Audit quality – a director's guide

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This handbook offers guidance for directors and shareholders of New Zealand FMC reporting entities about how to improve audit quality

FMA
FINANCIAL MARKETS AUTHORITY
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AOTEAROA - NEW ZEALAND

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Document history

This document was first issued in November 2017. This update was published in November 2020. It is based on legislation and regulations as at the date of issue.

About this guide

This handbook is aimed at directors of FMC reporting entities. It sets out how you, as a director, can contribute to the quality of your audit, as well as what you can expect from the FMA and your auditor.

Investor confidence is a key part of maintaining participation in successful financial markets.

This confidence depends partly on investors having access to credible and reliable financial information. Audits of FMC reporting entities provide an opinion that the financial statements are presented fairly in all material respects and the various statements are in accordance with IFRS (International Financial Reporting Standards).

Directors' responsibilities

As a director, one of your key responsibilities is to ensure your organisation's financial statements fairly represent your business and comply with NZ IFRS.

These financial statements must be supported by appropriate accounting records that correctly record the transactions of the FMC reporting entity and that will enable the financial statements of the FMC reporting entity or scheme to be readily and properly audited.

If your company is NZX-listed it must have an audit committee. Other FMC reporting entities may choose to have an audit committee.

Audit committees

An audit committee does not replace the directors' responsibility for financial reports. As it has the main relationship with the auditors, the audit committee can play an important role in the reporting process, and in supporting and promoting audit quality.

What affects audit quality?

The quality of an audit may be influenced by factors such as:

- the quality and timeliness of information provided by the entity being audited
- directors' involvement in the audit process
- the entity's culture and attitude to challenges by the auditor on key areas of judgement
- the entity paying a fair and reasonable fee for the audit, and providing the auditor with sufficient time to perform a compliant audit
- an audit firm's culture and focus on professional scepticism and consultation
- the experience and expertise of audit staff (including recruitment and training practices, the use of internal and external experts, and specialist industry knowledge)
- time spent by senior audit team members and the engagement quality control review (EQCR) partner, and effective supervision by the engagement partner
- the audit firm's compliance with independence requirements, including the length and nature of the relationship between the audit firm and the business
- the audit firm's investment in audit quality (for example, head count in the quality control department)
- effective oversight of the audit profession.

Selecting an audit firm

Selecting the appropriate audit firm is a key factor to help ensure a high-quality audit.

Audits of FMC reporting entities must be performed by a registered audit firm. Search the Auditors register for a list of registered firms.

Although there is mandatory rotation[1] of audit partners for FMC audits, New Zealand has no mandatory audit firm rotation to avoid a long or overly close relationship with a client. Directors should consider whether their relationship with their audit firm and/or key audit staff has become too close to ensure they provide sufficient challenge. This is not in the best interests of directors or investors.

Key things to think about when you select an auditor

- The tender process and appointment is led independently of management, preferably by non-executive directors.
- A timetable to enable a smooth transition if changing auditors. Allow sufficient time to hand over work between firms and ensure the new firm can get familiar with the business.
- Keep longer-term audit planning and rotation in mind when selecting different audit firms for use for non-assurance services. This may help ensure you have the choice of multiple audit firms for the tendering process. Non-assurance services may compromise an audit firm's independence, meaning they cannot participate in a tender.
- Engage with investors during the tender process, as they are the ultimate clients of the audit.
- Consider whether the audit firm should be appointed on a fixed-term basis only (for example 7 years). This may help increase independence between the management of the entity and the audit firm, as it removes the risks (and poor incentives) that arise when the audit firm is eligible for reappointment.

The tender process

Communicating with investors

- Communicate the timing of the tender process and which firms are being considered.
- Communicate conflicts of interest considered during the process.
- Communicate factors that led to the appointment of the audit firm.
- Allow questions from investors during the AGM regarding the appointment or reappointment of the auditor.

Decide which audit firms are suitable to be invited to a tender process

Things to consider include:

- the experience of the audit firm in the business's industry
- whether the audit firm's location aligns with the locations in which the business operates (including international jurisdictions)
- whether the audit team suggested by the firm matches the overall expectations of the directors.

Ask for any proposal to include details of:

- specific expertise of the audit team in the specific sector of your business
- availability of relevant specialists such as technical accounting and IT specialists, and how

1: Engagement lead audit partners have to rotate every seven years (or five years for most of the NZX-listed markets).

these will be used in the audit
- if applicable, how the audit firm manages the oversight of other auditors in a group audit
- the time expected to be spent on the audit by senior staff and engagement leaders
- time expected spent onsite during the audit by the engagement leader and senior staff
- results of the firm's audit quality reviews by external regulators
- staff attrition rates to gauge audit continuity
- level of mandatory training of audit staff.

Audit fees

Price should not be the key factor in choosing your auditor. We recommend businesses select their auditor based on the criteria outlined above. Audit fees should only be considered at the final stages of the tender process.

The setting of fees is a commercial decision by the business and the auditor. The business should expect to pay the auditor a reasonable fee to ensure the auditor has sufficient time and resources to perform a compliant audit. This will ultimately provide investors with the comfort they expect from the audit.

Directors and/or the audit committee should negotiate the audit fee – this should not be delegated to management. Directors and audit committees should ensure fees are not set at a level that could lead to audit quality being compromised.

When faced with circumstances that may impact the negotiation of audit fees, we urge directors to be cautious. Lowering fees could impact negatively on the audit's quality. A lower fee is a false economy if it compromises the assurance value of the audit, as this will increase risks for directors and investors.

What you should expect

Directors can expect their auditors to ensure efficiency when auditing financial statements. While there may be instances where a more efficient but still effective audit can be obtained for a lower fee, directors should consider whether reduced fees could impact audit quality. With increased requirements in the auditing standards and the complexity of some accounting standards, there may be little room for auditors to improve efficiency.

Factors to consider

- Companies that are under financial pressure often put pressure on auditors to lower their fees. However, audit fees are usually only a small proportion of costs, and reducing them does not generally have a significant impact on a company's profit.
- If an entity decides to put the audit out for tender, the primary focus should be on quality rather than cost. A quality audit provides assurance that the financial statements give a true and fair view of the financial position.
- In difficult economic conditions, auditors are faced with more challenging judgements in areas such as assessing whether a company is a going concern, impairments of assets and fair values. This increases the time spent on an audit, which may in turn increase audit fees.
- Changes in the business's operations and reporting, and increased regulatory requirements, may warrant increases in fees.
- The audit market is competitive, and some audit firms may offer discounted fees. Where there is a significant difference in fees, directors should question whether the auditor understands the company's business, and if low fees are sustainable in delivering a quality audit.

Auditor independence

Auditors are required to be independent when they perform audits of FMC reporting entities. Both independence of mind and independence in appearance are necessary for the auditor to express a conclusion free from bias, conflict of interest, and undue influence.

A breach of the independence requirements can influence investors' trust of the audit.

Directors also benefit from auditor independence, as it increases the chances of the auditor identifying any issues in controls and compliance with the accounting standards, lowering the risk of non-compliance.

Directors' responsibilities

Before you appoint an auditor, you need to assess the firm's independence. This assessment needs to be continually reviewed to ensure there is independence for the entire length of your relationship with the audit firm.

Non-assurance services

Directors need to think carefully before asking or allowing their audit firm to provide services in addition to the audit. These services are known as 'non-assurance services' and they may compromise the audit firm's independence.

The standard for auditor independence is built on the principle of viewing independence through the eyes of an objective, reasonable and informed third party. Globally, investors' expectations of independence have changed in recent years. Directors should consider whether investors or other users of the financial statements are comfortable with their auditor providing non-assurance services.

Auditor's independence requirements

> "A distinguishing mark of the [audit] profession is its acceptance of the responsibility to act in the public interest. Therefore, an [auditor's] responsibility is not exclusively to satisfy the needs of an individual client."
>
> – adapted from the IFAC Code Of Ethics For Professional Accountants

Guidelines when using an auditor for non-assurance services

- Have an internal policy to approve using the firm for non-assurance services. It should cover:
  - an overview of prohibited services for auditors of FMC reporting entities as set out in the Professional and Ethical Standards (PES 1)
  - the type of services provided and their impact on auditor independence
  - consideration of the expected public perception of these services being provided by the auditor
  - when it is appropriate to get another service provider to carry out non-assurance services
  - consideration of setting a maximum value for non-assurance services.
- Ask the audit firm for a detailed assessment outlining possible threats to the firm's independence from the non-assurance services and how it would mitigate risks, especially in complex and subjective areas. If a non-assurance service creates a self-review threat for the auditor, ask yourself if it is likely that the auditor would challenge work carried out by their own firm.

- At the end of the audit, ask the audit firm to confirm independence from all other services performed by the firm, including non-assurance services, and obtain details of how they implemented safeguards to mitigate the risk.
- Approve all services and fees provided by your audit firm yourself, and do not delegate this to management.

To avoid these issues, we recommend directors very carefully consider whether to appoint their auditor for the provision of non-assurance services, and do so sparingly.

How to help assess auditor independence

- Make sure there is distance between yourself, management and the audit team – getting too close can affect independence and objectivity.
- Challenge the audit team where threats are identified – and question if having the services provided by different teams is enough to maintain independence.
- In your annual report explain:
  - internal policies you have in place to ensure the independence of your auditor
  - any non-assurance services provided by the audit firm, and why they didn't compromise auditor objectivity and independence
  - how you were satisfied about your auditor's quality and effectiveness
  - any identified threats to auditor independence and how they were mitigated.
- Consider any other matters that may affect the independence and objectivity of the auditor.

Audit process

The audit process involves close cooperation between the audit firm and senior management. Directors and/or the audit committee need to keep in regular contact with audit teams during the audit. This helps positively contribute to the process.

Directors' responsibilities

How to ensure a satisfactory audit process:

- Plan your financial reporting process appropriately to make sure your auditors receive quality information. Provide information (including that related to complex accounting matters) in a timely manner. This will allow auditors to carry out the audit effectively.
- Ask your auditor to provide a written report about the planned scope and timing of the audit. This should include the significant risks identified and should be discussed with directors and/or the audit committee.
- Give the auditors an opportunity to attend audit committee meetings.
- Have regular meetings with your auditors during the audit process without management present so auditors can discuss any disagreements with management.
- Discuss with your auditor the management letter, which sets out any areas for improvement of your policies and processes. Ensure that management addresses the matters raised in this letter in a timely manner.
- Ensure management has sufficient knowledge and experience in financial reporting.
- Use an accounting specialist for complex and technical accounting matters.
- Request a written report, on a timely basis, that sets out all of the key issues the auditors identified. Meet with your auditors and the audit committee to discuss the report in detail.
- Challenge the auditors about the professional scepticism applied in the audit's key judgements, including significant accounting treatments.
- Ensure you are comfortable the auditor received all information and explanations relevant to the audit in a timely manner.
- Discuss matters that affect financial accounting, reporting and audit quality with the auditors.
- Provide the opportunity for your audit committee to meet the auditors without management present and without any minutes of the discussions being shared with management.
- Ensure early engagement on key audit matters included in the auditor report, and have a 'healthy debate' with your auditor about the procedures that have been performed by the audit team to address these key audit matters.

If any audit quality concerns cannot be resolved satisfactorily with the auditor, the audit committee should raise these with the full board of directors and leadership of the audit firm.

Please seek the FMA's advice where appropriate, including raising any concerns you may have.

Financial statements

A business must have its own systems, processes and controls, and sufficient resources to produce compliant financial statements.

Auditors can provide businesses with useful feedback about where internal systems, processes and controls could be improved. You can help by delivering quality financial information to the

auditor early in the audit process to improve audit quality.

However, you must not rely on the auditor when forming your own opinion on the financial report. This would undermine the objective of an audit, which is to provide independent assurance.

You should ensure the finance functions of the business are sufficiently resourced with the appropriate level of experience and knowledge. Directors may consider engaging a specialist to address matters requiring complex accounting treatments.

Businesses should ensure their financial statements are supported with the right level of accounting records. This includes, for example, papers that set out the accounting treatments chosen by the entity and any assumptions and judgements made by directors. We also recommend that directors document instances where they determined disclosure not to be material.

Evaluating your auditor's performance

Directors and audit committees need to evaluate their auditor's performance regularly. The following questions can help with that evaluation.

- Did the auditor clearly communicate how they complied with independence requirements?
- Did the auditor demonstrate sufficient understanding of the business and the key areas of risk related to the financial statements?
- Could the auditor describe the appropriate procedures they performed to address these risks?
- Did the auditor raise key issues in a timely manner?
- Were senior team members and partners sufficiently involved in the audit?
- Did the auditor's letter to management make relevant and clear comments about the risks, conclusions and audit work performed? Were any identified issues appropriately discussed and resolved?
- For internally or externally reviewed audit files, did the firm discuss the review outcomes?
- Did any issues about non-compliance with the accounting standards come to light as part of the audit process?

The FMA's role in audit quality

We are responsible for overseeing auditors of FMC reporting entities.

As part of this we are required to perform audit quality reviews of each registered audit firm. We inspect larger firms every two years, and other firms generally every three years.

We review the systems, policies and procedures audit firms have in place to comply with the Auditor Regulation Act 2011 (the Act), and the Auditing and Assurance Standards. We also test audit firms' care, diligence and skill in carrying out FMC audits by reviewing individual audit files.

When necessary we also perform follow-up reviews of audit firms to ensure they have effectively remediated significant findings.

After an audit quality review, if we believe the auditor has breached the Auditing and Assurance Standards in a way that has significantly impacted the audit outcomes, or has breached the Professional and Ethical Standards, we may refer the matter to the relevant accredited body for assessment.

The accredited bodies are responsible for the licensing of domestic auditors and the registration

of audit firms, based on the prescribed minimum standards set by us, and investigating any complaints about FMC audits.

Requirements for FMC audits[2]

The Act regulates auditors' performance of financial statement audits of FMC reporting entities. The Act recognises that auditing is a specialist job that cannot necessarily be performed by any qualified accountant. As a result, auditors for FMC audits must be licensed.

Before the audit, auditors must:

- Be licensed, and their firms registered.
- Develop and share an overview of the planned scope and timing of the audit. This includes details of significant risks identified by the auditor.
- Provide assurance that they are independent.

During and after the audit, auditors must:

- Conduct their audit in accordance with the Auditing Standards and Professional and Ethical Standards issued by the External Reporting Board.
- Discuss significant matters with management.
- Communicate circumstances that affect the form and content of the auditor's report, including the key audit matters.
- Request certain written representations from management that include (but are not limited to):
  - the responsibility of directors for preparing the financial statements
  - that related party relationships and transactions are appropriately accounted for and disclosed
  - the director's assessment of the risk that the financial statements may be materially misstated as a result of fraud, and disclose any known instances of fraud
  - a statement that auditors have had access and are provided with all information relevant to the audit.
- Ensure the financial statements present fairly, in all material respects, the financial position of the entity.
- Provide an independent opinion about whether the financial report complies with the Accounting Standards.

2: Under the Financial Markets Conduct Act 2013 and Auditor Regulation Act 2011

Useful resources

Publication	Content
Audit Quality Monitoring Report 1 July 2019 – 30 June 2020 Published November 2020	We issue an annual monitoring report summarising our audit quality review findings. These reports highlight key findings and the areas audit firms should focus on to improve audit quality. The reports contain specific messages for directors, as it is useful for directors to be aware of how they can help improve audit quality in these areas. Audit findings may change from year to year; it is important to take note of previous reports as they contain information that remains useful for directors when interacting with auditors.
Financial reporting – review findings and guidance for entities in light of COVID-19	This document outlines what we have seen in our recent reviews of financial reporting, and sets out our expectations and areas that entities should consider when preparing financial statements, particularly in light of the COVID-19 situation. It is useful for anyone involved in preparing or approving financial reporting for FMC reporting entities.
XRB Alerts • What can you expect from auditor reports in response to COVID-19? • What is the impact on going-concern disclosures in response to COVID-19? • Auditor communication in the COVID-19 environment	XRB alerts provide further explanations about the relevant accounting and auditing standards. The alerts deal with questions and concerns related to COVID-19.
IOSCO Report on Good Practices for Audit Committees in Supporting Audit Quality Published January 2019	This report, issued by the Board of the International Organization of Securities Commissions (IOSCO), seeks to assist audit committees in promoting and supporting audit quality.
Disclosure of significant accounting estimates Published July 2018	Information sheet on common areas of concern noted in disclosing significant accounting estimates, and our guidance on more transparency and better disclosure.

Publication	Content
Improving financial statements Published June 2018	Summary of the findings from our thematic review to determine the extent of improvements in the presentation of financial statements in a clear, concise and effective way, and suggestions for additional improvement.
Enhanced auditor reporting: A review of the third year of the revised auditor's report Published May 2020	Covers areas relevant for directors such as: • useful summary of the evolution of key audit matter reporting in the three years since the revised auditor's report was introduced • most common key audit matters reported • user feedback on how the auditor reporting is delivering transparency and clarity • FMA's focus.
Going concern disclosures in financial statements Published June 2014	Informs market participants of the findings of our review of use of the going concern assumption and highlights areas of concern. It also reminds directors of the importance of the going concern assumption when preparing accounts using New Zealand GAAP and disclosure requirements.
Disclosure of fees paid to auditors by listed issuers Published April 2014	Summary of our findings and the concerns we have about the quality of disclosure of audit and non-audit fees.

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