

December 2014

# Audit Quality Review Report

1 July 2013 – 30 June 2014

This report should be read by:  
Auditors  
Issuers  
Chartered accountants

# About the FMA

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The FMA is an independent Crown entity with a mandate to promote and facilitate the development of fair, efficient and transparent financial markets. We work with financial markets participants to raise standards of good conduct, ethics and integrity and to achieve best standards of practice and compliance.

**[www.fma.govt.nz](http://www.fma.govt.nz)**

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# About this report

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The *Auditor Regulation Act 2011* (the Act) requires the Financial Markets Authority (the FMA) to ensure that a quality review of the systems, policies and procedures of registered audit firms and licensed auditors, that perform issuer audits, is carried out at least once every four years. The Act also requires the FMA to prepare a report annually on the quality reviews that have been carried out in the preceding financial year.

To support this requirement, this report summarises the overall findings from quality reviews undertaken in the financial year 1 July 2013 to 30 June 2014 (the Review Period).

## Approach and methodology

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### Approach to regulation

The 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 our expectations, while providing market participants with scope to develop the way they meet these expectations.

We monitor market participants' compliance with the obligations imposed upon them. 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 increase over time, as regulatory regimes are embedded. Quality review of audit firms is just one of our monitoring activities.

### Quality review methodology

The purpose of quality reviews is to ensure 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.
- promoting reasonable care, diligence and skill in carrying out issuer audits.

The Act prescribes certain matters that must be included in a quality review and our review methodology is designed accordingly. Our primary focus is on the quality of issuer audits undertaken. There are two key elements: assessing the audit firm's overall quality control systems, and reviewing a selection of individual issuer audit engagement files.

### References

Full details of the quality review framework and the quality review approach are contained in Appendix 1 to this report. Appendix 2 contains a summary of market data relevant to this report. Capitalised and abbreviated terms are then defined in the glossary in Appendix 3.

# Executive summary

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Audits of issuers' financial statements are intended to enhance investor confidence, ensuring the statements comply with the required financial reporting standards and give a true and fair view of the financial position of the issuer. Audit firms fulfil an important role as front-line gatekeepers within the regulatory framework. They help to ensure that investors have access to credible and reliable financial information on which to base their investment decisions. Audit quality reviews of audit firms are a key component in ensuring that audits are performed on a consistent basis in accordance with the Auditing and Assurance Standards.

Our findings from audit quality reviews carried out in the Review Period were similar to those from previous reviews (published by the FMA in December 2013) and were also consistent with the findings of regulated auditor regimes in other countries.

While we did not see material improvements on previously reported issues, the majority of audit files reviewed in this period had financial reporting dates that fell prior to the publication of our first audit quality review report, meaning that audit firms had not had the opportunity to reflect on the comments in that report and make changes to their processes.

We expect improvement in audit quality will only be visible when audit firms have implemented any required changes resulting from individual quality reviews. Therefore, improvements in areas we have previously reported on will be visible in subsequent reviews of the same audit firms.

During the Review Period, we noticed that the audit quality review regime has had a positive impact on the overall attention to audit quality at a firm level. Where there was appropriate support from senior leadership regarding audit quality, we noticed a higher quality of audit performance.

Focus from senior management within audit firms is a key factor in quality. In order to fully comply with Auditing and Assurance Standards, most of the audit firms need to improve and enhance their audit quality systems.

We have started our first follow-up reviews to ensure that registered audit firms are taking appropriate actions where the audit quality at a firm level was considered unsatisfactory. We will report on the outcome of these reviews in the 2015 audit quality review report.

## Key findings

We found that the systems, policies and processes auditors have in place for independence and quality monitoring remain an area for improvement.

Other key areas where we require improvements to be made include:

- professional scepticism
- going concern statements
- use of management or audit experts
- the audit of revenue
- audit sampling
- analytical procedures
- overall level of audit evidence obtained to issue an audit opinion.

Our comments on these areas are detailed in the key findings section of this report.

## Our expectations

Firms should continue to increase their efforts to improve quality and consistency in performing issuer audits. Audit firms not subject to quality review during this period should consider the areas highlighted in this report in their ongoing monitoring of audit quality. We believe that multiple parties play a role in improving the quality of issuer audits. We encourage directors and audit committees to discuss their audit plans with auditors and to incorporate the key messages provided in this report.

# Key findings

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Key findings arising from quality reviews carried out during the Review Period are set out in this section, including findings on:

- monitoring of audit quality
- auditor independence
- professional scepticism
- going concern
- using the work of a management or auditor's expert
- insufficient audit evidence for revenue recognition
- analytical procedures
- audit sampling
- forming an opinion and reporting on financial statements
- other areas of improvement, including related parties and written representations.

We expect audit firms to consider these findings, as well as the prior year's findings, in order to improve overall audit quality. A number of our findings are similar to those of equivalent overseas regimes and will continue to be areas of focus for our team, as set out in the Auditor Regulation and Oversight Plan 2014–2017.

Findings in this section of the report reflect the audit firms reviewed during the period. The level of change required to improve audit quality may vary due to the significant differences between individual audit firms.

Each key finding contains a high level summary, followed by examples of non-compliance identified during our reviews. We have also included details on our expectations as to how these areas should be improved.

## Monitoring of audit quality

### Key insights

- Effectiveness of internal quality reviews of audit firms could be improved.
- The Engagement Quality Control Review (EQCR) should:
  - be documented on the audit file, to evidence compliance with the requirements
  - 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. Audit failure is an increasing reputational risk to audit firms. We believe it is important for audit firms to embed systems and processes that promote audit quality, and effectively monitor these systems and processes. During the Review Period we noted opportunities for many of the registered audit firms to improve in these areas. We consider that improvements could be achieved through the firm's leadership by:

- making audit quality a priority
- setting expectations
- providing adequate resources to support the audit practice.

We found that quality control procedures, and in particular monitoring of those procedures, could be improved to ensure the policies and processes within a quality control system are relevant, adequate, and operating effectively. We believe these systems can only be effective if reviews are performed within a risk-based framework, by staff with the appropriate knowledge and authority. In some firms, no review had been undertaken.



Where internal reviews had been performed, we saw instances where the review showed significantly more positive results than our review findings. Also audit files were not always selected on a risk basis. These differences bring into question the robustness of audit firms' internal review processes.

We also noted the effectiveness of the EQCR could be improved. In the audit files where we considered that significant improvements to audit quality were required, the EQCR did not always seem to have identified failure in documentation, or non-compliance with Auditing Standards.

In addition, the evidence within audit files needs to improve to demonstrate the scope of the EQCR that has been undertaken. This is a particular issue with files where there are significant technical issues, modifications to the audit opinion, or significant audit judgments requiring discussions between the engagement partner, the EQCR partner and the firm's technical specialists.

### Specific examples of non-compliance for the monitoring of audit quality

The following are some of the weaknesses that were identified through quality reviews. These areas affected the overall quality of audits performed.

- Audit firms did not have an up-to-date quality control manual that included all requirements of the most recent Auditing and Assurance Standards.
- Some of the smaller audit firms did not have a monitoring process in place to ensure the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. In some of the larger audit firms, not all offices were subject to the quality review process.
- The policies and procedures relating to the rotation of the key audit partner, EQCR partner and other key staff, could be improved. Examples of findings included breaches of a firm's own independence policies, or exceeding the rotation period without documenting any mitigation of familiarity threats.
- The outcome of internal quality reviews were not always communicated to all engagement partners, EQCR partners and other appropriate personnel.
- Where firms operate within a network with common monitoring policies and procedures relating to the quality control systems, the network had not:
  - communicated the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms, at least annually
  - identified deficiencies in the system of quality control to appropriate individuals within the network, or firms, so that the necessary action could be taken.
- The EQCR was not always documented. Our quality reviews raised a number of issues which we would expect to have been addressed by the EQCR. Further, there was little documentation on the files to indicate what the EQCR partner considered to be significant audit judgments.
- Policies and procedures setting out the nature, timing and extent of an EQCR were not always clearly documented, resulting in inconsistencies in the way EQCRs were performed within the same firm.
- There were instances where audit file sign-off by the EQCR partner did not occur before issuance of the audit opinion. Accordingly, we were not able to identify if the EQCR had been performed on a timely basis, before the audit opinion was issued.
- There were instances where acceptance and continuance procedures were not documented on the audit file, were not performed on a timely basis, or failed to take into account all issues identified during the prior year's audit.
- Firms' internal consultation procedures were not always effective, and were not always evidenced on the audit file.
- Audit firms failed to identify the audited entity as an issuer and therefore did not comply with the requirements of the Act specific to issuer audits.

## Our expectations

We require firms to have quality control manuals that comply with the most recent Audit and Assurance Standards. Manuals should be updated on a timely basis when new or revised standards, or new legislation concerning audit quality, come into effect. Audit firms should also establish processes to test the effectiveness of the systems and procedures set out in these manuals.

The internal quality reviews performed by an international or national network can only be effective if those reviews are performed under a risk-based framework and cover issuer audits from across the New Zealand firms that are part of the network. We recommend discussing issues identified from quality reviews (both internal and external) with all audit staff, including licensed auditors and EQCR partners, to promote audit quality and share common findings.

Where applicable, firms should also discuss the findings from a quality review by the FMA with their international network. We recommend that audit firms obtain international reports (including network-specific reports where applicable) from other audit regulators, as they may provide useful information on issues being identified globally, that can be used to improve audit quality within the firm.

The EQCR partner can play an important role in improving audit quality and EQCR partners are required to be appointed to all issuer clients. We recommend that audit firms:

- issue proper guidelines for EQCRs that meet the prescribed minimum standard<sup>1</sup>
- provide training to all licensed auditors acting as EQCR partners
- emphasise clear documentation of the EQCR.

Audit firms should improve communication to directors and audit committees of issuers regarding key aspects of the audit. Audit committees or directors should ensure they have discussed with their auditors:

- the auditor's views about significant qualitative aspects of the entity's accounting practices, including

accounting policies, accounting estimates and financial statement disclosures

- significant difficulties, if any, encountered during the audit
- other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

Audit committees or directors may also wish to ask an audit firm whether it has been quality reviewed by the FMA, and if so, what lessons were learned by the firm from the review and what actions the firm has taken to address any issues identified. We also encourage audit firms to share findings from our quality reviews with their issuer audit clients as part of their audit planning.

## Auditor independence

### Key insights

- **Audit firms need to improve documentation regarding independence threats.**
- **Independence requirements and documentation should be reviewed in detail by the EQCR partner.**
- **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 to independence, the application of appropriate safeguards, and the proper reporting of these to audit committees or directors, are critical in ensuring the auditor's independence is maintained. The majority of audit firms have systems, policies and processes in place to monitor their independence. However, although a firm's systems, policies and processes may be adequate to meet the requirements of the Professional and Ethical Standards (PESs), we found a large number of instances of non-compliance with the PESs when reviewing individual audit files. This could undermine the confirmed independence and objectivity of an auditor as stated in the auditor's opinion.

<sup>1</sup> The Auditor Regulation Act (Prescribed Minimum Standards and Conditions for Licensed Auditors and Registered Audit Firms) Notice 2012 paragraph 8 (1) (f)



We are concerned by the high level of non-audit services being provided by audit firms, and the absence of separate systems or evidence on the audit files in relation to the firm's independence regarding these services. In most instances we were unable to determine whether the impact of non-audit services on the firm's independence had been considered, or if the firm had followed its internal policies to satisfy itself that the requirements had been met. Without an appropriate description of the non-audit services provided, an assessment of self-review threats and how those threats had been mitigated, independence rules may have been breached.

### Specific examples of non-compliance for the review of audit independence

Examples of specific issues identified during quality reviews are detailed below.

- We found examples of audit firms preparing or formatting financial statements on behalf of the issuer, resulting in self-review threat that could not be mitigated by appropriate safeguards.
- A lack of evidence on the audit files was identified. Evidence should include that all non-audit services had been communicated to those charged with governance of the issuer, and total fees charged for these services. Evidence would also include the threats identified by the audit firm, and how those threats had been mitigated.
- Insufficient review of the disclosure of audit fees and non-audit fees in the financial statements of the issuer was identified as an issue. For example, in seven of the 56 audit files reviewed, the audit fee for auditing the financial statements was not disclosed.
- We found examples of audit firms not obtaining written confirmations from all firm personnel required to be independent by relevant ethical requirements. We found that firms could improve their processes to ensure that confirmations are accurate and complete.
- Where an audit firm had used another audit firm to perform its EQCR, there was no evidence that an

independence confirmation had been obtained from the other firm and licensed auditor.

- In some cases the acceptance procedures for new clients did not include network or office circulations to identify any possible independence threats.

### Our expectations

In relation to auditor independence, we expect audit firms to improve in:

- documentation of annual independence confirmations from staff and licensed audit partners
- the firm's internal review of compliance with its independence policies
- documentation on audit files of independence threats, mitigating safeguards, and the audit work performed to ensure that the mitigation was effective
- review of the disclosure of audit fees and non-audit fees<sup>2</sup> in the financial statements, and reconciliation of this disclosure with the fees charged for each service
- communication of independence, including threats identified and safeguards applied, to those charged with governance of issuers, especially in relation to non-audit services
- review by the EQCR partner of all independence requirements, to ensure that all appropriate audit evidence is documented on the audit files.

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

Audit firms should review the adequacy of their independence procedures, and provide ongoing training to all staff in order to achieve improvement in the overall compliance with the relevant PES.

<sup>2</sup> The FMA has issued a report regarding the disclosure of fees paid to auditors, which includes guidance on best practice regarding audit fee disclosure. This report can be found in the 'Reports' section of our website at [www.fma.govt.nz](http://www.fma.govt.nz).

## Professional scepticism

### Key insights

- Audit firms must reinforce the importance of exercising professional scepticism and should provide appropriate training to all audit staff.
- Directors and audit committees should encourage a sceptical approach by 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.”

Many issuers continue to face difficult economic conditions that give rise to 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 affected by the following factors:

- long standing relationships between auditors and issuers, resulting 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
- continuing downward pressure on audit fees.

### Specific examples of non-compliance in professional scepticism

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

- accepting clients’ changes in accounting treatments without documenting the auditor’s consideration of the merits of the treatment, possible alternative treatments, and the extent to which the proposed treatment complied with International Financial Reporting Standards

- auditors seeking audit evidence to corroborate estimates and accounting treatments rather than appropriately challenging them and considering alternatives
- accepting management confirmations relating to going concern assessment without performing an independent assessment of the assumptions made by management
- auditors continuing to place reliance on management confirmations where issues have been identified with management’s integrity
- a lack of 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
- not considering fraud risk (including financial reporting fraud) in instances of dominant management and directors, or other indications of potential fraud
- accepting unrealistic budgets from management without the appropriate audit evidence to support going concern assumptions and not considering the fact that historical forecasts have not been met
- accepting confirmation from directors in their directors’ representation letter that they have been compliant with all laws and regulations, when they have been shown to be non-compliant with the *Financial Reporting Act 1993*
- not considering buildings significantly damaged by the Christchurch earthquake for impairment, and holding valuations at pre-earthquake fair values without considering the impact on the audit opinion
- placing undue reliance on IT-generated reports without appropriate testing
- accepting third party confirmation through the issuer instead of obtaining it directly from the third party.

## Our expectations

Audit firms should emphasise the importance of professional scepticism in audit work performed, and provide sufficient ongoing training for audit staff to improve professional scepticism. Further, 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 of issuers 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.

## Going concern

### Key insights

- **Financial statements disclosure must meet the requirements of ISA (NZ) 570.**
- **Auditors should clearly document their consideration regarding the audit opinion.**

In recent years there has been a significant increase in audit reports that contain an emphasis of matter paragraph regarding going concern. During the Review Period we selected 11 audit files for review where an emphasis of matter paragraph was issued in respect of going concern.

The disclosure of going concern in the financial statements, and the audit work required to obtain sufficient audit evidence regarding the assumptions made by directors or management of the issuer, can be challenging. Compliance with ISA (NZ) 570 requires detailed and timely communication between management, directors and auditors regarding the requirements of this Audit Standard, especially when the auditor expects to issue a modification to the audit opinion, or to include an emphasis of matter paragraph.

Our reviews noted that auditors had not always obtained sufficient audit evidence to demonstrate their consideration of the appropriateness of the going concern assumption. In the files we reviewed, the use of incorrect wording in the audit opinion, insufficient disclosure in the financial statements, and insufficient or inappropriate audit evidence, resulted in 10 instances where we considered that the emphasis of matter opinion was inappropriate. This was based upon our review of the financial statements, audit opinion and audit file.

## Specific examples of non-compliance with going concern

When reviewing the issuer audit files we noted the following areas of non-compliance.

- In three instances, the emphasis of matter paragraph did not include the required wording that the audit report was not qualified in respect of the matter. The absence of the required wording creates the potential for the user of the financial statements to misunderstand this paragraph.
- The audit files either lacked audit evidence that the entity's going concern assumption was appropriate, or the auditor had not performed any work to establish whether the entity's assumptions such as budgets and cash flow forecasts (including key assumptions) were reasonable and appropriate.
- Disclosures in financial statements contradicted the going concern assumption. For example, auditors accepted the going concern assumption for entities that had stated in their financial statements an intention to cease their main business activities or to wind up the business.
- Those charged with governance did not provide forecasts for the 12 month period from the date of the auditor's report. In addition the auditor did not require the issuer to extend its forecast, or the auditor did not consider the impact of the lack of forecasts on the audit opinion.

- In instances where auditors identified a material uncertainty, the financial statements did not meet the following mandatory disclosures<sup>3</sup>:
  - the principal events or conditions that may cast doubt on the entity's ability to continue as a going concern
  - management's plans for dealing with these events or conditions
  - there is a material uncertainty relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern
  - the entity may be unable to realise its assets and discharge its liabilities in the normal course of business.
- There was no evidence on the audit file that the auditor had communicated with those charged with governance, including:
  - whether the events or conditions constituted a material uncertainty
  - whether the use of the going concern assumption was appropriate in the preparation and presentation of the financial statements
  - the adequacy of related disclosures in the financial statements.

## Our expectations

We expect to see significant improvement in relation to the work performed on the going concern assumption, especially in instances where there is a material uncertainty.

We recommend that audit firms should emphasise the following aspects when performing their work regarding going concern.

- Timely communication with the audit committee or directors and management of the issuer, should be a main focus particularly where the auditor believes that a material uncertainty regarding going concern exists. Further, the auditor should provide specific guidance regarding the required disclosure in the financial statements, as management or those charged with governance may not be familiar with the requirements of ISA (NZ) 570.
- Audit firms should request the appropriate audit evidence from those charged with governance and management regarding management assumptions.
- The audit committee or directors should be provided with the required communication.
- The type of audit opinion that should be issued, based on the audit evidence obtained and the disclosures provided by the issuer in the financial statements, should be documented clearly.

Directors and audit committees have an important role in ensuring the appropriate disclosure of the going concern assumption in financial statements. Directors and audit committees should:

- familiarise themselves with the requirements of ISA (NZ) 570 in relation to the going concern assumption in the financial statements, as this standard places additional requirements on going concern disclosure in the financial statements
- ensure that appropriate audit evidence is provided to the auditor regarding management's assumptions on the going concern assumption in the financial statements.

On 30 June 2014 we issued a report on the disclosures of going concern assumptions in financial statements<sup>4</sup>. We recommend that both auditors and directors take note of this report.

<sup>3</sup> Paragraph 18 of ISA (NZ) 570

<sup>4</sup> A copy of the FMA report can be found in the 'Reports' section of our website at [www.fma.govt.nz](http://www.fma.govt.nz)

## Using the work of a management or auditor's expert

### Key insights

- Auditors should assess the relevance and reasonableness of assumptions and methods used by experts.
- Auditors should assess relevance, completeness, and accuracy of the source data.

Issuers frequently place reliance on management experts to determine significant amounts in the financial statements. For example, experts are often used in estimating property valuations, resource revaluations, biological assets and valuations of business combinations.

Auditors may need to use their own specialist to obtain sufficient appropriate audit evidence for significant accounting balances in the financial statements, where the auditor does not have sufficient knowledge or expertise. Auditors must also assess the reliability of the underlying source data provided to the expert, and ensure that data is consistent with the auditor's understanding of the business.

### Specific examples of non-compliance in using the work of a management or auditor's expert

We noted that, in the majority of instances, firms failed to assess the competence, capabilities, objectivity and understanding of the methodology used by the expert to develop estimates and valuations. We also identified instances where audit firms failed to:

- evaluate the adequacy and reliability of the work of experts engaged by the issuer
- appropriately review the work and reports of experts
- assess the completeness and accuracy of the data used by experts

- use their own experts where members of the audit team did not have sufficient knowledge, skill and experience
- apply professional scepticism in reviewing the work of experts.

### Our expectations

We expect to see improvement in the use of the work of management or auditor's experts. The main areas for improvement identified relate to the evaluation of the adequacy of the expert's work. We therefore require auditors to pay specific attention to:

- the relevance and reasonableness of the expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements
- if the expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods
- if the expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Guidance regarding procedures that should be considered is provided in paragraphs A32 to A39 of ISA (NZ) 620 in relation to an auditor's expert, and paragraphs A34 to A48 of ISA (NZ) 500 in relation to a management expert.

The auditor should engage their own expert to assess the relevance and reasonableness of the key assumptions, in instances where issuers have material balances that require significant industry expertise (for example, the exploration of mineral resources or actuarial calculations). In situations where a valuation, such as a valuation of a property portfolio, is of fundamental significance to the financial statements, we would expect to see the auditor engage an appropriately qualified in-house or external expert. The expert would evaluate the relevance and reasonableness of assumptions underlying the valuation.

## Insufficient audit evidence for revenue recognition

### Key insights

- Audit firms should improve documentation regarding the audit comfort obtained on an assertion level.
- Audit firms should critically assess the audit procedures to ensure they are performed in accordance with the standard and provide the intended audit comfort.

In the majority of audit files, where revenue recognition was a key risk, we found the auditor did not perform adequate or sufficient procedures to gain sufficient and appropriate audit evidence about the accuracy and completeness of revenue for the reporting period.

### Specific examples of non-compliance for insufficient audit evidence for revenue recognition

We noted the following issues which had a negative impact on the level of audit comfort obtained from the audit procedures. These issues resulted in insufficient audit evidence.

- The audit approach placed reliance on the operating effectiveness of controls, but without the audit firm testing the effectiveness of these controls.
- Reliance by audit firms on substantive analytical procedures were not performed in accordance with the relevant Auditing Standard.
- Very low sample sizes were used in areas of key risk without obtaining any other audit comfort, such as tests of controls.
- Audit firms were using judgmental sample sizes, especially in areas like cut-off testing or completeness testing, without either providing the statistically-based calculations or documenting the professional judgment applied. For example, how the audit sample was sufficient to reduce the sample risk to an acceptably low level.
- Auditors were rebutting fraud in revenue recognition where the fraud section of the audit file identified fraud risk, or where the auditor did not take into account other risks such as management override.
- Auditors were not performing detailed procedures to cover all assertions regarding revenue recognition, particularly in instances where the risk of fraud in revenue recognition was not rebutted.
- The use of IT-generated reports, such as sales reports for detailed reporting, were used without establishing the reliability of those reports and without performing any general IT controls. We noted that tests for completeness were in most instances only based on recorded sales after year end. However, no tests were performed to establish if there were any unrecorded sales, or how the auditor determined those sales reports were complete.
- Sample sizes for detailed testing were often dependent on the level of audit comfort obtained from other procedures, such as analytical procedures and test of controls. We noted the following instances where we believed the sample sizes were too low:
  - analytical procedures performed did not comply with the standard and therefore did not provide the required audit evidence to reduce the sample size
  - controls tested only related to high level entity controls such as the review of board reports, and did not provide comfort in relation to assertions addressed by the test of details.
- In some instances the auditor identified tests of controls that were in fact tests of details, and therefore the incorrect sample sizes were used.

### Our expectations

Audit firms should emphasise the importance of the audit work performed in key risk areas such as revenue recognition. In order to obtain sufficient and appropriate audit evidence regarding revenue recognition, we recommend that firms undertake the following activities.



- Audit firms should clearly document the key risks identified in revenue recognition, and link this to the audit comfort obtained from the test of controls and test of details on an assertion level.
- Audit firms should document sample sizes and perform sample selections in accordance with ISA (NZ) 530.
- If reliance is placed on IT-generated reports, the firm should perform sufficient procedures to obtain reliance over these reports.
- If reliance is placed on internal controls, sufficient audit evidence should be obtained on the effectiveness of those controls.
- Analytical procedures should be performed in accordance with ISA (NZ) 520.
- Where the auditor concludes that the presumption of fraud in revenue recognition is not appropriate, the auditor must document the reasons for this decision.

## Analytical procedures

### Key insights

- Auditors should test the reliability of reports and data used in substantive analytical procedures.
- Analytics alone do not provide sufficient audit evidence in significant risk areas.

In many of the files reviewed, analytical procedures were used to obtain detailed audit evidence in revenue recognition and in other key risk areas. Analytical procedures are an important part of the audit process and can range from simple comparisons to the use of complex models involving many relationships and elements of data. We noted a large number of weaknesses in how analytical procedures were conducted, meaning that the procedures did not then provide the required audit comfort.

Paragraph 5 of ISA (NZ) 520, as set out below, provides a detailed four step model that auditors should follow to be able to obtain appropriate audit evidence from a substantive analytical procedure:

*When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with ISA (NZ) 330, the auditor shall (paragraph A4-A5):*

- determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions (paragraph A6-A11)*
- evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation (paragraph A12-A14)*
- develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated (paragraph A15)*
- determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7 (Paragraph A16).*

### Specific examples of non-compliance for analytical procedures

We noted the following issues with analytical procedures used.

- It was unclear from the audit programme what audit comfort was intended to be obtained from the analytical procedures in combination with other substantive procedures, and what comfort was to be obtained from controls testing on an assertion level.
- The four step model (as described in this section) was not used.
- Thresholds were used that exceeded the overall materiality by up to five times. In instances where financial information was significantly disaggregated, the threshold remained consistent with the overall performance materiality. We believe that in these examples the expectation was not 'sufficiently precise' to detect a material misstatement.

- Often analytical procedures were performed in comparison with previous years, and the auditor was trying to explain why there was a difference rather than setting an independent expectation. When expectations were set, the auditor did not take into account all factors that could have an impact on the change in revenue.
- Where differences were noted between the recorded amounts and expected values above the threshold, no further audit evidence was obtained. In other instances the audit evidence obtained was based on a discussion with management, without obtaining appropriate audit evidence to support management responses.
- Auditors used IT-generated reports, such as sales reports, volume reports, average price reports and product mix or export reports, for analytical procedures without establishing the reliability of these reports.
- We also noted instances where the auditor tested one to three items of a report for accuracy without performing any IT-general controls, or without establishing if the data in the report was complete.

### Our expectations

We expect that when audit teams consider relying on substantive analytics as a test of detail, the four step model as required by ISA (NZ) 520 will be properly documented and the required audit procedures for each of the steps performed. When performing analytical procedures, the auditor should ensure that:

- there are appropriate relationships between the data used and the balance tested
- source data is adequately tested
- suitable thresholds are developed
- explanations for variances are obtained and corroborated with appropriate audit evidence
- in key areas of risk, substantive analytics should also be supported by other tests of details.

## Audit sampling

### Key insights

- Sample size should be set at an appropriate level in order to reduce sampling risk to an acceptable level.
- Auditors should test the reliability of IT-generated reports used to select samples.
- Expectations should be followed up as required by the standard.

The appropriate use of audit sampling in performing audit procedures is important to determine if sufficient audit evidence is obtained. The selection of sample varies depending on a large number of assumptions, such as:

- size of the population, both in value and in number of transactions
- type of test that is performed, such as test of controls or test of details
- the audit firm's methodology that determines sample sizes
- level of comfort the auditor intends to achieve with the test
- other audit procedures performed that complement the test.

### Specific examples of non-compliance for audit sampling

When we reviewed auditors' use of statistical and non-statistical sampling when designing and selecting audit samples, performing tests of controls and tests of details, and evaluating the results from the sample, we noted a large number of issues in applying ISA (NZ) 530 – Audit Sampling.

- The documentation of the audit sample did not provide details of whether the test was a statistical sample, a target test or a judgmental sample.
- Tests of details were conducted applying the sample

size formula for a controls test. In such cases the audit team may not have applied the correct sample size under the firm's methodology.

- We did not see evidence that audit teams had considered sampling risk in setting sample sizes, or whether the sample size should have been set higher than the minimum permitted level in order to reduce sampling risk to an acceptable level.
- Audit firms did not follow their own guidance regarding sample sizes or use of the tools provided within the firm's audit software.
- Where the firm's methodology did not provide guidance on sample sizes, the auditor used mainly professional judgment to select the sample size. In such cases, the audit team did not document the basis for determining the sample size and how the audit team ensured the sample was representative of the population. This was evident in areas such as cut-off testing or testing the reliability of IT-generated reports.
- In some cases the audit team appeared to incorrectly identify the frequency of a control, resulting in a lower sample size than the firm's methodology should determine.
- The documentation for the selection of sample sizes for statistical sampling did not show how the sample was designed or which items were selected for testing. In other instances the selection was based on the highest values. In these cases, not every sampling unit had a possibility of being selected and therefore did not comply with ISA (NZ) 530.
- Sample sizes in many instances are impacted by the level of other audit evidence obtained, such as a test of controls or substantive analytics. We noted instances where the test of controls did not address the assertions, and substantive analytics were not performed in accordance with the auditing standards. As a result, the sample sizes selected were too low.

- Where exceptions were found in sample tests, in many instances they were explained away without any further enquiry. The auditor did not project errors to the total population, or in instances of control testing errors, did not seem to consider the appropriateness of placing reliance on the effectiveness of these controls.

### Our expectations

We recommend audit firms emphasise the requirements of ISA (NZ) 530. While an audit firm's methodology may be fully compliant with the Auditing Standards, the main issue we noted during quality reviews was the application of the firm's methodology. Sample selections and sizes may significantly differ by applying auditor's judgment. It is therefore important that all factors influencing audit sampling are clearly documented.

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
- why the audit team is comfortable regarding the untested balances
- the test reduces the sample risk to an acceptably low level.

Where exceptions are found in sample tests, auditors should investigate the nature and cause of the exceptions and evaluate their possible effect on the purpose of the audit procedure and other areas of the audit. Exceptions should only be treated as an anomaly in rare circumstances where the auditor has been able to obtain a high degree of certainty that the exceptions are not representative of the population. Additional audit procedures should be performed to support such a conclusion (refer to paragraphs 12 and 13 of ISA (NZ) 530). Where exceptions are found in a test of details the auditor should always make a projection of the misstatements to the population.

## Forming an opinion and reporting on financial statements

### Key insights

- Auditors should ensure that sufficient and appropriate evidence is obtained to issue an audit opinion.
- Internal review and consultation processes could be improved.

Issuing an appropriate audit opinion, based on sufficient and appropriate evidence, is the foundation of a quality audit. In a significant number of audit files, we found that it was unclear how the auditor had become satisfied that appropriate audit evidence had been obtained to issue the audit opinion. We also noted a large number of audit opinions where it was unclear which judgments had been made by the engagement partner and EQCR partner to provide the audit opinion included in the financial statements.

### Specific examples of non-compliance in forming an opinion and reporting on financial statements

The following are some examples of issues identified during quality reviews in relation to the audit opinion.

- Issues were identified in instances where auditors were unable to obtain sufficient and appropriate audit evidence in respect of the valuation of primary forestry assets in a forestry scheme, or fair value of the investment property in a property syndicate, as a result of directors who were unwilling to comply with the appropriate Accounting Standards. In all files reviewed, the auditor issued a qualified audit opinion. However, no evidence was provided to demonstrate that the auditor had considered whether it was possible to perform alternative procedures to obtain sufficient audit evidence, or, in the absence of sufficient appropriate evidence, if an adverse or disclaimer audit opinion would have been more appropriate.
- Insufficient audit evidence was obtained regarding the going concern assumptions made by directors and/or management.
- In instances where the auditor was intending to issue a qualified audit opinion, or an audit opinion including an emphasis of matter or other matter paragraph, we did not find evidence that the auditor had communicated those intentions to those charged with governance of the issuer. Further, where a qualified audit opinion was issued, in some cases we did not see evidence that the auditor had provided the opportunity to those charged with governance to provide further information and explanation about the information that gave rise to the expected modifications.
- In a large number of audit files, the audit approach, identification of key risks and the level of audit evidence obtained on an assertion level were not clearly documented. In these instances it was not clear how either the engagement partner or the EQCR partner had satisfied themselves that sufficient and appropriate audit evidence had been obtained before issuing an audit opinion.
- Audit firms' internal processes could be improved to review the audit opinion before it is issued. We noted the following instances where mistakes were identified.
  - Emphasis of matter paragraphs did not include the required wording stating that the audit report was not qualified in respect of this matter.
  - Emphasis of matter paragraphs included more information than had been included in the financial statements.
  - The audit opinion did not include the word "independent" as required.
  - The date of the audit opinion in the annual report was incorrect.
  - The list of non-audit services provided by the auditor was incomplete.
  - Audit opinions on the audit files signed off by

engagement partners and the EQCR partner were different from the audit opinions included in the financial statements.

- Documentation of internal processes where audit opinions were reviewed by the firm's technical department could be improved. We noted instances where there was no evidence that the audit opinion had been reviewed, or whether the reviewer had considered all relevant evidence in relation to the nature of the audit opinion. Furthermore, processes were unclear about which instances would require consultation within the firm.

## Our expectations

We acknowledge that issuing an audit opinion can require a high level of professional judgment by the audit team. However, we are concerned that in a large number of instances, the relevant audit firm had failed to provide sufficient and appropriate evidence of how it had reached the conclusion that the appropriate audit opinion had been issued. We recommend that audit firms clearly document their audit processes, findings and considerations made in issuing audit opinions.

We also recommend that firms follow a consultation process in instances where they issue a modified opinion (including emphasis of matter opinions). The reviewer of these audit opinions should be provided with all audit evidence relevant to reaching the audit opinion, as well as a copy of the financial statements, to ensure that the independent reviewer has all information necessary to draw a conclusion.

We were also concerned to find a number of issuers that were unwilling to comply with key accounting principles and we consider this behaviour to be unacceptable. We recommend that audit firms should consider the following aspects when identifying significant non-compliance with Accounting Standards:

- whether the issuer meets the pre-conditions of an audit
- the impact of significant non-compliance on the audit opinion.

## Other areas for improvement

### Key insights

- Audit evidence obtained regarding related party transactions is insufficient.
- Written representations should fully comply with the requirements of ISA (NZ) 580.

We continue to identify issues in relation to related parties and written representations.

### Related parties

ISA (NZ) 550 includes specific procedures 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.

### Written representations

Paragraph 10 of ISA (NZ) 580 requires the auditor to *“request those charged with governance to provide a written representation that they have fulfilled their responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.”*

We noted that a number of directors' representation letters did not confirm the requirements of paragraph 10 of ISA (NZ) 580.

### Our expectations

#### Related parties

The deficiencies identified are of serious concern, especially in light of identified audit failures of finance companies in relation to related party transactions.

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

### Written representations

We recommend that audit firms review their standard templates on a regular basis to ensure they comply with the most recent requirements, especially where there have been changes in any applicable standards.

Audit committees and directors of issuers also have responsibilities regarding written representations and should familiarise themselves with the requirements of this standard. We also note that ISA (NZ) 580 has specific New Zealand requirements that are different from those in other jurisdictions that apply the International Standards of Auditing.



## Future focus

We 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 previous quality reviews.

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

Each year we will aim to review licensed auditors and registered audit firms that represent approximately 33 percent of the issuer audit population. We will select audit files based on the following criteria:

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

We will complete our first cycle of three yearly quality reviews by 30 June 2015. Our areas of focus for 2014/2015 are consistent with previous years, and are aligned with areas of focus for other overseas auditor regulators and our findings from quality reviews already performed.

The areas of focus for quality reviews for this period are set out in the following table.

| Area   | Standard                    |
|--|-----------------------------|
| Audit quality control system and supervision | PES 3 & ISA (NZ) 220        |
| Auditor independence                         | PES 1                       |
| Audit documentation and evidence             | ISA (NZ) 230 & ISA (NZ) 500 |
| Professional scepticism                      | ISA (NZ) 200                |

| Area   | Standard                    |
|--|-----------------------------|
| 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                |
| Use of a management or auditor's expert  | ISA (NZ) 500 & ISA (NZ) 620 |
| 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.

We will review compliance with auditor independence requirements.

- We will review compliance with the auditor rotation requirements, including the requirement to rotate the EQCR.
- We will review compliance with independence requirements regarding the provision of non-audit services. We will focus on how providing these services is approved within the firm, documentation of the assessments of threats and mitigation of these threats by the firm, reporting to those charged with governance of the issuer, and documentation requirements in the financial statements and audit opinions.
- The investigation of a change of audit firm by an issuer and the reasons for a change, such as lower audit fees or acceptance of specific accounting treatments by the new auditor, will also be reviewed.

## Audit evidence and documentation

We will review whether licensed auditors have obtained appropriate audit evidence to determine that issuer financial statements are free of material misstatements. We will also review whether sufficient audit evidence has been obtained to support the audit opinion. Our focus on audit documentation will cover:

- the auditor's work performed on going concern, especially the work regarding the reasonableness of management's assessment of the entity's ability to continue as a going concern
- the completeness and accuracy of the related party transactions
- subsequent event procedures up until the date of the audit opinion
- revenue recognition, especially in relation to the fraud assumption and management override
- the use of sample sizes, especially where the audit approach is mainly based on substantive audit procedures
- the reliance on analytical procedures
- key risk areas specific to the individual issuer.

## Professional scepticism

We expect an appropriate level of professional scepticism to be maintained during an audit. Engagement partners, EQCR partners and staff should maintain questioning minds, 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

We expect an adequate understanding by the auditor of the business model of the issuer. This should be reflected in the auditor's risk assessment and the auditor's interaction with the audit committee, to ensure that key areas of risk are included in the audit strategy and have been properly addressed using 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.

## Use of an auditor's expert

Where financial reports include complex matters, or matters requiring specialist skills or knowledge, for example valuations of assets, audited entities may obtain advice from external or internal experts. We expect an auditor relying on the work of other auditors and experts to assess their competence and objectivity, and evaluate the appropriateness of the work performed by them. Where the auditor or firm doesn't have this expertise, we expect the auditor to engage their own independent expert to assess the appropriateness of the work performed.

## Audit fees and audit performance

We will focus on whether there have been fee reductions on past years' fees, or whether the audit fee is otherwise low and doesn't appear to reflect the complexity of the current business of the entity and therefore the audit required.

# Appendix 1 – Quality review framework

Under the Act, 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 subject to a quality review at least once in every four-year period. In order to remain internationally aligned, we endeavour to keep our review cycle consistent with the European Union, which currently has a three year cycle.

The New Zealand Institute of Chartered Accountants (NZICA) conducts the quality reviews on behalf of the FMA, as a delegate of the FMA under the Act. These quality reviews are carried out in accordance with our approved methodology, and the firms and licensed auditors are selected for review in accordance with a programme and schedule approved by us. The timing and frequency of reviews and selection of audit files are determined using a risk-based framework and will therefore differ between audit firms.

During the Review Period, 17 registered audit firms were reviewed, covering 44 percent of the domestic licensed auditor population and approximately 35 percent of the issuer audit population. Please note that statistics for 2012/2013 reflect a truncated February 2013 to June 2013 Review Period.

The table below provides an overview of the selected firms.

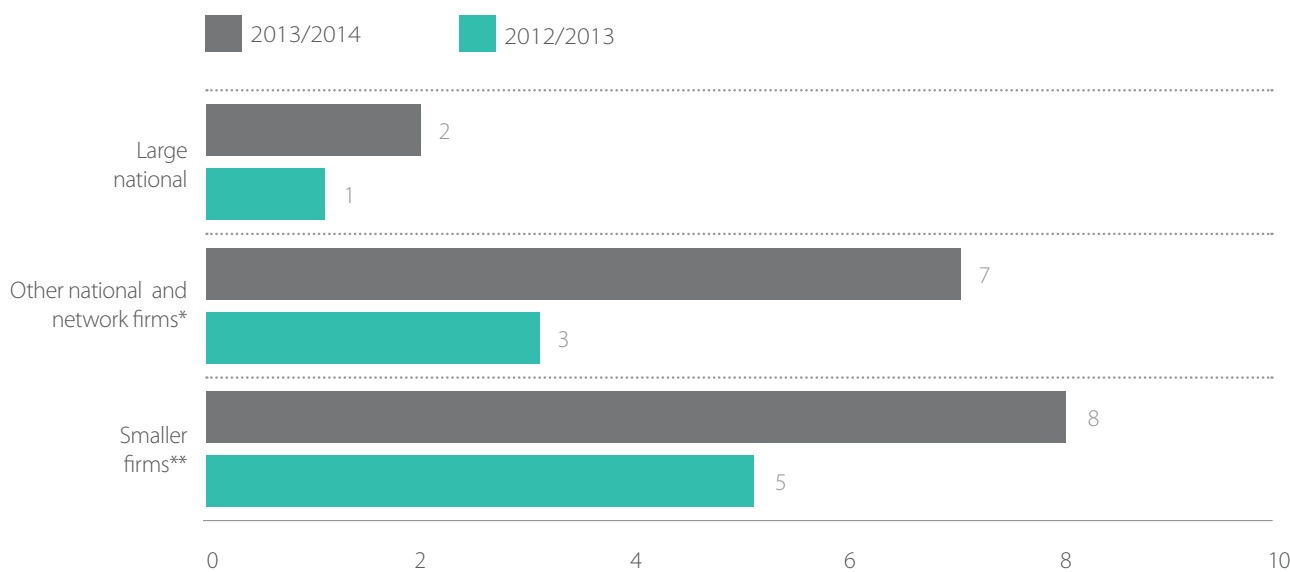
## Quality review methodology

The purpose of quality reviews is 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
  - Auditing and Assurance Standards
- otherwise promoting reasonable care, diligence and skill in carrying out issuer audits.

The Act prescribes certain matters that must be included in a quality review and our review methodology is designed accordingly. Our primary focus is on the quality of issuer audits undertaken. There are two key elements:

- assessing the audit firm's overall quality control systems
- reviewing a selection of individual issuer audit engagement files.



\* 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 auditors

Quality reviews during the Review Period focused on the key areas set out in our Auditor Regulation and Oversight Plan 2014–2017<sup>5</sup> and are summarised in appendix 1.

### Quality control systems

Auditors and audit firms must comply with a number of different sets of governing standards in their work, including standards that set out requirements for the quality control of audit engagements. These requirements include that audit firms must establish and maintain a system for quality control, which must include policies and procedures to address particular matters. For example, acceptance and continuance of client relationships, ethical requirements, and monitoring of the quality control system.

Assessment of an audit firm's quality control system is focused on whether the system is compliant with the relevant standards, whether the policies and procedures within the system are being adhered to, and whether the system is contributing to high quality issuer audits.

Another important aspect of quality control is the requirement to perform an Engagement Quality Control Review (EQCR) on each issuer audit file. The EQCR is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team has made and the conclusions it has reached in formulating the auditor's report. The EQCR has to be performed by a licensed auditor who is suitably qualified, with sufficient and appropriate experience and authority to give the objective evaluation required.

### Individual file reviews

Individual file reviews are carried out in order to assess compliance by the licensed auditor with Auditing and Assurance Standards, and whether the licensed auditor has exercised reasonable care, diligence and skill in carrying out issuer audits. We consider a quality audit should include, at a minimum:

- the performance of an independent audit by a licensed auditor
- the application of an appropriate level of professional scepticism
- the issuance of an audit opinion that can be relied upon, because sufficient and appropriate audit evidence has been obtained and the Auditing and Assurance Standards have been followed.

Our selection of individual issuer audit engagement files for review is based on the level of risk that the issuer may pose to investors, and the level of public interest in the issuer. It also takes into account the audit firm's policies and procedures regarding audit quality. During the Review Period, the selection of audit files 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
- 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.

We also tried to ensure that audits carried out by different licensed auditors within a registered firm were subject to review.

We rate the quality of the audit work we examine on individual issuer audits on three levels:

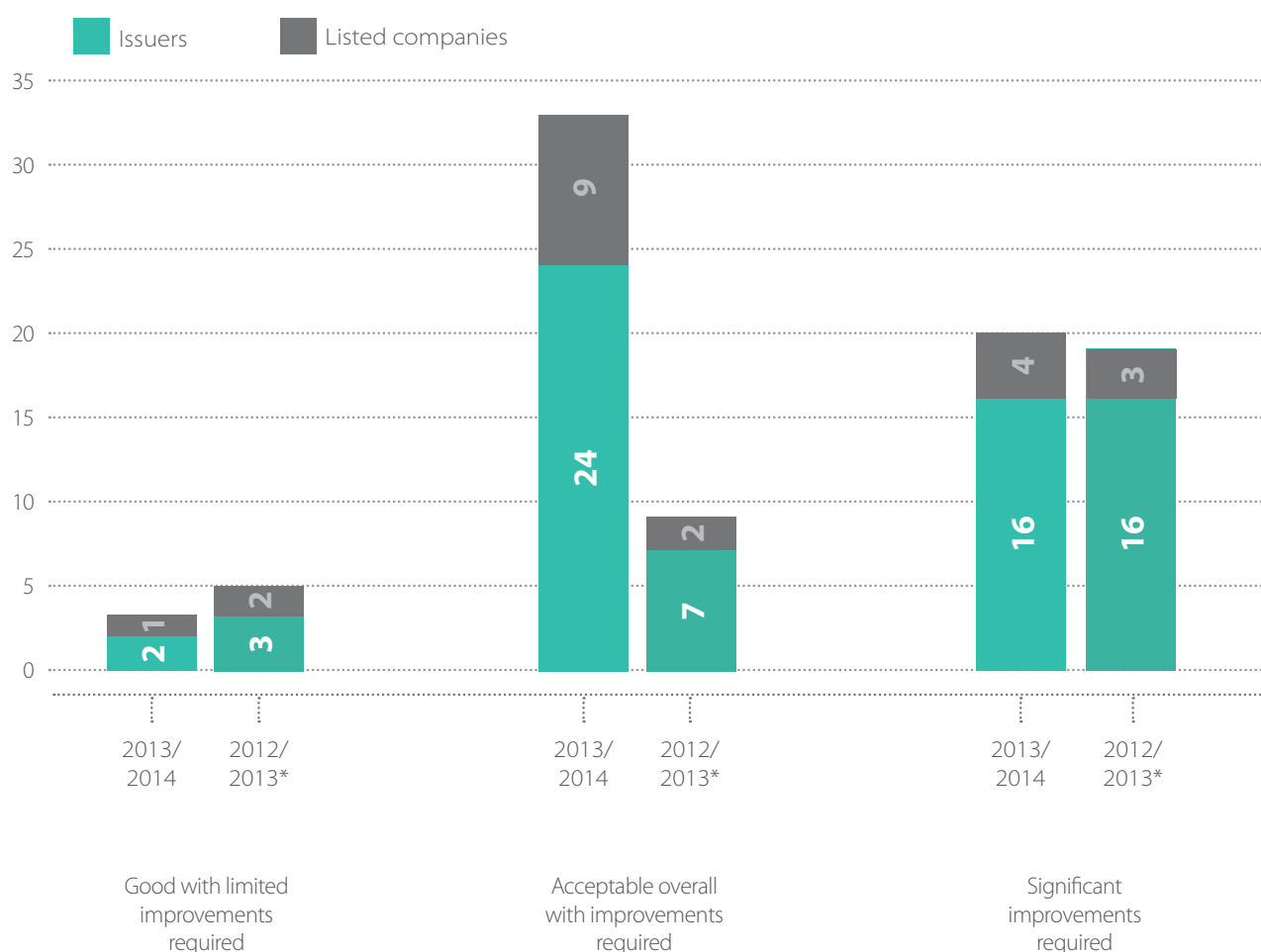
- good, or good with limited improvements required
- acceptable overall with improvements required
- significant improvements required.

<sup>5</sup> A copy of this plan is available in the 'Reports' section of the FMA website at [www.fma.govt.nz](http://www.fma.govt.nz)

An audit is classified as requiring significant improvements if:

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

The following table provides an overview of the ratings given to the individual issuer audit files inspected during the Review Period, compared to the ratings from the 2012–2013 year. Please note that statistics for 2012/2013 reflect a truncated February 2013 to June 2013 Review Period.



\* 2012/2013 reflects a truncated review period of February 2013 to June 2013.

The individual audit files selected cover the following industries<sup>6</sup>.

|  | 2013/2014 | 2012/2013 |
|--|-----------|-----------|
| Agriculture and fishing                      | 9         | 4         |
| Accommodation and food services              | 4         | –         |
| Arts and recreation services                 | 2         | –         |
| Construction                                 | 1         | –         |
| Electricity, gas, water and waste services   | 1         | 1         |
| Financial and insurance services             | 18        | 6         |
| Health care and social assistance            | 1         | 1         |
| Information media and telecommunications     | –         | 2         |
| KiwiSaver schemes and superannuation schemes | 5         | 2         |
| Manufacturing                                | –         | 2         |
| Mining                                       | 2         | –         |
| Other services                               | 2         | 2         |
| Rental, hiring and real estate services      | 8         | 3         |
| Retail trade                                 | 1         | 2         |
| Retirement village operators                 | 2         | 7         |
| Transport, Postal and Warehousing            | –         | 1         |
| <b>Total files reviewed</b>                  | <b>56</b> | <b>33</b> |

The issuer audit files selected had reporting dates covering the period 31 March 2011 to 31 March 2014 (2012/2013: 31 March 2012 to 31 March 2013).

## Quality review feedback and reporting

Our quality reviews are subject to thorough internal quality control procedures. Quality reviews are carried out in accordance with an FMA-approved audit quality review manual, and a peer review is conducted on each audit file reviewed. The overall quality review report of an individual audit firm is also subject to peer review and assessment by an independent audit regulatory advisory group, before a final review is performed by staff at the FMA. This helps to ensure both a high quality of reporting and a consistent approach across all reviews.

Our assessment of the quality of individual audit engagements is based primarily on the evidence in the audit files provided to us. In cases where we find that the audit files do not contain the level of documentation and evidence required by the standards, the audit firm is given an opportunity to explain the deficiencies and give reasons why the relevant standards were not breached. These responses are considered before we issue our final quality review report to the audit firm.

Quality reviews focus on how particular audits were performed.

**While a compliant audit of issuer financial statements contributes to market confidence, it is important to emphasise that a non-compliant audit does not necessarily imply that the financial statements audited were in any way deficient, or that an inappropriate audit opinion was issued.**

The quality review process is not intended to assess whether all of the information audited was correctly reported.

## Cost of the regime

The Act requires that the registered audit firm pay the prescribed fees and charges to the FMA for quality reviews, as set in the Auditor Regulations. The Auditor Regulations provide that the FMA may recover the costs incurred during the reviews, which mainly relate to the outsourcing arrangement with NZICA.

<sup>6</sup> Industries are categorised based on the listing of descriptions by general industry classification category published by ACC



## Appendix 2 – Market data

|                            | As at 30 June 2014   | As at 30 June 2013  |
|----------------------------|--|---|
| Domestic licensed auditors | 141  | 150   |
| Domestic registered firms  | 30 (this includes 9 registered firms that have separate firm registrations, but operate under two brand names) | 40 (this includes 13 registered firms that have separate firm registrations, but operate under two brand names) |
| Listed issuers             | 147  | 135   |
| <b>Total issuers</b>       | <b>1,700</b>   | <b>1,550</b>  |

|  | 2013/2014 Review Period | 2012/2013 Review Period |
|--|-------------------------|-------------------------|
| New licences issued to domestic auditors                               | 8                       | 18                      |
| Licences cancelled from domestic auditors                              | 17                      | 18                      |
| Registrations cancelled or registration expired from domestic auditors | 11                      | 5                       |
| Firms reviewed   | 17                      | 9                       |
| <b>Audit files reviewed</b>  | <b>56</b>               | <b>33</b>               |

## Appendix 3 – Glossary

| Term                               | Meaning in this document  |
|------------------------------------|---|
| Act (as referenced in this report) | <i>Auditor Regulation Act 2011</i>  |
| 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 (XRB)   |
| Auditing Standards                 | International Standard on Auditing (New Zealand) to be applied in conducting audits of historical financial information as issued by XRB  |
| Auditor                            | Licensed auditor as defined by the Act  |
| Emphasis of matter paragraph       | A paragraph included in an auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.   |
| EQCR                               | Engagement Quality Control Review. This is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team has made and the conclusions it has reached in formulating the auditor's report.  |
| EQCR partner                       | Licensed auditor who performs the EQCR. In some instances this may be a licensed auditor that is not a partner in the audit firm  |
| FMA                                | Financial Markets Authority   |
| Going concern                      | Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless those charged with governance either, intend to liquidate the entity or to cease operations, or have no realistic alternative but to do so.  |
| ISA (NZ)                           | International Standard on Auditing (New Zealand)  |
| Issuer                             | Has the same meaning as in section 4 of the <i>Financial Reporting Act 1993</i>   |
| Issuer audit                       | Has the same meaning as in section 6 of the <i>Auditor Regulation Act 2011</i>  |
| NZICA                              | New Zealand Institute of Chartered Accountants  |
| Professional scepticism            | An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.  |
| PES                                | Professional and Ethical Standard   |
| Quality review                     | Means a review of an audit firm as defined in the <i>Auditor Regulation Act 2011</i>  |
| Revenue recognition                | Incorporating the gross inflow of economic benefits (cash, receivables, other assets) arising from the ordinary operating activities of an entity (such as sales of goods, sales of services, interest, royalties, and dividends) in the income statement when it meets the following criteria: <ul style="list-style-type: none"> <li>• it is probable that any future economic benefit associated with the item of revenue will flow to the entity, and</li> <li>• the amount of revenue can be measured with reliability.</li> </ul> |
| Review Period                      | 1 July 2013 to 30 June 2014   |

## Notes

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# Notes

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