Speaker 1: Hello and welcome to the CPA Australia Podcast, your weekly source of business, leadership, and public practice accounting information.

Claire: Welcome to this CPA Australia podcast, on the New Zealand Financial Market Authority's findings from their Audit Quality Reviews for 2018, which has been published in their Audit Quality Monitoring Report. I'm Claire Grayston, CPA Australia's Policy Advisor for Audit and Assurance, and joining me to discuss the FMA's findings, is Jacco Moison, Manager for Audit Oversight at the FMA. Thank you for joining us Jacco.

Jacco: Thank you, Claire.

Claire: Firstly, could you explain to us, which auditors the FMA reviews and the types of audits which these reviews cover?

Jacco: Yes. The FMA only has a mandate to review registered audit firms, and audit firms that are registered are able to provide services to audit financial statements of, what we call in New Zealand, FMC Reporting Entities. These include, basically, our listed entities and our NZX Stock Exchange, but also cover quite a number of other entities where they actually issue securities to the public, and it also covers things like licenced banks and the licenced non-deposit takers, and insurance companies in New Zealand.

Claire: Thank you. The FMA have been doing these reviews for some years now, six years now, and what structural changes are you seeing in the audit market in New Zealand?

Jacco: We have seen quite some changes from the beginning, a lot of audit firms had transitional licences, so there wasn't a real licencing regime to start off with, so most of the people could transition to an auditor licence automatically if they had been doing audits in the past. We had about 40 firms joining us at that point in time, and roughly about 150 auditors. Over the six years we've seen a number of registered audit firms, that has decreased significantly, we are at the moment at 19 licences. However, the number of auditors remains reasonably stable, at about 140.

Jacco: The changes are mainly due to kind of changes in regulation. For example, each FMC reporting audit needs two audit partners on there and they both need a licence, so both the engaging lead and the EQCR need to be licenced. A lot of the small firms have issues to finding a second partner because they were just one partner firms. Some other changes have come through the rotation requirements in the international standards, where there is shorter rotation periods and also a longer stand-down period, so you effectively need more auditors within your firm to be able to rotate these audit engagements.

Jacco: Again, where audit firms only have one or two licenced auditors that becomes quite difficult, so a lot of these firms either look with the market for FMC audits, or have looked to kind of increase sc ale, and we've seen quite a few mergers as well between some smaller firms. That ultimately has led to the reduction of the number of audit firms. However, what I say is the number of auditors has remained stable.

Claire: Right, so in terms of the actual findings, what are the FMA's overall findings in relation to the quality of audits in New Zealand? Are you seeing progress by the firms over this period in addressing the issues that you've been raising so far?

Jacco: We definitely have seen progress in the last six years. We went from a totally unregulated population to a regulated population, and I think in the first few years we have seen some people struggle with making the necessary improvements. Overall, we've seen improvements in the quality of audits. Our findings have reduced per audit firms, so where we had quite a large number of findings in the first review, we have significantly reduced in the second or the third review.

Jacco: However, we are still concerned about huge inconsistencies in the quality of individual audits from the same firm, so while you think that hey, it's all of the same policies and procedures and same methodology, we've seen their quite different outcomes based upon individuals doing these audits. That is our main concern and it's also our main focus on how we can make sure that the audit firms understand the issues that led to these kind of inconsistencies and how they got to address them.

Claire: Before we get into the detail of the areas that you found in the quality reviews, I'd just like to have a look at some of the material that you've included in appendix one on the summary of your review ratings for the files. I noticed that you've rated files as good or compliant with improvements needed as well as files where significant improvements are required. The percentage of files that require significant improvements seem to have varied quite significantly over those past six years. They've ranged, for example, from 15% for listed entities in 2015 and up to 53% in 2016 for listed entities.

Claire: Whereas for other FMC reporters, 33% of files in 2017 required significant improvements. Whereas, it was 61% in 2013. It doesn't seem to have a clear trend. How do you see the progress in improving audit quality reflected in these ratings? How can we understand what these ratings mean?

Jacco: Certainly it's an interesting question. Maybe go back a little bit to our report and our reporting cycle is we don't mention the names of the firms in our report and also our kind of review cycle is every three years with the big four we review every two years. If you purely look at the numbers, they reflect different audit firms every year, so it's difficult to do that comparison from year to year just looking at the numbers because it is essentially not the same audit firm. Because, of course we know what the underlying things that we have reviewed in the past we've very much compared firm on firm when we make progress against the year.

Jacco: We've seen improvements from the same audit firm year on year and that's difficult to explain in a report if you cannot mention the audit firm, themselves. You will be able to look into to provide better in our audit file ratings. Also, to mention is that those file ratings are not just statistical samples. For example, if you have one failure more in one year, then another very small sample, it might have some big impact on the percentages if you put them out in percentages. That is another implication of being a similar regulated and reviewing, only a limited number of audit files across a year and some of those smaller checks will have quite a reasonable impact on percentages.

Jacco: How we try to progress the improvement of all the qualities, what I say on a firm-by-firm basis and it's mainly looking at areas where we had a previous findings and how they've had been addressed by the audit firms. If we see continuous findings in the files that we review in the next reporting cycle, that is kind of reflected on Page Six in our report that shows you a better overview of the areas where we previously seen some issues in or how the audit firms get to address it and how successful they were at and addressing those issues.

Claire: Page Six, you mentioned, does provide a handy overview then of the improvements where you are seeing improvements and where there's been no improvements found and perhaps we'll come back to that. Could you just explain to us the areas where you see this greater scope for improvement in audit quality?

Jacco: Yes. In our report, we basically highlighted seven areas where we think if improvements are made, would have a good effect on the overall audit quality to relate to the firm-wide findings and the other ones are more related to the audit files, themselves. Those areas are auditor independence, where you still kind of concerned about some of the services provided by auditors and how well those audit areas then are to justify the auditing. Talking about things like where people provide valuation or help the entity with due diligence, how well do the auditors address [inaudible] later on when they purchase the business. Another part is okay, how firms respond to our findings, and do they really find them [inaudible]. How do they address them to improve their own quality going forward?

Jacco: An important part that we find in our reviews is the role that directors play in order to quality and the management of an entity. That's particularly important when there's low quality information provided to the auditors, and how can the auditors then make sure that he has enough audit evidence in the audit file to address some of these balances. Another area that we highlighted in our report is the use of management experts and that goes together with another area being accounting estimates, where there's a lot of emphasis focused on what management of entities do using experts in getting complex valuations or where they made accounting estimates. That has a large number of assumptions that drive a certain outcome, and what we've seen is where auditors are not paying enough attention on forming their own independent view, mainly trying to agree with the end result that management came up with and tried to find some evidence to support that.

Jacco: Another area that is a bit of concern is how auditors respond to the most risky areas and how they excuse reasonably basic audit procedures to address those. That's mainly where we see auditors not really performing the appropriate audit procedures or the audit procedures that they'd done; didn't really fully address the risks so that we have some issues with, if the auditor actually added up with sufficient audit evidence to support those key audit areas. This year, we also have an overview of how orders of schemes and funds are performed. That's basically a result of the whole six years where we offset the result of some of these audits compared to the average of audit quality they we've seen. And we're especially concerned about some of the orders of schemes of property schemes and forestry schemes because they seem to have significantly a higher rate findings then what we've seen in some of the other audits.

Jacco: We also happened to look at fund audits, very important for New Zealand. That includes also our superannuation model that we set up recently in New Zealand. The KiwiSaver, because a lot of New Zealanders all have a KiwiSaver account and we all find it important that you will face significant attention to making sure that these funds are appropriately audited and that people can take home from the audit opinion.

Claire: Jacco, perhaps I can just ask a bit more about a couple of those areas. I'm interested in the directors' impact on audit quality. And perhaps you can outline some of the areas where they might be undermining audit quality or where they can assist in the audit process.

Jacco: I think what we've seen when we look at audit files where directors or management might not have the right expertise or hadn't paid specific attention to certain areas, it is very difficult for auditors to do a good audit. The auditors might try to fix a lot of problems, but some of the issues might go undetected because of the quality of information. So they might address 80 percent of this, but the 20 percent that remains undetected, that might be areas that we pick up through our quality reviews. Where directors have provided, for example, information about the valuation of an investment where they only do a very short summary of how they believe they come up to the right valuation. However, we didn't see how they took into account the accounting standards by reaching that result, and also some of the assumptions made in that valuation wasn't supported by any audit evidence.

Jacco: That puts the auditor in a very difficult position because they try to find some information that would support the director's view rather then coming up with an independent view on the valuation. When there's insufficient information, it's very difficult to come up with your own view, as well, because you don't have the information available to yourself. It's very difficult to audit these areas and we say that the auditors should really assess if they have insufficient information to report it directly back to the directors that they don't have the information. If they don't receive the correct information that they might have to, they don't need to account what they're issuing the audit opinions and it might lead to either qualifications, or, in some cases when it's really significant to a disclaimer opinion.

Claire: And the Director's Guide to Audit Quality that the FMA issued last year, that would be the resource that presumably you direct directors to, to understand their obligations.

Jacco: That is correct. For this year we have made some changes to the Director's Guides. It's mainly an update on some of the things that we experienced in the market, that we believe that the director should be aware of. But, the Director's Guide is a very good starting point for directors to have a look at their own policies and procedures on how they can improve their audit, and how they can provide better governance models to making sure that the auditor can do his job appropriately and, therefore, provide conference with the directors that the entity is operating well, but also provide the right financial information.

Claire: Thanks, Jacco. I just wanted to ask you about one more area where you identified the greatest scope for improvements in audit quality, and that is firms' response to the FMA's findings and how you think that could be executed better.

Jacco: It is a response, of course, on our findings but I think sometimes it's also about the internal firm's quality reviews. They might raise certain issues and what we've seen in the past by audit firms is that most of these issues, they try to address that with a bit more training. But they haven't really gone back and identify any root causes why certain noncompliance happened in the first place. I think where we've seen some firms done a quite good cause analysis has actually resulted in certain findings that we believe that are not addressed by training; such as, all the partners having a too big portfolio and, therefore, can't pay their full attention to each of the audits. We believe, but also with some of these inconsistencies happening in audit firms, why certain auditors are able to perform a good audit in one situation but not in another.

Jacco: We believe that there might be other reasons underlying those qualities rather than training. We've seen, for example, where we believe that the auditor should have consulted with other partners and that didn't happen. So the question is why did he not consult and that reason is not okay, that he needs more training, but maybe did not have a full appreciation of all the audit avenues, or basically what was special to make a quick decision and consultation didn't fit into that process because that would have not met certain deadlines that were due by the clients. These are the things that we want audit firms to focus on to really understand why certain failures happen, and if they spend enough time and resources in doing that, I think that will make their responses and where they appear at mediations more effective and ultimately to better quality.

Claire: When you go back in your reviews, that's presumably one of the first things you look at is that response to previous findings?

Jacco: If you look at our future focus areas of the FMA, one of the key drivers is looking at the firm's remediation plans and how they have implemented that and how they monitor them, themselves. It is an area where we see that some people have coupled with good solutions but not necessarily doing a lot of monitoring in the space to see if it is effective. That's what we want audit firms to focus on.

Claire: How well have auditors implemented the changes to auditor reporting that we've seen recently?

Jacco: This is actually one of the areas of our reports that has been very positive about the steps audit firms have taken to implement the new reporting and the efforts that they've put into that area. New Zealand basically has to comply with the International Standards so that there's a slightly less stricter version than they, for example, have in the U.K. But we're still seeing a lot of audit firms actually providing more information in the new auditor's report that is required by the Standards. We've seen a lot of audit firms, for example, providing information about materiality. Some people provide more information on what they've seen when they performed certain audit procedures, and in some cases they started reflecting what drove the scope of their work. I think that's all been very positive from an audit point of view. We of course looked on what they have reported if that was actually supported by the audit evidence on the audit file.

Jacco: I would say that, that we've seen high compliance in that area, as well. We've seen a couple of instances where small things were not correctly reflected in audit reports and we believe that that was mainly the result of a lot of people that weren't involved in the audit file reviewing and making changes to the auditor within their first year and maybe overstating the one or two elements of the audit procedures that they had performed. But overall we think that that didn't have a significant effect on the overall audits being, that it wasn't misleading, that they did the procedures that were necessary for that audit. Overall, the FMA is very satisfied in how the audit firms have embraced the new order-to-be and we hope to see, in the future that they continue to focus on that.

Claire: The most significant change being the key audit matters that you were talking about; those had been required for the auditor's reports for listed entities since December 2016 year ends. But now other FMC reporting entities, those with higher public accountability, will also require key audit matters in their auditor's reports from December this year. So are there any particular tips you would have for auditors who are perhaps reporting for the first time in relation to those clients?

Jacco: I think what we're seeing now with the listed entities is audit firms were early in doing draft looking-ins, basically on the previous year to make the directors aware of what they could expect, when the next audit would be coming up. If you have clients, they would already draught up what an audit opinion should have looked like in the previous year would be a good starting point to get early discussions with directors on what type of information is the key audit matter and what is not. Also, making sure that you alert the entity early, that, in some cases, the information should kind of mirror what is in the financial statements. If they have any questions, for example, on the draft audits. Make sure that they really reflect on what they should be reporting in their financial statements so that there's not kind of a mismatch between the key audit matters and the information in the financial statements as such.

Jacco: Other than that, start the process early. As soon as the auditors become aware of areas that they should report. Direct them early to the directors because directors are not that sophisticated as some the big list of entities. You might have to take a bit more time between when you finish your audit and when, when the entity has to report. So don't leave it till the last minute because if you and end up in a debate on the last day that an audit's set of financial statements would need to be filed, you're probably late in the piece to try to explain to an auditor why your report certain matters. So being early in the processes is quite important.

Claire: So finally, Jacco, in the current Quality Review Period for 2018-2019. What are the key focus areas that FMA are looking at?

Jacco: I think we definitely look at the firm's plans and how they have been implemented. So, from a quality control perspective, we're definitely looking at things like - Did we do a root-cause analysis? What were the outcomes on that? How did that change your policies and procedures? Of course we're also soon coming into a period where a lot of new accounting standards become effective. That will alert us to have a look more about on how auditors have been comfortable with some of the decisions made by entities to apply the new accounting standards and we will expect to focus a little bit more on the auditor's process on reviewing the compliance at the end with that straight work. That's the significant changes. We also, based on my earlier comment about directors and the role they play. We continue to monitor what's going on in the market with announcements to the market and where we have concerns that maybe policies and procedures at an entity are weak and, therefore, the risk of getting things wrong are higher. So that will definitely play a role in the entities that we select for a quality review. So we'll be definitely focusing on entities that are less well-managed than the good-managed entities.

Claire: Jacco, thank you very much for spending the time to discuss the FMA's Audit Quality Monitoring Report. I think there's a lot in there that can really steer auditors and audit firms in the right direction to improving their audit quality. And let's hope that they continue to do that into the future to maintain those gains that you've been seeing so far. So, thank you again.

Jacco: Thank you, Claire.

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