Audit Quality Review Report

For the year ended 30 June 2013

FINANCIAL MARKETS AUTHORITY
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Introduction

Context of this report

This report provides an overview of the outcomes of the audit quality review activities of the Financial Markets Authority (FMA) for the period 1 July 2012 to 30 June 2013.

FMA is obligated to prepare a report[1] no later than six months after the beginning of each financial year, ending 30 June, on the quality reviews that have been carried out under the Auditor Regulation Act 2011 (the Act), which came into force on 1 July 2012. The first quality reviews under the Act commenced in February 2013.

FMA performs these quality reviews in compliance with section 68 of the Act, which sets out the minimum requirements of a review. The quality reviews were carried out on registered audit firms and licensed auditors by reviewing their overall internal quality control systems and individual audit files.

Our report contains the outcomes of these quality reviews for the period February 2013 to 30 June 2013.

This report summarises the overall assessment of audit quality (section 1); provides key messages for audit firms, directors and audit committees (section 2); and outlines the future focus of quality reviews (section 3).

FMA's approach to regulation

FMA's principal objective is to promote and facilitate the development of fair, efficient and transparent financial markets. Our approach is to work with financial market participants in an open and educative way, to achieve best standards of compliance. We seek to be clear about FMA's expectations, while providing the market with scope to develop the way it meets these expectations.

FMA monitors market participants' compliance with the obligations imposed upon them. Quality review of audit firms is just one of FMA's monitoring activities. Our monitoring activities are designed to facilitate voluntary compliance by market participants and are one of the ways through which we communicate our expectations and work to raise standards. Our expectations of regulated participants will increase over time, as regulatory regimes are embedded.

Interpretation

Key terms used in this report are defined in Appendix 1. Appendix 2 contains a summary of relevant market data in relation to our report.

[1] Section 73 of Auditor Regulation Act 2011

Executive summary

Summary

FMA considers that the majority of audit firms reviewed require significant improvements to fully comply with Auditing and Assurance Standards. This finding and the reasons for it are consistent with regulated auditor regimes in other countries at an equivalent stage of development to New Zealand.

At 30 June 2013, 40 registered firms, 150 licensed auditors and approximately 1,550 issuers were included in the auditor oversight regime. During the review period, nine audit firms and 33 issuer audit files were reviewed.

From the sample of firms reviewed over the period, there appears to be a significant gap in quality between the Big Four firm and the other firms. We acknowledge that the Big Four firms have been subject to review by overseas regulatory bodies which contributes to audit quality. The Big Four firms and some other international network firms also have their own international quality review programmes which aim to contribute to audit quality.

FMA recognises that audit firms in New Zealand have not previously been subject to independent regulation and therefore, we expect more non-compliance in comparison with jurisdictions that have been subject to regulation for a number of years.

The findings in this report are a reflection of the audit firms reviewed during the period. Other audit firms may have different policies and procedures to meet their obligations as licensed auditors, and as registered firms, the findings of this report may not be an accurate reflection of the audit industry as a whole.

FMA will conduct follow-up reviews or spot reviews for firms where we have noted significant issues during our review. These follow-up reviews will ensure that registered audit firms are taking appropriate actions to address our key findings.

Key findings

From its quality reviews, FMA has identified four key areas requiring improvement by audit firms:

- auditor independence and ethical issues
- audit quality monitoring
- audit documentation and evidence
- use of professional scepticism.

Our comments on these key areas are detailed in section 2.

FMA's expectations

Firms should increase their efforts to improve audit quality and their consistency in performing issuer audits. This report identifies some significant areas where firms need improvement. We expect audit firms that were not subject to quality review in this period to consider these areas of focus in their ongoing monitoring of audit quality.

FMA believes that multiple parties play a role in improving the quality of issuer audits. We encourage directors and audit committees to discuss with auditors their audit plans and to incorporate the key messages provided in this report regarding auditor independence, audit quality monitoring, and the use of professional scepticism.

Audit committees or directors of issuers may wish to ask audit firms whether the audit firm has been quality reviewed by FMA. What lessons were learnt by the firm from the review and what actions the firm has taken to address any issues identified should be discussed. We also encourage audit firms to share findings of FMA's quality reviews with their issuer audit clients as part of their audit planning.

Future focus

FMA will continue to review licensed auditors and registered firms. Our areas of focus for future reviews are set out in our Auditor Regulation and Oversight Plan 2013-2016[2] and in section 3.

[2] A copy of this plan is available from FMA's website http://www.fma.govt.nz/keep-updated/reports-and-papers/auditor-regulation-and-oversight-plan-for-three-years-ending-30-june-2015

1. Assessment of audit quality

1.1 Audit quality review approach

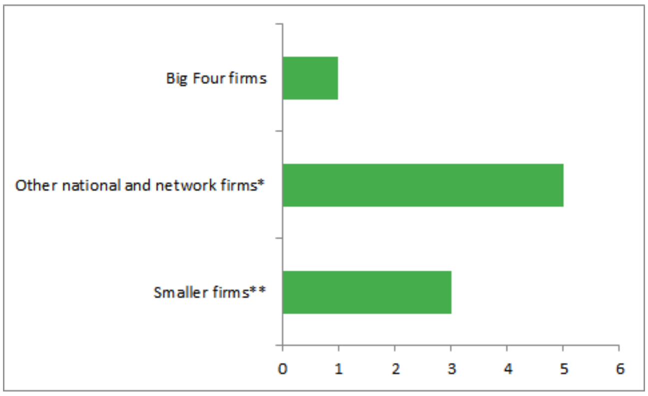
FMA must ensure that quality reviews are conducted in accordance with the Act[3]. Quality reviews are carried out to ensure that the systems, policies and procedures of audit firms are satisfactory in terms of:

- promoting compliance with:
    - the requirements imposed under the Act and other enactments that relate to the conduct of issuer audits; and
    - Auditing and Assurance Standards;
- otherwise promoting reasonable care, diligence and skill in carrying out issuer audits.

Each registered audit firm and every other audit firm that has at least one partner, director, or employee who holds a licence issued under the Act, will be the subject of review at least once in every four year period[4]. FMA will endeavour to keep its review cycle consistent with the European Union (EU) to remain internationally aligned. The review cycle required by the EU is currently three years.

NZICA, acting as a delegate of FMA, conducts the quality reviews on behalf of FMA. The quality reviews are carried out in accordance with FMA approved methodology. The firms and licensed auditors are selected for review in accordance with a programme and schedule approved by FMA. The timing, frequency and selection of the audit files are determined using a risk-based framework. This may result in different sample selections and frequency of visits for different registered firms.

During the period, nine registered audit firms were reviewed, covering 25 percent of the domestic licensed auditors and approximately 34 percent of the issuer audit population. The table below shows an overview of the selected firms.



* Other national and network firms include registered firms with multiple offices across New Zealand and registered firms that have separate firm registrations, but operate under one brand name and have more than four licensed auditors
** Smaller firms are firms covering one or two locations with less than four licensed audit auditors

[3] Section 68 of the Act defines certain matters that must be included in a quality review
[4] Section 65 of the Act defines the review period

1.2 Assessment of individual audit files

Our primary focus is on the quality of issuer audits undertaken. This is assessed on the basis of the overall firm quality control systems and the review of a selection of individual issuer audit engagement files. File reviews are carried out in order to assess compliance with Auditing and Assurance Standards and whether the licensee has exercised reasonable care, diligence and skill in carrying out issuer audits.

FMA's approach to the selection of individual issuer audit engagement files for review is based on the public interest and risk that the issuers pose to investors. It takes into account firms' policies and procedures regarding audit quality. The selection of audit files to be reviewed focused, where possible, on:

- entities that are likely to be of significant public interest based on the value of securities issued to the public, such as KiwiSaver schemes and listed companies
- those entities and industries that are more vulnerable to risks arising from existing and emerging market conditions and other higher risk entities, such as finance companies
- ensuring that the majority of licensed auditors within the registered firm were subject to the review.

Our reviews focussed on the key areas set out in our Auditor Regulation and Oversight Plan 2012-2015[5], and in particular, on the appropriateness of key audit judgments made in reaching the audit opinion, based on the sufficiency and appropriateness of the audit evidence obtained.

Our assessment of the quality of individual audit engagements is based primarily on the evidence in the audit files provided to us and takes into account as appropriate, any explanations and responses provided to us by audit teams to explain why the evidence in the audit files did not provide the level of documentation and evidence required by the standards, and why these standards were not breached.

FMA's review of each issuer audit is subject to thorough internal quality control procedures. Each review of an issuer audit is based on an approved audit quality review manual. A peer review process is in place for each audit file reviewed. The overall quality review report of an individual audit firm is also subject to a peer review and assessment by an independent audit advisory group before a final review is performed by staff at FMA. These processes are designed to ensure both a high quality of reporting and a consistent approach across all reviews.

[5] A copy of this plan is available from FMA's website http://www.fma.govt.nz/media/1772210/auditor-regulation-and-oversight-plan-2013-final.pdf

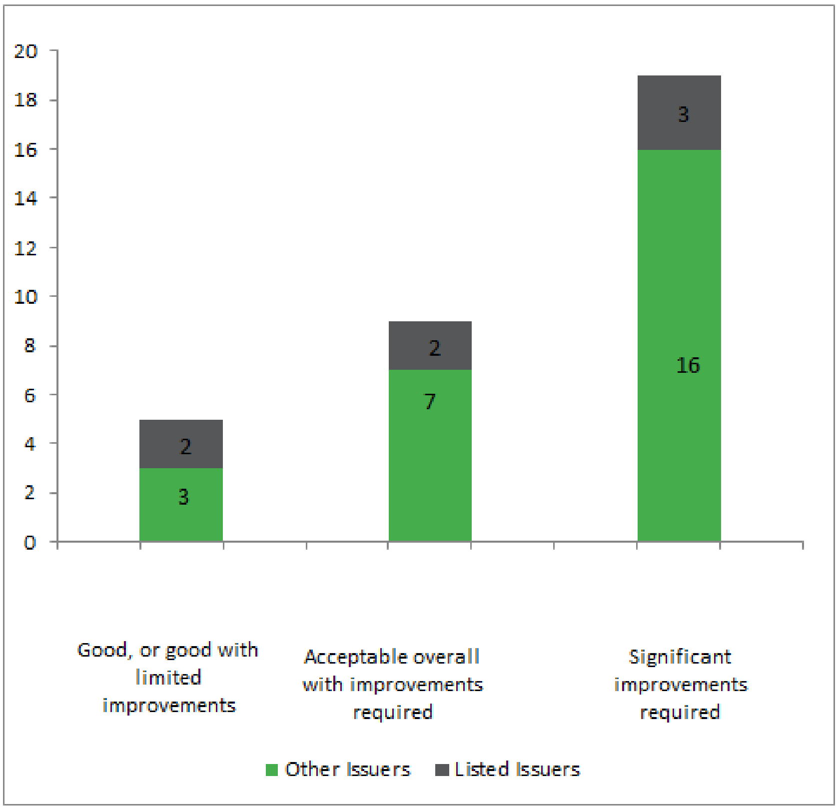
For issuer audits, we rate the quality of the audit work we examine on individual audits on three levels, which are as follows:

- good, or good with limited improvements required
- acceptable overall with improvements required
- significant improvements required.

An audit is classified as requiring significant improvements if:

- FMA has significant concerns in relation to the sufficiency or quality of audit evidence in key areas of the audit
- FMA has significant concerns in relation to the appropriateness of audit judgments in one or more key audit areas
- the implications of concerns relating to other areas were considered to be individually or collectively significant.

The following table provides an overview of the rating of the individual issuer audit files inspected during our quality reviews.



A compliant audit of issuer financial statements contributes to market confidence in those financial statements. It is important to emphasise however, that a non-compliant audit does not necessarily imply that the financial statements were materially inaccurate or incomplete, or that an inappropriate audit opinion was issued. Our review focusses on how a particular audit was performed and is not designed to assess whether all the information audited was correctly reported.

The individual audit files selected cover the following industries.[6]

Agriculture and Fishing	4
Electricity, Gas, Water and Waste Services	1
Financial and Insurance Services	6
Health Care and Social Assistance	1
Information Media and Telecommunications	2
KiwiSaver Schemes	2
Manufacturing	2
Other Services	2
Rental, Hiring and Real Estate Services	3
Retail Trade	2
Retirement Village Operators	7
Transport, Postal and Warehousing	1
Total files reviewed	**33**

The issuer audit files selected had reporting dates covering the period 31 March 2012 to 31 March 2013.

[6] Industries are categorised based on the listing of descriptions by general industry classification category published by ACC.

2. Key findings

Key findings arising from our 2012/2013 quality reviews are set out in this section. We expect audit firms to pay particular attention to these findings in order to improve overall audit quality. A number of these findings are similar to the findings of equivalent overseas regimes and will continue to be areas of focus for FMA, as set out in the Auditor Regulation and Oversight Plan 2013-2016.

The key findings relate to:

- auditor independence
- audit quality monitoring
- audit documentation and evidence
- professional scepticism.

Each key finding contains a high level summary of the relevant standard, followed by examples of non-compliance identified during our reviews, as well as FMA's expectations as to how these areas should be improved.

2.1 Auditor independence

- **Audit firms should maintain adequate independence and ethical procedures and provide training to all staff regarding auditors' independence**
- **Independence requirements and documentation should be reviewed in detail by the Engagement Quality Control Review (EQCR) partner**
- **Compliance with auditor rotation requirements should be monitored**
- **Audit committees or directors of issuers should seek confirmation of independence and challenge audit firms to demonstrate their independence.**

The effective identification and assessment of threats, the application of appropriate safeguards, and the proper reporting of these to audit committees or directors are critical to maintaining auditor independence. In a number of cases, significant independence issues were noted due to a lack of appropriate systems or insufficient knowledge of the independence requirements as set out in the Professional and Ethical Standards 2 and ISA (NZ) 200.

Examples of issues identified during our quality reviews include:

- the audit firm preparing financial statements on behalf of the issuer, and audit firms providing the issuer with tax calculations for inclusion in the financial statements, which results in self-review risk
- a lack of audit evidence that independence policies have been followed, or documentation as to why the audit firm considers that they have fully complied with the Professional and Ethical Standards, for example the documentation of independence in providing non-audit services

- a lack of evidence on the audit files that non-audit services have been communicated to audit committees, or those charged with governance, and inconsistencies or incomplete disclosure of non-audit fees in the financial statements and audit opinions
- auditor rotation is not documented on the audit file, and is not closely monitored at an audit firm level to identify non-compliance with the Professional and Ethical Standards
- in one instance we noted that the audit lead partner and EQCR partner were involved in the audit of the issuer for more than 20 years, without:
    - documenting how familiarity threats were addressed
    - taking into account the requirements for a partner rotating after a pre-defined period not to be involved with the issuer audit in any other capacity.
- monitoring of independence and rotation requirements is not performed centrally and therefore increases the risk of non-compliance
- a lack of proper confirmation of independence by staff members, engagement partners and EQCR partners involved in the audit of the issuer.

FMA's expectations:

Firms should review the adequacy of their independence and ethical procedures and provide ongoing training to all staff to achieve improvement in the overall compliance with the relevant Professional and Ethical Standards. Improvements are required in documenting independence threats and communicating and documenting independence issues to those charged with governance. Non-audit services should be reported accurately in the audit opinion and should match the records of the audit firm regarding the fees earned and services provided.

We expect the EQCR partner to review all independence requirements and ensure that all information and audit evidence regarding independence threats, provision of non-audit services and auditor rotation is documented on the audit files in accordance with the standards.

Audit committees or directors should emphasise the need for high standards of reporting of independence threats by their auditors and challenge auditors regarding the specific safeguards they have in place to protect their independence, especially in instances where non-audit fees are significant in relation to the audit fee.

2.2 Audit quality monitoring

- **The EQCR should:**
  - **be documented on the audit file to evidence compliance with the requirements of ISA (NZ) 220 paragraph 20-22**
  - **identify possible non-compliance with Auditing Standards**
  - **be performed at key stages during the audit and performed on a timely basis**
- **Audit committees or directors of issuers should engage with their licensed auditor regarding quality control within the audit firm**

There is an increased focus on audit quality, both within New Zealand and internationally, and audit failure is an increasing reputational risk to audit firms. FMA believes it is important for audit firms to embed systems and processes that promote audit quality and have effective monitoring and accountability systems and processes. We noted opportunities for many of the registered audit firms to demonstrate a greater commitment to audit quality. This could be achieved through the firm's leadership, making audit quality a priority, setting expectations, and providing adequate resources to support the audit practice.

We found the majority of small to mid-size network firms had not established a monitoring programme to periodically review a selection of issuer audit files. Through monitoring and evaluating quality control systems, the registered audit firms can assess whether their systems are operating effectively to ensure compliance with the Auditing and Assurance Standards and other relevant laws and regulations.

FMA believes these systems can only be effective if reviews are performed, based on a risk-based framework, by staff with the appropriate knowledge and authority. We found instances where the internal review (where such reviews were performed) showed significantly more positive results than our inspection findings, and files selected for these reviews did not seem to focus on higher risk issuers. The significant difference in these findings, questions the robustness of these processes.

EQCR should provide a level of quality control during the audit of the issuer. An EQCR partner is required to be appointed for all issuer audits, paragraph 19 of ISA (NZ) 220 requires the engagement partner to ensure a reviewer has been appointed, to discuss significant matters with the reviewer during the audit, and not to date the audit report until the EQCR is complete. Paragraphs 20 and 21 specify mandatory procedures to be completed by the EQCR partner. When performed effectively, these reviews may reduce the number of non-compliance issues in audit files.

Overall, the evidence within audit files to demonstrate the scope of the EQCR work needs to improve. This is particularly an issue with files where there are significant technical issues or significant audit judgments requiring discussions between the engagement partner, the EQCR partner and the firm's technical specialists.

FMA quality reviews identified the following weaknesses that impacted on the overall quality of some issuer audits performed:

- When audit firms provided information to FMA regarding issuer audits, we noted that, in a significant number of audits, no EQCR partner was appointed. This is in a breach of the requirements of ISA (NZ) 220 and PES-3.
- The signing of the audit file by the EQCR partner did not always occur before issuance of the audit opinion. Accordingly, we were not able to identify if the EQCR was performed on a timely basis, before the audit opinion was issued.
- The EQCR was not always documented. Further, there was little documentation on the files to indicate what the EQCR partner considered to be the significant audit judgments, and what conclusions were reached from their review and discussions. Our quality reviews have also raised a number of issues which we would have expected to be addressed by the EQCR.
- Acceptance and continuance procedures were not always documented on the audit file, or failed to take into account all issues identified during the prior year's audit, such as management fraud.
- Audit firms did not always consider if it had the requisite skills to conduct an issuer audit before accepting the issuer as a client, for example where the client's revenue was based on complex IT systems and no IT audit knowledge was available within the firm.

FMA's expectations:

Audit firms should establish processes to monitor the quality of their issuer audits and the effectiveness of their internal procedures, such as auditor independence and rotation requirements.

Client acceptance and continuance procedures should focus on independence considerations, possible conflicts of interest and whether the firm is competent to perform the engagement, and has the capabilities, including time and resources to do so.

EQCR partners are required to be appointed to all issuer clients of the audit firm and the EQCR partner should, at a minimum, perform the requirements set out in ISA (NZ) 220. We recommend that audit firms issue proper guidelines and training to all licensed auditors acting as EQCR partners, and emphasise that adequate documentation is key evidence that an EQCR has been performed properly.

The Auditor Regulation Act (Prescribed Minimum Standards and Conditions for Licensed Auditors and Registered Audit Firms) Notice 2012, requires an audit firm to ensure that key decisions and judgments in an issuer audit must be subject to EQCR by another licensed auditor. Best practice therefore, would be for this to include the EQCR partner in planning, and for the audit file to evidence that the EQCR partner has been consulted on audit risks, professional judgments, significant accounts, and has reviewed the financial statements, audit report and reports to those charged with governance (with any observations from the review appropriately evidenced on the file).

2.3 Audit documentation and evidence

- **Audit documentation should:**
  - **be timely**
  - **address the requirements of the relevant standard**
- **If there is no documentation on the audit file, the presumption will be that the auditor did not obtain the necessary audit evidence.**

Auditing Standards require the auditor to obtain sufficient and appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. ISA (NZ) 230 also requires timely preparation of audit documentation. The documentation must provide a sufficient and appropriate record of the basis for the auditor's report and evidence that the audit was performed in accordance with Auditing Standards and applicable legal and regulatory requirements.

In most cases, the concerns with audit documentation we identified during our inspections involved a failure to record in a timely manner, all the information the auditor relied on in forming conclusions. In other cases, we identified deficiencies where the auditor failed to perform certain audit procedures and therefore could not document any evidence in relation to them.

We noted a significant number of areas where the documentation of audit procedures and audit evidence could be improved. The following areas are examples where some audit firms did not comply with the documentation standard or failed to provide sufficient audit evidence:

- **ISA (NZ) 530 Audit sampling**
  We noted a significant amount of judgmental sampling in audit files. The sample sizes used were in most instances, very small or smaller than the statistical sample sizes determined in accordance with the audit methodology of the audit firm. In instances of judgmental sampling, no documentation was provided on how these smaller sample sizes were sufficient to address the risk. Samples were not selected in such a way that each sampling unit in the population had a chance of selection as required by the standard.

- **ISA (NZ) 520 Analytical procedures**
  In many audit files, audit firms had not complied with Auditing Standards in the application of substantive analytical procedures. In some instances where substantive analytical procedures were used, this would sometimes be the only test performed for a material balance. Other procedures such as testing of controls and substantive testing of detail were not undertaken. Analytical procedures alone are not sufficient to address key risk areas.

The analytical procedures themselves often did not comply with the Auditing Standards. Examples included:

- Reliance was placed on the accuracy of the data used in the analytical procedure without performing sufficient audit work. This was noted especially where reliance was placed on automated reports from the client IT systems, where no testing was performed on the issuer's general IT controls, or on how reports were derived from the system, to test the reliability of the report itself.
- Adequate expectations to identify a misstatement that individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated, were not set before carrying out the analytical procedure.
- Where disaggregated data for substantive analytics was used, thresholds for following up variances from expectations did not take into account this disaggregation. This results in thresholds that are too high for identifying any variances.
- Where differences were identified, explanations provided by management were not corroborated with audit evidence.

- **ISA (NZ) 315 Identifying and assessing the risks of material misstatement through understanding the entity and its environment**

  A major concern in our reviews was the lack of documentation evidencing an organised audit process. The audit process should involve identifying risks, designing procedures to mitigate those risks, completion of those procedures, and documenting the conclusion to provide sufficient audit comfort to leave the auditor satisfied that the risks identified have been mitigated to the auditor's satisfaction.

  Across a number files, we were not able to confirm that the audit work undertaken was either appropriate or sufficient for the purpose of supporting the issuance of the audit opinion. We have not formed a view on whether this has resulted in the audit opinions being incorrect.

  Examples where insufficient audit procedures were performed included:
    - the valuation of loans
    - completeness of revenue, inventory and investments
    - risk of fraud in revenue and other fraud risks
    - related party transactions.

- **ISA (NZ) 240 The auditor's responsibilities relating to fraud in an audit of financial statements**
  Paragraph 26 of ISA (NZ) 240 requires that "*When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks*".

Where the auditor concludes that the presumption of fraud in revenue recognition is not appropriate, the auditor must document the reasons for this decision (paragraph 47). In many audit files we did not see any explicit consideration of whether the presumption of fraud in revenue recognition applied, nor did we see any documentation to indicate that the presumption had been rebutted, or on what grounds. Audit files did not always contain evidence of the performance of audit procedures where fraud risks were identified and audit procedures were planned in response to those risks, and certain required audit procedures were not performed, such as the testing of journal entries that may detect fraud and management override.

- **ISA (NZ) 550 Related parties**
  ISA (NZ) 550 includes specific procedures that are intended to ensure all related party relationships and transactions are identified (paragraphs 12 to 15). These include:
    - enquiry of management and those charged with governance regarding related parties and transactions
    - obtaining an understanding of controls that management has established to identify and disclose related party information and to authorise related party transactions
    - inspecting bank and legal confirmations, minutes of shareholder and board meetings, and other documents as appropriate, for indications of the existence of undisclosed related party relationships or transactions.

  In many audit files reliance was placed on information provided by management and we did not see evidence that the audit team had performed procedures designed to identify undisclosed related parties and related party transactions.

In the absence of adequate documentation on the audit files, it is difficult for an experienced auditor to assess whether sufficient and appropriate audit evidence was gathered and whether the requirements of the Auditing Standards were complied with, even allowing for oral explanations. In other instances audit documentation was not available on the audit file. If there is no documentation on file, the presumption will be that the auditor did not obtain the necessary audit evidence.

Where there is insufficient appropriate audit evidence documented in engagement files, it implies that insufficient and appropriate audit evidence was gathered. This leads to the risk that a material misstatement in the financial report as a whole may not be detected. We found this issue on a high number of audit files.

FMA's expectations:

Audit documentation
Audit firms should consider establishing a more standardised approach to documentation in the audit software, including referencing and recording of the audit work and conclusion on each financial statement item or audit procedure to achieve a clear audit file to support the conclusions.

Audit Sampling
FMA recommends that audit firms should reinforce the use of sample sizes in accordance with ISA (NZ) 530. Where the audit team decides to use judgmental sampling, clear documentation should be on the audit file to support the sample chosen, how each sampling unit in the population has a chance of selection, and why the audit team is comfortable regarding the untested balances.

Analytical procedures
We expect that where audit teams consider relying on substantive analytics as a test of detail, the four step model as required by the Auditing Standards, is properly documented and the required audit procedures for each of the steps are performed. The auditor should ensure that there are appropriate relationships between the data used and the balance tested, that the source data is adequately tested and that suitable thresholds are developed and explanations for variances are obtained and corroborated. In key areas of risk, substantive analytics should also be supported by other tests of details.

Identifying and assessing the risks of material misstatement through understanding the entity and its environment
Audit firms should consider improving the documentation by referencing and recording the audit work performed and conclusions reached on each financial statement item or audit procedure to achieve a more consistent and clear audit file to support the conclusions.

The auditor's responsibilities relating to fraud in an audit of financial statements
We expect audit firms to establish procedures to ensure that the presumption of fraud in revenue recognition is addressed by appropriate audit procedures. When other risks of fraud are identified, clear documentation of the audit procedures should be evident, addressing this risk of fraud at each assertion and in accordance with the documentation standards. We further expect the use of professional scepticism in performing these procedures.

Related parties
Audit firms should reinforce to engagement leaders and staff the need to document their understanding, audit work performed and the audit evidence obtained regarding related party transactions, to ensure compliance with requirements of the Audit Standards. We expect clear documentation demonstrating how all assertions in relation to related party transactions have been substantiated.

2.4 Professional scepticism

- Audit firms must reinforce the importance of exercising professional scepticism and should provide appropriate training to all audit staff
- Audit committees and directors should encourage the sceptical approach of their auditor

Professional scepticism is defined in ISA (NZ) 200 as *"an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence"*.

Financial reporting requirements seek to address information that is more relevant to users. As a result, more judgment and increased subjectivity is involved in management's accounting and reporting decisions (for example in relation to some fair value measurements). Recently, many entities have faced difficult economic conditions or other events such as the Christchurch earthquake that give rise to unique financial reporting and auditing challenges. These developments heighten the importance of professional scepticism by auditors, especially in areas of financial reporting that are complex or highly judgmental.

Professional scepticism can be negatively impacted by the following factors:

- the audit firm's plans to significantly increase revenue from issuer audits, the firm therefore lacks professional scepticism in accepting or continuing a client relationship
- long standing relationships between auditors and issuers have resulted in a lack of professional scepticism, especially in the areas of management override and fraud
- over reliance on industry experts without following the required procedures of the Auditing Standards.

Our reviews noted a number of areas where we considered some audit teams lacked appropriate professional scepticism. These included:

- Accepting clients' accounting treatments without documenting any consideration of the merits of the treatment, possible alternative treatments, and the extent to which the proposed treatment complied with International Financial Reporting Standards.
- Performing a test of loan impairment primarily through unsubstantiated discussions with client staff.
- Acceptance of management confirmations around going concern assessment without performing an independent assessment of the assumptions made by management.
- Testing of journal entries was not performed as the auditor concluded there was no risk of fraud, however testing of journal entries is a requirement of the standard.
- Accepting directors' representations regarding bank balances without any other form of audit evidence.
- No evidence of audit procedures testing the validity of all assertions regarding related party transactions, such as the completeness of these transactions, or the terms and conditions.

- Where auditors rely on work of experts such as valuers, we noted that the auditor did not:
    - evaluate the competence and independence of the valuer
    - take into account all assumptions made in the valuation report, such as comments on the market value of the assets
    - adequately evaluate the adequacy and reliability of the work performed by the valuer.
- Remaining alert while performing other audit procedures for instances of non-compliance or suspected non-compliance with those laws or regulations that may have a material effect on the financial statements, or that have a fundamental effect on the operations of the entity causing it to cease operations or call into question its continuance as a going concern. We also found instances where compliance with relevant capital adequacy ratios of the Reserve Bank of New Zealand were not considered in going-concern assumptions.

Adequate two-way communication between the auditor and those charged with governance at of the issuer assists in challenging how the auditor has applied professional scepticism. In particular, communication should include details about areas assessed to be at higher risk of material misstatement, particularly critical accounting estimates, and how the auditor has responded to those assessed risks. We noted in many instances significant judgments were not included in reports to audit committees or directors.

FMA's expectations:
FMA believes that audit firms should emphasise the importance of professional scepticism in the audit work performed and provide sufficient ongoing training for audit staff to improve professional scepticism. Furthermore, we expect to see documentation and independent audit evidence of the exercise of professional scepticism. It is not sufficient for audit firms to assert that appropriate procedures were performed, where there is no evidence of that work on the audit file.

Audit committees and directors should encourage professional scepticism from their auditors and should discuss the work performed and the concerns of the auditor regarding management's key judgments. Audit committees and directors should also ensure that management has provided all relevant information to audit teams to assist in their assessment of the appropriateness of key judgments made by management.

3. Future focus

FMA will continue to review licensed auditors and registered audit firms. Our quality review programme will focus on the risks that non-complying issuers pose to investors and will build on the results of the quality reviews performed over the previous period.

Where audit firms have been subject to quality review, they are required to report to FMA on how issues identified in the quality review have been addressed, within a timeframe set by us. Where we believe responses by the audit firm are not appropriate to address the issues, we may issue directions for the audit firm to implement the required changes. FMA will conduct follow-up reviews or spot reviews for firms where we noted significant issues in the previous review. These ongoing reviews ensure that registered audit firms are taking appropriate actions to address our observations on key findings.

Each year FMA will look to review licensed auditors and registered audit firms, representing 33 percent of the issuer audits population. We will select audit files based on the following criteria:

- whether entities are likely to be of significant public interest
- entities that are otherwise higher risk entities, such as finance companies, KiwiSaver schemes and listed companies.

Areas of focus for quality reviews for the period 2013-2014 are set out in the table below:

Area	Standard
audit quality control system and supervision	ISA (NZ) 220
auditor independence	PES 2
audit documentation and evidence:	ISA (NZ) 230 /ISA (NZ) 500
a) related parties	ISA (NZ) 550
b) subsequent events	ISA (NZ) 560
c) going concern	ISA (NZ) 570
professional scepticism	ISA (NZ) 200
a) auditing accounting estimates	ISA (NZ) 540
understanding of the issuer and its environment	ISA (NZ) 315
the auditor’s responsibilities relating to fraud in an audit of financial statements.	ISA (NZ) 240
Audit fees and audit performance	ISA (NZ) 200

Audit quality control system and supervision

We will focus on the involvement of the engagement partner and EQCR partner at all stages of the audit, including audit planning, reviewing key judgments and the conclusions reached. The engagement partner is responsible for audits being performed in accordance with the firm's audit policies.

Auditor independence

We will review compliance with auditor independence requirements, including:

- auditor rotation requirements and the requirement to rotate the EQCR partner
- independence requirements regarding the provision of non-audit services. We will focus on how providing these services is approved within the firm, reporting to those charged with governance within the issuer and documentation requirements in the financial statements and audit opinions
- 'opinion shopping', particularly where an audit firm's views are sought on specific accounting treatments before a decision is made about whether to appoint the auditor

Audit documentation and evidence

FMA will review whether licensed auditors have obtained appropriate audit evidence to conclude whether the issuer's financial statements are free of material misstatements. We will also review whether sufficient audit evidence is obtained to support the audit opinion. We will focus, in particular, on audit documentation in the following areas:

- going concern
- related party transactions
- subsequent events.

Professional scepticism

FMA expects a level of professional scepticism to be maintained during an audit. Engagement partners, EQCR partners and staff should maintain questioning minds and aim to obtain sufficient evidence and not be over reliant on management's explanations and representations. Our focus on the use of professional scepticism will be in the following areas:

- significant judgments in relation to accounting estimates and fair value calculations
- management and directors' representations regarding going concern
- impairment calculations and recoverability of assets including deferred tax assets
- using emphasis-of-matter opinion as an alternative to issuing a qualified audit opinion
- accepting and continuing client relationships.

Understanding of the issuer and its environment

FMA expects that the licensed auditor has an adequate understanding of the issuer and its environment through interaction with the audit committee and management, along with other research. Key areas of risk identified during this process should be appropriately addressed with sufficient audit procedures.

The auditor's responsibilities relating to fraud in an audit of financial statements
One of the objectives of the auditor is to identify and assess the risks of material misstatement of the financial statements due to fraud, and to obtain sufficient appropriate audit evidence to properly assess this risk. This specifically relates to fraud in revenue recognition and management override of controls.

Audit fees and audit performance
FMA will review audit files and in particular we will be reviewing whether there have been fee reductions on past years fees, or whether the audit fee is otherwise low and not reflective of the current business of the entity, or changes in the entity, that would indicate that a low fee or a fee reduction is appropriate. We will review whether these low fees or fee reductions have impact of the quality of the audits performed.

Appendix 1 – Key

Term	Meaning in this document
Audit firm	Registered audit firm as defined by the Act
Auditing and Assurance Standards	The current auditing and assurance standards issued by the External Reporting Board (XRB)
Auditing Standards	International Standard on Auditing (New Zealand) to be applied in conducting audits of historical financial information as issued by XRB under section 24 of the Financial Reporting Act 1993
Audit Quality	FMA considers that a quality audit should include, but is not limed to: an independent audit performed by a licensed auditor, issuing an audit opinion that can be relied upon because sufficient and appropriate audit evidence has been obtained by following the Auditing and Assurance Standards and using the correct level of professional scepticism
Auditor	Licensed auditor as defined by the Act
Big Four firms	Deloitte, Ernst & Young, KPMG and PwC
EQCR	Engagement quality control review
EQCR partner	Engagement quality control review performed by a licensed auditor. In some instances this may be a licensed auditor that is not a partner in the audit firm.
FMA	Financial Markets Authority
ISA (NZ)	International Standard on Auditing (New Zealand)
NZICA	New Zealand Institute of Chartered Accountants
PES	The Professional and Ethical Standards as issued by XRB under section 24 of the Financial Reporting Act 1993
Professional and Ethical Standards	PES 1, 2 and 3
Quality Review	Means a review of an audit firm as defined in the Auditor Regulation Act 2011
Review period	1 July 2012 to 30 June 2013
The Act	Auditor Regulation Act 2011

Appendix 2 – Market data 30 June 2013

Domestic licenced auditors	150
New licences issued to domestic auditors	18
Licences cancelled from domestic auditors	18
Domestic registered firms	40 (these include 13 registered firms that have separate firm registrations, but operate under two brand names)
Listed issuers	135
Total issuers	1,550 (approximately)
Firms reviewed	9
Audit files reviewed	33

FMA

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND