected fraud.

Going concern

The audit opinion states that the directors are responsible on behalf of the entity for assessing the entity's ability to continue as a going concern. It is the auditor's role to conclude on the appropriateness of the use of the going concern basis of accounting and whether a material uncertainty exists.

The audit procedures that are required to cover going concern include testing if the entity's assessment of going concern (of at least 12 months from the date of the auditor's current report) is appropriate and supportable, and considering if sufficient evidence can be obtained to form a conclusion.

The going concern of an entity can be impacted by a range of factors. Therefore, if an entity fails within 12 months of the audit opinion, it doesn't necessarily mean the auditor did not perform an appropriate evaluation of the entity's going concern assessment.

Observations from our monitoring

Material misstatements due to fraud in an audit of financial statements

Fraud risk is a standard area of focus for our reviews. For each audit file we cover the following areas in some detail:

- The auditor's testing of the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.
- Any other audit work performed to address the risk of management override of controls.
- Any specific procedures performed to address the risk of fraud in revenue recognition.

For this year's review cycle, we wanted to better understand how the auditors applied the requirements of the fraud standard[4]. We were interested in whether audit firms identified any fraud risks other than management override of controls and fraud risks associated with revenue, which are usually assessed as significant risks. We also reviewed whether instances where the auditor decided to rebut the risk of fraud associated with revenue were appropriate in the circumstances.

From the 19 audit files we reviewed, we identified 2 instances where the auditor identified other fraud risks. These related to:

- possible fraudulent withdrawals in a credit union
- the risk of earnings manipulation for a listed entity facing substantial financial difficulties.

In both instances we were satisfied that the auditor designed appropriate audit procedures to address the identified risks.

There were also 5 instances where the auditor rebutted the risk of fraud associated with revenue due to the nature of the revenue streams. From our reviews, we were satisfied that, based on the auditor's risk assessment, it was appropriate in the circumstances to rebut the risk.

We did find instances where the auditor assessed there was significant fraud risk over revenue, but it wasn't clear what procedures the auditor performed to appropriately address this.

The required audit work over journal entries is an area where we have seen improvement over the last couple of years. Auditors generally design procedures that are appropriate to address

4 ISA (NZ) 240

the risks identified. However, we are still seeing shortcomings in the risk identification process, in relation to appropriately documenting what risk factors were considered to select the journals to be tested. Examples of findings in journal testing include the following:

- In selecting the journals for testing, the auditor did not give any consideration to journals processed by staff who ordinarily would not be expected to post journal entries.
- The auditor identified a risk that the CFO of the entity could approve, edit and process journals. However, it was not clear how this risk was addressed in the testing of the journal entries.
- There was no clear link between the fraud risks identified and the selection of journal entries tested to address the risk of fraud.
- In some audits only one journal entry was tested out of a population of 1,000 without a clear explanation of how this addressed the fraud risk.
- It was unclear how the auditor assessed the completeness of journal entries and how the auditor selected the journals that required testing.

While the work around journal entry testing has improved over the years, more work is required to make these procedures more specific, to align with the requirements of the standard.

Going concern

Although the going concern assessment is in scope for all the audit files we assess, the work we perform depends on the financial position of the entity and risk assessed by the auditor. For audits where the auditor assessed going concern to be a significant risk or included a key audit matter, or included a material uncertainty paragraph in the auditor's report, we would expect the auditor to design and perform specific procedures to address the elevated risk associated with going concern. In these instances, we closely review all the audit procedures.

This year we found one instance where the auditor did not obtain sufficient audit evidence to support a going concern assessment. The auditor did include a material uncertainty paragraph in the auditor's report, but we could not establish how the auditor:

- obtained supporting evidence to show if a third party was able to provide the financial support if needed for the entity to continue as a going concern
- reviewed the key assumptions in the forward-looking cashflows
- verified if the disclosures in the financial statements met the requirements of the Accounting Standards.

Going concern and the response to fraud in the audit of financial statements are recurrent areas where we have findings in our reviews. Although the findings are not a systemic issue and are often isolated to individual audits and circumstances, the potential impact of poorly executing procedures can be significant.

What we want directors to focus on

Management and directors of FMC reporting entities have an important role in improving external reporting of going concern, and improving the internal control environment in relation to fraud in financial statements. To ensure audited financial statements are free of material misstatements due to fraud, and properly reflect the accounting treatments based on a going concern where appropriate, directors of FMC reporting entities should:

Material misstatements due to fraud in an audit of financial statements

- Together with management, directors should regularly assess the risk of fraud. Specific focus should be given to how key incentives for staff could lead to potential financial reporting fraud and the misappropriation of assets. Discuss and understand the auditor's procedures around the risk of fraud and ensure the auditor has received all relevant information to perform a robust assessment.

Going concern

- Have a robust process in place for budgets supporting the going concern assessment of the entity, which includes critical timings of cashflows and supporting evidence of the judgements made in this assessment. Directors should consider that the auditor needs to assess the going concern assessment for the foreseeable future but at a minimum for a period of 12 months after signing the audit report. Therefore, the auditor may ask the entity to provide further evidence to support this assessment.
- Ensure that the disclosures in the financial statement comply with the requirement of the accounting standards. This is particularly relevant in instances a material uncertainty exists.

What we want auditors to focus on

Material misstatements due to fraud in an audit of financial statements

- A risk assessment that includes enquiry of the board of directors and management about the risks of fraud. Where appropriate they should consider using a fraud expert and undertake additional training to help identify risks.
- Having a clear understanding of management incentives that could impact the risk of management override of control and fraud.
- Clearly documenting their consideration of how risks identified will be addressed by the mandatory journal entry testing or other specifically designed procedures.

Going concern

- Applying scepticism when evaluating the going concern assessment of the entity and seeking corroborating evidence to verify the disclosures in the financial statements for instances where a material uncertainty exists about the entity's ability to continue as a going concern.

Due to the importance of fraud and going concern, we will continue to focus on these areas when selecting and reviewing audit files.

Potential changes to the fraud and going concern auditing standards

Auditors' responsibilities related to fraud in an audit of financial statements and going concern are under review by audit standard setters internationally, and by the External Reporting Board (XRB). The XRB is considering ways to promote consistent practice and reinforce the importance of the appropriate exercise of professional scepticism, to clarify auditors' responsibilities related to fraud and going concern and promote transparency. These projects are expected to be completed in 2025.

Implementation of the new quality management standard

The Act recognises the importance of a strong internal quality control system and requires the FMA, as part of our audit quality reviews, to test if each registered firm has implemented the standards appropriately. With the new Professional and Ethical Standard 3 (PES 3 (revised)) coming into effect on 15 December 2022, for this review cycle we tested the implementation of the revised standard across all registered audit firms.

The main objective of our review was to gain an overall understanding of the design of each firm's System of Quality Management (SQM).

As part of our work, we looked at assigned roles within the audit firm for ultimate accountability and operational responsibilities, including responsibility for compliance with independence requirements, and the monitoring and remediation process. To assess firms' initial design and implementation of their SQM, we did not review all components of the new standard, but took a risk-based approach. This was informed by the firms' own risks assessments, focus areas of international regulators, and areas under the previous standard that were more challenging. Our review did not include testing of the effectiveness of the systems; this will be included in the 2024/25 review cycle.

Audit firms spent considerable time and resource to implement the new standard by designing compliant SQMs. The systems varied based on each firm's size and complexity, and the resources available. The areas of focus and our observations are set out below.

Risk assessment process

PES 3 requires audit firms to design and implement a risk assessment process to establish quality objectives, identify and assess quality risks, and design and implement responses to mitigate the quality risks.

We reviewed each firm's risk assessment process, to understand how it determines the conditions, events, circumstances, and actions or inactions that may adversely affect achievement of the quality objectives, and how the audit firm considered the nature and circumstances of each engagement. We also assessed whether the firms considered all the risks and whether these were clearly defined and appropriately rated.

We are encouraged by the robust risk assessment processes followed by audit firms.

Audit firms that are part of a global network that prescribes matrices of quality objectives, quality risks and responses to these risks for all components, not only complied with the prescribed requirements, but also incorporated the specific requirements under the New Zealand standards.

In performing the risk assessment, firms considered the likelihood and magnitude of risks when assessing the overall risk rating.

Governance and leadership

The standard requires audit firms to establish quality objectives that address the audit firm's governance and leadership, which in turn establishes the environment that supports the SQM.

The allocation of responsibilities within audit firms is mainly driven by size. Some firms had to make changes to their organisational structure to facilitate assigning the roles, responsibilities and authority, so the SQM would function appropriately. When assigning roles, firms assessed the appropriateness of competency and capability based on experience and knowledge, and assessed capacity based on workload information.

Every audit firm has formally allocated the ultimate and operational responsibilities of SQM to the appropriate persons or governance body, including the:

- CEO
- managing partner
- board chair.

In some instances, responsibility for the SQM sits with another person within the audit firm due to some structures not having a clear hierarchy.

Firms have included quality in their strategic plans, and overall SQM implementation processes reflect conscious allocation of resources to maintain a culture of quality. All firms have emphasised a culture of quality to the staff by various means, including training and internal communications.

Relevant ethical requirements

Ethical behaviour is critical for auditors, to ensure stakeholders have trust and confidence in the profession. Because of its importance of ethics there is a separate Assurance Standard setting out all Professional and Ethical Standard requirement (PES 1).

With existing comprehensive policies, manuals and procedures in place, firms were mainly required to make minor updates to satisfy the new requirements.

All firms have taken the necessary steps to establish a whistleblowing process designed to appropriately deal with complaints, with due emphasis given to independence throughout the process.

Training is one of the more effective options available to audit firms to ensure staff are aware of their ethical responsibilities. However, to demonstrate the effectiveness of training, firms should test staff and partners' knowledge by doing a test. We saw several instances where the firm provides training but does not test staff to ensure they understand their responsibilities.

Ethical requirements encompass more than just independence. We saw instances where the firm's risk assessment and responses did not appear to cover all aspects of ethical requirements.

Engagement performance

While engagement performance is the component with the second-highest number of prescribed quality objectives in the new standard, our review focused on:

- consultation on difficult or contentious matters
- differences in opinions
- engagement quality review (EQR).

Audit firms have exercised care in developing their policies in these areas and have allocated appropriate resources to achieve the quality objectives. This includes firms:

- designing appropriate policies and processes to encourage consultation
- promoting the concept of 'a culture of consultation'
- having a clear process that links consultation with differences of opinion between roles on the audit, and directs engagement teams to follow the consultation process to resolve differences of opinion
- having an EQR policy in place to oversee specific responses to non-compliance with ethical standards or other breaches set out in the standard.

We saw one instance where the firm combined the consultation process and the EQR review as one process. As these are different processes designed to achieve different objectives, we did not view this as appropriate. The consultation process involves a discussion at the appropriate professional level, with individuals within or outside the firm who have specialised expertise, on difficult or contentious matters. However, this process should not replace the EQR, which involves performing an objective evaluation of the significant judgements made by the engagement team and the conclusions reached.

For some components of the standard and quality objectives, it is only possible to determine their effectiveness through reviews of the audit files rather than the policies, procedures, and controls. We will continue to raise any issues resulting from these reviews as part of our overall engagement with the audit firms.

Self-evaluation of the firms' systems of quality management

The standard requires that the individual(s) who are assigned ultimate responsibility and accountability for the SQM need to evaluate its effectiveness on behalf of the firm on an annual basis.

We noted these evaluations were based on a monitoring model consisting of:

- internal monitoring
- monitoring by the firm's wider network
- external monitoring. We identified one instance where the audit firm had not fully implemented a robust monitoring and remediation process covering the entire SQM, which meant the conclusion reached by the person with ultimate responsibility for completing the firm's self-evaluation was not properly supported.

Focus for audit firms

Although we did not identify any common findings across firms, we highlight the following areas for firms to consider:

- A formal performance evaluation mechanism will help ensure quality is adequately linked and evaluated as part of the leaders' annual performance evaluations, including those with responsibility for SQM and audit partners.
- For those with EQR responsibilities, performance evaluations should consider the quality of EQRs performed.
- Risks should be evaluated continuously, not as an annual one-off exercise.
- Documenting the nature, timing and extent of responses to audit quality risks, to support that these are appropriately addressed.
- Ensuring that the ethical risks assessment includes all ethical requirements and is not limited to auditor and audit firm independence.

Auditor’s risk assessment

The auditor’s assessment of risk is a vital process in an audit. Performing a proper risk assessment and complying with the relevant standards is not only critical to ensure the audit is done efficiently, but also ensures a quality audit. Where the auditor performs their risk assessment appropriately, it enables them to design the right procedures to obtain sufficient appropriate evidence to address the risks.

Although our reviews usually include a review of the auditor’s risk assessment, for the 2023/24 review cycle we placed specific emphasis on this area, to ensure firms appropriately implemented and followed the new standard Identifying and Assessing the Risks of Material Misstatement (ISA (NZ) 315 (Revised 2019).

Overall, we are encouraged by the level of compliance in implementing and adopting the new risk standard. We noted that firms updated their audit methodology to incorporate the new requirements and, from the files we reviewed, applied the requirements of the standard appropriately. We also noted that firms updated their software to enable the audit teams to appropriately document the required evidence, to reflect the implementation of the standard and demonstrate the auditor’s assessment of the risk.

One of the main differences in the new standard is that auditors are only required to assess the inherent risk of likelihood and magnitude of material misstatements for the relevant assertions identified for significant classes of transactions, account balances and disclosure. This creates a risk that auditors may not identify relevant assertions for material classes of transactions, account balances or disclosures that have not been determined to be significant classes of transactions, and therefore won’t be required to assess the inherent risk and may end up not identifying a significant risk of material misstatement.

We found that firms were detailed in their risk assessments, which focused on specific risks for specific assertions, enabling the auditor to design procedures specifically tailored to address those risks.

In our reviews we noted two instances where the audit firm’s software did not enable the auditor to clearly document the likelihood of risks causing material misstatements. This included the auditor’s considerations of the likelihood, and what impact this had on the overall inherent risk assessment. In one instance we were able to review a software update that was rolled out for subsequent audits, to confirm the issues were addressed. In the other instance, the root cause was audit teams were not familiar with the updated software and how to appropriately complete the work papers. In future reviews we will check that the necessary training was provided and that the risk assessments are being completed in a compliant manner.

Accounting estimates

Accounting estimates is an area where we have seen continuous improvement in the work performed by auditors. However, we continue to identify findings regarding the documentation and sufficiency of evidence obtained, so this should remain an area of focus for auditors.

We noted the following deficiencies in the work performed by auditors in testing accounting estimates:

- The auditor did not assess the relevance and reasonableness of underlying assumptions used by management experts in assessing the fair value of investment property, for example:
  - the capitalisation rate in valuation models assessed by an expert
  - the material assumption of percentage of vacancy
  - the current market conditions and market rental calculations included in an expert valuation.
- In testing income and expenditure used as a key input in valuing investment properties, the auditor identified misstatements. In assessing the misstatements, the auditor incorrectly considered the impact of the misstatements and therefore did not consider if they could be material.
- The cost to complete an investment property development was a key input in determining whether there was an impairment in the fair value. The auditor did not identify that the entity incorrectly assessed the cost required to get the property into a state that it could be rented out. Therefore, there was a possibility that the impairment was materially understated.
- The auditor engaged an expert to assist with the impairment assessment of goodwill. However, it was not evident what procedures the auditor performed to assess the adequacy of the expert's work, as required by the auditing standards.
- In the impairment assessment of goodwill, it was unclear what procedures the auditor performed to test the accuracy of the revenue allocated to this specific cash-generating unit.
- The discount rate disclosed in the notes to the financial statements included both a risk-free component and an equity premium. While the auditor was able to obtain sufficient and appropriate audit evidence to verify the risk-free portion, it was not evident what procedures the auditor performed to obtain assurance that the equity premium rate was reasonable.

Focus for auditors

Where the auditor has used an expert, the auditor should assess the:

- relevance and reasonableness of the expert's findings or conclusions, and their consistency with other audit evidence
- relevance and reasonableness of the expert's significant assumptions and methods
- relevance, completeness and accuracy of source data that is significant to the expert's work.

Revenue recognition and the use of service organisations

Revenue is often assessed as a significant risk and is therefore covered in most of our audit quality reviews. It is also an area where we identify the most significant findings.

Below we highlight some instances where the auditor did not obtain sufficient evidence to support the audit opinion. We expect auditors to consider these matters when they design their audit approach and procedures related to audit revenue.

Obtaining an understanding of the revenue process and systems

In instances where the auditor did not obtain sufficient audit evidence related to revenue, we often find that understanding of the revenue process and system is not properly documented. Documentation should be detailed enough to evidence that the auditor understands how the revenue cycle works. Relevant details will typically include:

- What initiates a revenue transaction
- How revenue is recorded, including who is responsible, whether there is a review process and what controls are in place
- When and on what basis revenue should be recognised
- What information or evidence is available and generated through the revenue system that can be used as audit evidence, and who prepares that information
- Whether any third parties are involved and are responsible for any process that affects the entity's financial statements, and should therefore be considered and assessed as a service organisation

The following examples highlight instances where we found the auditor did not obtain sufficient audit evidence.

Example: Unclear understanding of the revenue process

The auditor's documentation of the revenue process did not provide a clear understanding of the business process. For initiation of orders, the auditor only documented that a contract, which contains underlying terms, is in place for large customers. The auditor did not consider and document how the revenue system works for any other smaller customers.

Work to be performed is based on different milestones set in the contract. There was no documentation of how the transaction is initiated and by whom. It was not evident the auditor obtained an understanding of contract details such as milestones, and whether all contract details are recorded in the accounting system.

For the invoicing process, it was only documented that "When work has been completed, the accountant is notified by the account managers, about the quantity of work performed and what to bill the customers, which she follows. Sometimes for our larger clients, a PO is required to be received before invoicing happens as the customer will not pay otherwise".

There was no documentation on the audit file to explain:

- How the account manager determines the job is complete
- What information is used to determine the job is complete and what controls are in place to ensure the information is accurate and complete
- Whether information from the contracts is entered directly into the accounting system
- How the account manager ensures the milestones per the contract have been met and the work should be invoiced

- How the account manager communicates with the accountant, e.g. by email, phone or verbally, and how the account manager provides the accountant with information to support their request
- How the accountant ensures the information provided by the account manager is accurate and complete

Further, there was no documentation on file of the auditor's understanding of when the performance obligation is met. In the detailed work performed there was mention of third parties being contracted by the entity to assist the entity in executing its services. However, there was no reference in the documentation to who these third parties are, what their roles, functions, duties and responsibilities are, and where they fit in the entity's revenue process.

The work performed was not documented in detail and as a result, we were unable to determine whether the procedures performed by the auditor in their detailed testing were appropriate, and what information was inspected as supporting evidence.

Example: No evidence of reliability of production reports

The entity purchases raw materials and contracts a third party to process these into final goods and sell them on behalf of the entity. The auditor did not identify the third party as a service organisation and did not obtain a type 1 or type 2 report.

The sales price of the final goods is based on the weight of the final products. The entity further uses the production reports to record the costs of sales. One of the controls in place is the review of the production reports by management of the entity, to assess whether the weight of the final goods is reasonable based on the weight of raw materials used in the production process.

The auditor's documentation did not provide evidence that the auditor obtained an understanding of how management determined the expected conversion rate from raw materials to final goods. Based on discussions during the review, the auditor noted there is an industry norm of what the expected weights could be based on the input weight. However, this information and associated evidence was not documented and not used in the evidence supporting the revenue.

Example: No third-party process documentation

This example doesn't relate to revenue recognition but does highlight problems with the use of service organisations. An insurance entity contracted a third party to assess and pay insurance claims on its behalf. The entity would reimburse the third party for the claims paid. The auditor elected to follow a combined approach, performing both test of controls and test of detail, to test insurance claims paid. Although the firm did identify the third party as a service organisation, it assessed that it was not necessary to obtain a type 1 or type 2 report, as the auditor will be able to obtain sufficient appropriate evidence directly from the service organisation.

The auditor did perform test of controls and substantive procedures over the approval of the reimbursement by the entity. However, from the documentation on the audit file we did not see how the auditor traced the transactions through to the:

- approved claim
- underlying external supplier invoices
- information in the insurance policy.

Therefore, it was unclear how the auditor ensured the insurance claims were valid and accurate. During the review the auditor provided examples of documents obtained from the entity to support certain payments, but this did not form part of the audit evidence. What information was sighted as part of the payment process was not documented in the testing template and was also inconsistent with other claims procedures where this information was sighted. It was therefore not possible for us to confirm these documents were inspected by the auditor at the time of performing the audit.

Focus for auditors

Assessment of service organisations

As noted in the examples above, entities may contract third parties to provide services to and on behalf of the entity. As part of the auditor's assessment of these services, the auditor should consider if they are classified as 'service organisations' in accordance with the standard. In a couple of instances above it was not evident the auditor considered whether the third parties were services organisations or not, and what impact this may have had on the auditor's approach. Often with service organisations the auditor would obtain a type 1 or type 2 report to support their understanding of the service organisation. If these reports are not available or the auditor decides not to use them, the auditor needs to develop other procedures to obtain sufficient evidence. It should be clear from the documentation what approach the auditor took.

Testing the reliability of third-party reports

Where auditors used information prepared by a third party as audit evidence, we found this information was not always tested to ensure it was accurate and complete. In the examples above the auditor did not identify the entity as a service organisation and did not obtain a type 1 or type 2 report. The auditor should be suitably sceptical of information prepared by a third party. To obtain sufficient audit evidence, auditors should perform procedures similar those the entity itself would have performed. Therefore, we expect the auditor to focus on the following:

- Documenting their understanding of the third party's business process that is driving the revenue process. This should include detailed documentation of the processes and be confirmed by a walkthrough.
- Clearly documenting evidence that the auditor inspected and verified during the walkthrough.
- Designing a testing approach that may include controls testing and test of details.
- Where testing controls relies on system controls, documenting how the auditor obtained comfort that the systems operate effectively.
- Where the auditor relies on reports for their detailed testing, testing the accuracy of the report, either through test of controls (if applicable) or substantive procedures.
- Ensuring the documentation in the audit file is sufficient to enable an experienced auditor who has no previous connection with the audit to precisely understand:
    - what procedures exactly the auditor performed and what documentation the auditor inspected as part of the procedures performed
    - the evidence obtained and the results from the audit procedures performed; and
    - significant matters arising during the audit, the conclusions reached, and significant professional judgements made in reaching those conclusions.

Revenue will remain an area that we cover in most reviews.

Disciplinary proceedings

Accredited bodies have the primary responsibility for investigating potential auditor misconduct. The FMA can investigate only those matters that accredited bodies have referred to us or decided not to investigate, or related matters. We can also investigate overseas auditors that we have licensed directly.

When we have concerns about compliance with the Auditing and Assurance Standards following an audit quality review, we have various tools available to us including:

- requiring an audit firm or auditor to perform additional work to address our findings
- requesting a remedial action plan to address the compliance issues
- in our next review, reselecting files from the previous review to assess whether the audit firm has taken appropriate action to address our findings
- issuing directions to remediate any findings.
- referring complaints to the accredited body to be dealt with under its disciplinary procedures

We consider several elements when determining if a referral to an accredited body is needed, including:

- Did the issue have a significant impact on the audit's outcome?
- Did the auditor or audit firm breach the Professional and Ethical Standards?
- What is the overall quality of the audits performed and is there a pattern of non-compliance by the auditor?

Matters may also be referred to the relevant accredited body for further investigation following a complaint or any other intelligence we obtain. Where matters are referred to the accredited body, we try to assist with the evidence we have obtained as part of our reviews and provide further evidence where needed.

Accredited bodies also take regulatory action directly against licensed auditors following complaints made by third parties or their own monitoring activities. This can be related to either FMC audits or other engagements for which a licence is not required.

Overseas auditor investigation

This year we started an investigation into the FMC audit of a New Zealand incorporated entity, performed by an overseas licensed auditor.

Following the lodgement of the entity's financial statements, the FMA performed an initial review that raised concerns about the auditor's work regarding the following areas of the audit:

- Investments, which made up most of the total assets and were 100 percent impaired during the 2022 financial year. During the 2020 and 2021 audits, the auditor was unable to obtain sufficient evidence to verify the value of the investments.
- The entity's going concern assessment, which relied on the prospect of a capital injection from a third-party financier.

Following our initial concerns we started a detailed investigation involving the lead engagement partner and the Engagement Quality Review (EQR) partner. Although the lead engagement partner is responsible for the audit, the EQR partner is tasked to objectively evaluate the significant judgements made by the engagement team and the conclusions reached thereon before the audit opinion is signed.

The investigation observations raised concerns about the following elements of the audit:

- Evidence obtained regarding the key areas of the audit including:

  - various investments that the entity held during the year and management's impairment assessments
  - cash and cash equivalents held by the entity
  - going concern assessments, in particular the support for management's assumptions made to support the going concern assumption.
- The EQR partner's involvement in the significant judgements areas of the audit and the timing of the sign-off provided to the lead engagement partner.
- The level of reasonable care, diligence and skill exercised in performing the audit.

Any regulatory outcome that may be reached following FMA's completion of this investigation process will be published on FMA's website, unless exceptional circumstances apply or we consider the effect of publication would be disproportionate to the misconduct.

Appendix 1 – Audit oversight regime

Oversight of FMC auditors

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

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

What are FMC reporting entities?

The FMC Act defines an FMC reporting entity as:

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

Financial Markets Authority

The FMA is the Crown entity responsible for enforcing securities, financial reporting and company laws as they apply to financial services and financial markets. This includes the regulation of auditors of FMC reporting entities, and the accreditation and monitoring[5] of professional bodies. We also license and register overseas auditors and audit firms.

External Reporting Board

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

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

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

Professional bodies

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

- licensing domestic auditors and registering domestic audit firms using the standards set by the FMA

5 Accredited Body Report – New Zealand Institute of Chartered Accountants | fma.govt.nz
Accredited Body Report - CPA Australia | fma.govt.nz

- monitoring those auditors and registered audit firms
- promoting and monitoring the competence of these members
- taking action against misconduct.

All licensed auditors can be found on the Auditors Register.

Monitoring audit quality

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

We report annually on our findings by issuing this Trends in Audit Quality report (formerly called the Audit Quality Monitoring Report (this report). The publication Audit Quality: A director's guide is also available to directors.

Quality review methodology

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

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

We aim to review all firms every year, however some of the small firms may be reviewed every second year. As a result of our Memorandum of Understanding (MOU) with the Auditor-General, we may review audits of FMC reporting entities carried out by private audit firms on behalf of the Auditor-General. The results of these reviews are included in this report and our findings are communicated directly to the Auditor-General.

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

Quality control framework

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

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

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

We have prescribed additional requirements[6] for the EQR given its importance to the audit process. We expect the EQR partner to be suitably qualified and have relevant experience to enable them to give an objective evaluation. We therefore require the EQR to be licensed.

Individual file reviews

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

Key attributes of audit quality are:

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

Risk-based file selection

We choose audit files to review at random, as well as selecting audits from higher-risk sectors and industries.

Our selection of audit files tends to be primarily focused on risk. These include businesses that are more vulnerable to risks from existing and emerging market conditions, such as businesses that are newly listed or experiencing significant growth, or other higher-risk businesses that have compliance issues such as qualified audit reports. The audit firms and audit files we review change each year, so it is difficult to compare year-on-year results. Trends in audit quality should be analysed over several years to better understand what progress has been made. Due to the small sample sizes and the selection approach, the result may not be indicative of the overall quality of audit firms reviewed.

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

File selection and ratings for individual audit files

The number of audit files we select for each audit firm is determined by the number of licensed auditors at the audit firm, the number of FMC audits completed and the results of the audit firm's previous review.

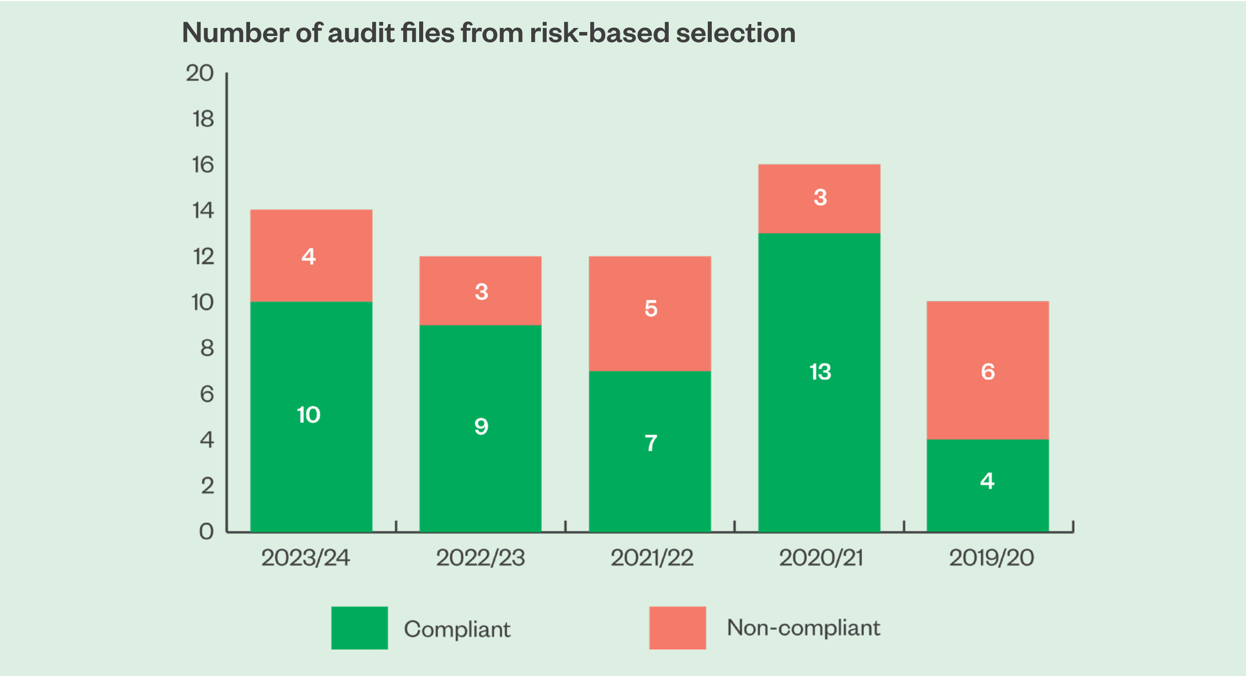
In selecting specific files for review, we consider:

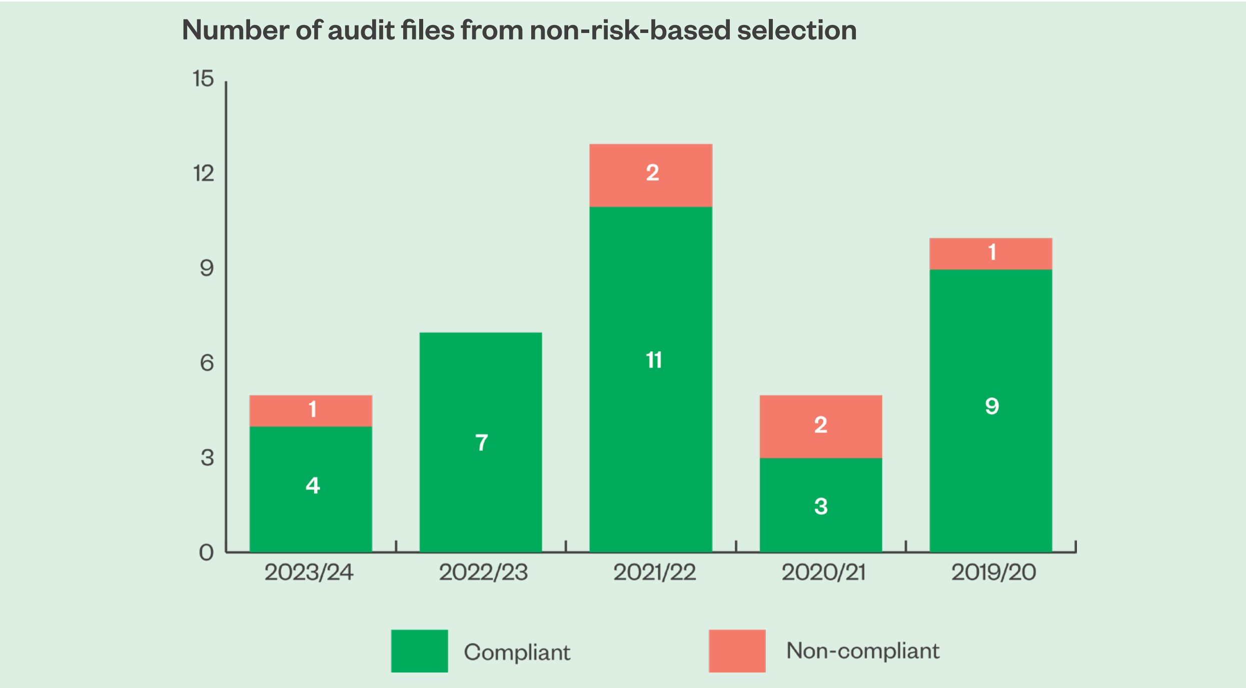
- Businesses of significant public interest, given the value of financial products issued to the public (such as KiwiSaver schemes, banks, insurance companies and businesses listed on the NZX).
- Businesses and industries that are more vulnerable to risks from existing and emerging market conditions, such as newly listed businesses, or businesses that experienced significant growth.

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

- Other businesses considered higher risk, such as finance companies, or businesses that have non-compliance issues such as qualified audit reports, or that have not complied with laws and regulations.
- 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 likely we would review that auditor or audit file again.





File ratings

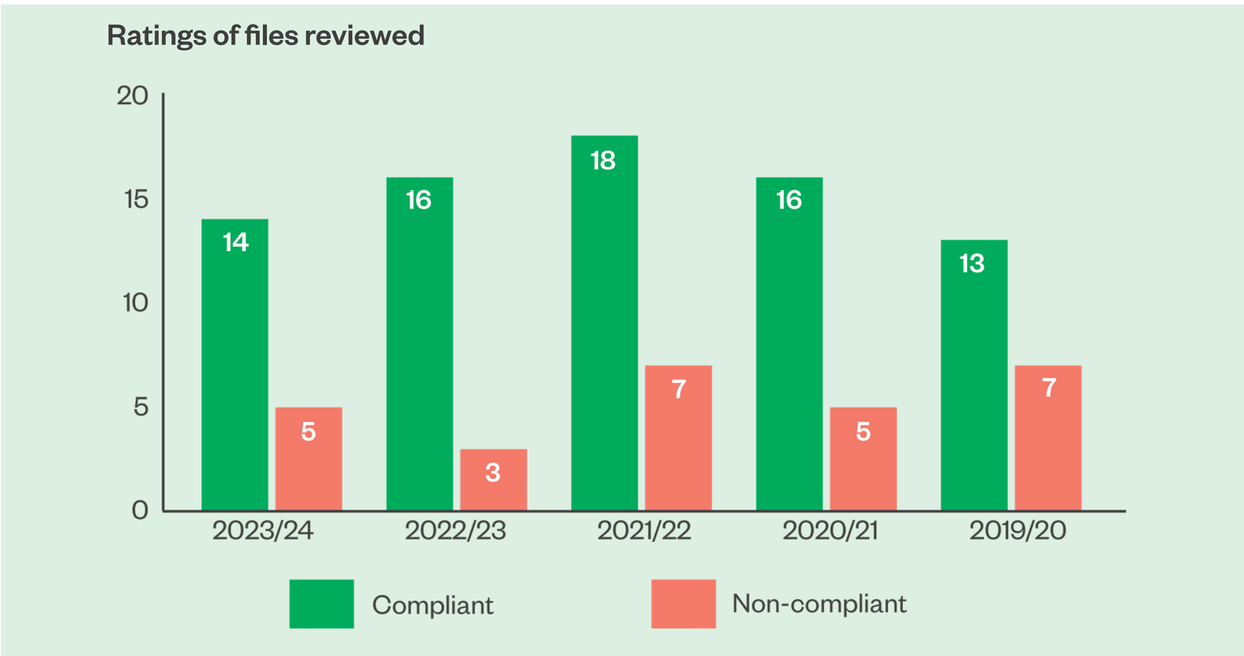
When we complete a file review, the reviewer gives each individual finding on that file a rating from low to high, and proposes a final overall file rating from the categories below:

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

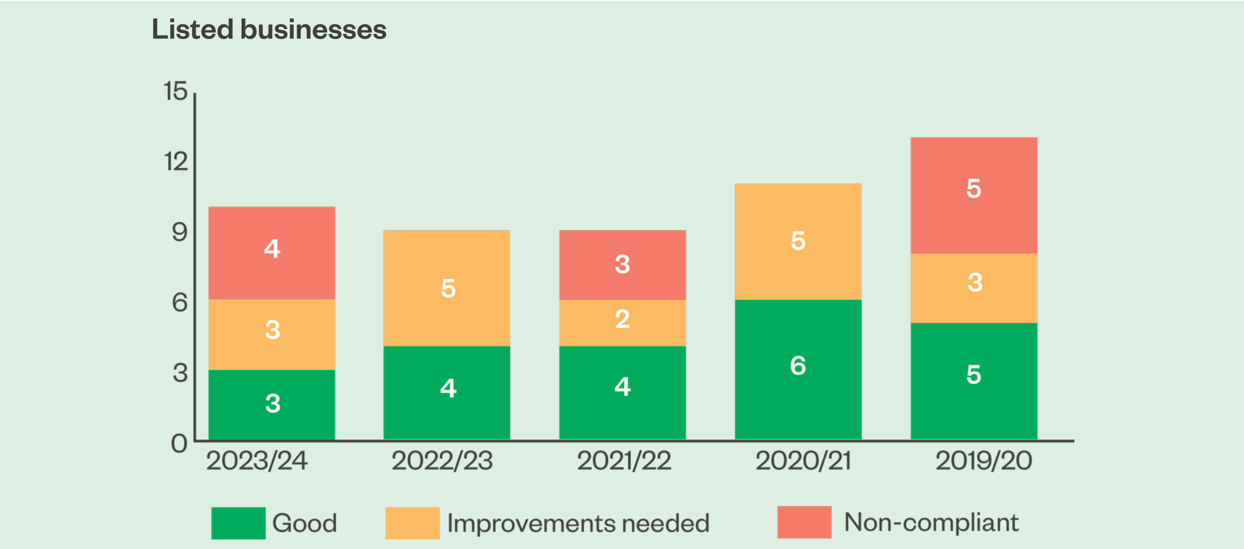
The ratings are moderated by the AOC.

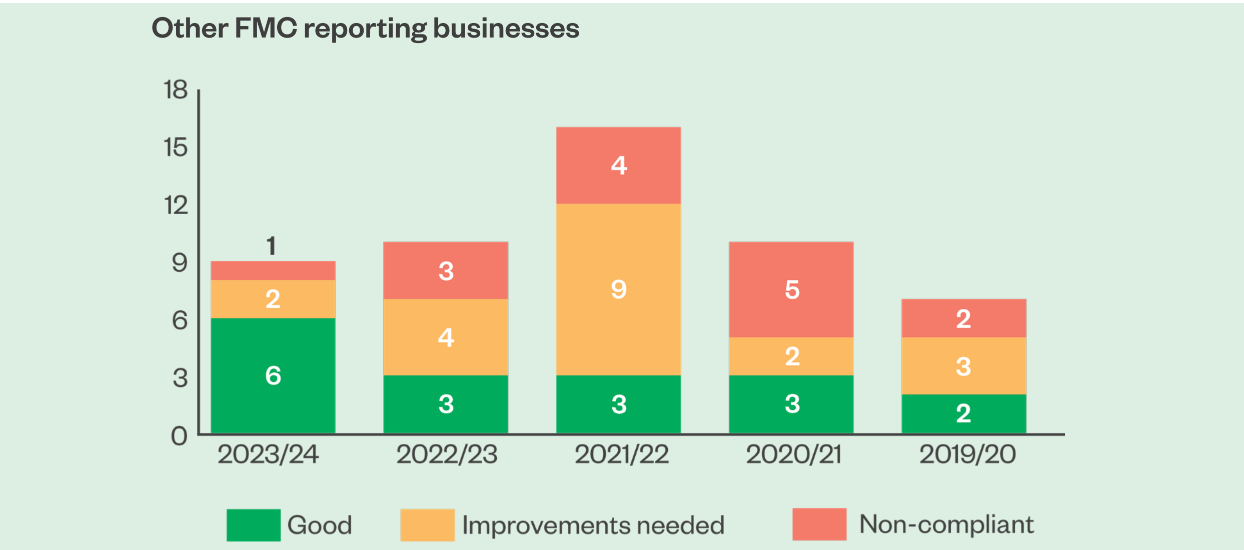
Summary of review ratings

The graph below provides an overview of how we rated the individual audit files over the last five years.



This is broken down further between listed and other businesses as follows:





Background to our rating criteria

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

Appendix 2 – Market data

	30 June 2024	30 June 2023	30 June 2022	30 June 2021	30 June 2020
Domestic licensed auditors	133	135	135	138	135
New licences issued to domestic auditors	8	7	4	9	10
Domestic auditor licences cancelled	10	7	7	6	7
Domestic registered audit firms[7]	12	12	13	14	14
Domestic audit firms licensed	0	0	0	0	1
Domestic audit firms' registrations cancelled or expired	0	1	0	0	1
NZX-listed companies	201	203	185	186	178
FMC audits	1,230	1,190	1,050	1,130	1,200
Firms reviewed	9	4	7	5	4
Audit files reviewed	19	19	25	21	20

7: This includes two brand names with five individual licences. We have included these as 2 registrations as we combine the reviews of this individual licences. This disclosure has changed from previous year where they were disclosed as separate firms. In total there are 5 large firms, 4 medium firms and 3 small firms.

Glossary

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

IFIAR	International Forum of Independent Audit Regulators
ISA (NZ)	International Standard on Auditing (New Zealand) issued by the External Reporting Board.
FMC reporting entity	Has the same meaning as in section 6 of the Act.
FMC audit	Has the same meaning as in section 6 of the Act.
Materiality	Information is material if its omission or misstatement could influence the economic decisions of users taken based on the financial statements.
NZICA	NZICA and the Institute of Chartered Accountants of Australia (ICAA) formally amalgamated on 1 January 2015 to form the Chartered Accountants Australia and New Zealand (CA ANZ). After the amalgamation, NZICA continues to regulate the accountancy profession for Chartered Accountants ANZ members who remain resident in New Zealand (and by virtue of their residence continue to be NZICA members) according to the NZICA Act 1996, and the terms of the amalgamation agreement. For the audit oversight regime, NZICA continues to be the accredited body.
PES	Professional and Ethical Standards issued by the External Reporting Board.
Quality review	A review of an audit firm as defined by the Act.
Type 1 / type 2 report	A service organisation may engage a service auditor to report on the description and design of its controls (type 1 report) or on the description and design of its controls and their operating effectiveness (type 2 report)

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

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

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