Regulatory Impact Statement

Audit Firm Incorporation

Agency Disclosure Statement

1 This Regulatory Impact Statement has been prepared by Ministry of Business, Innovation and Employment.

2 It provides an analysis of options to allow auditors and audit firms to choose the corporate form that best suits their circumstances, while ensuring that the interests of investors and consumers of audit services are adequately protected, generally by promoting auditor independence.

3 In the absence of quantitative data, our analysis draws on qualitative evidence (in the form of key stakeholder submissions and discussions) and observations of those restrictions adopted by overseas jurisdictions that allow the incorporation of audit firms. A relative lack of data makes it difficult to effectively quantify the benefits to the investors and consumers of incorporated firms. However, we consider that on the evidence we have the constraint on audit firms' choices of business structure is not justified.

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Summary

4 Currently, firms that perform audits under the Companies Act 1993 and the Securities Act 1978 are not permitted to be a 'body corporate'. Instead, single auditors are sole practitioners and audit firms take on the 'partnership' model of business structure. This creates a number of limitations for audit firms, including their ability to structure themselves in a way that best meets their needs.

5 This RIS examines the issue of whether audit firms in New Zealand should be allowed to incorporate and take on certain body corporate forms (company, limited liability partnership and limited partnership structures). We recommend that audit firms be allowed to incorporate as a company, and that overseas limited liability partnership audit firms be recognised in New Zealand. Keeping in mind our objectives to protect the interests of consumers and investors by maintain auditor independence, we recommend that minimum restrictions be imposed on audit firms that incorporate.

6 This RIS also considers what minimum restrictions on incorporation are necessary. We recommend that these restrictions relate to governance, ownership and professional indemnity insurance. We conclude that there is a distinction between audit firms that conduct issuer audits (with restrictions to be set by the Financial Markets Authority (FMA)) and those that conduct other audits required under statute (restrictions to be outlined in regulations).

Status quo and problem definition

The status quo

7 Currently, firms that perform audits under the Companies Act 1993 and the Securities Act 1978 are not permitted to be a 'body corporate' i.e. incorporated as a perpetual entity with a separate legal personality and personal liability for shareholders. Another 65-odd Acts and Regulations include the same prohibition, mostly by cross-referring to the prohibition in the Companies Act. Instead, single auditors are sole practitioners and audit firms take on the 'partnership' model of business structure.

The problem

8 The New Zealand Institute of Chartered Accountants (NZICA) believes this issue is as an unnecessary restriction on their members. They believe removing the prohibition is an important step towards addressing the concerns of the audit profession regarding the audit liability system in New Zealand.

9 The prohibitions appear to be based on an outdated view that partnerships are small entities with few partners and that each individual partner has the time and inclination to monitor every other partner, and thus provide better protection for investors.

10 The prohibition on incorporation appears to be founded on the idea that personal liability:

- Promotes high levels of care and monitoring between partners to ensure that professional and ethical standards are maintained; and
- Increases the potential pool of money available to be paid out where auditors are found liable.

11 However, our view is that the main motivation for firms to have high quality monitoring systems is the harm to their reputation if they conduct substandard audits. This is regardless of the audit firms' structure. Also, many auditors already limit their liability through contractual terms. The widespread use of family trusts also means that practitioners' wealth is rarely, if ever, available for paying out.

12 There are limitations created by the sole practitioner and partnership models, such as:

- Difficulties managing firm growth and enabling transfer of ownership;
- Limited access to business finance and other options for raising capital; and
- Partners being personally financially exposed when other partners professionally default, due to joint and several liability (although incorporation on its own would not overcome this issue[1]);

13 The reality is that the "Big Four" accounting firms (PwC, KPMG, Deloitte and Ernst & Young) and the second-tier firms are complex businesses that have much in common with large and medium-sized companies. Good governance is largely obtained through robust systems and processes, not from individual partners monitoring every other partner.

14 New Zealand is out of step with international practice in regard to audit firm incorporation. Many overseas jurisdictions permit audit firms to incorporate, including Australia, the U.S., the U.K., most of the European Union, Switzerland, Singapore and Japan. Limited liability partnership (LLP) is the predominant structure in many of these jurisdictions. New Zealand's prohibition on incorporation has the effect of barring almost all top-tier overseas audit firms from becoming registered audit firms in New Zealand. This is causing some issuers who have cross-border business to face significant difficulty finding an auditor who is able to understand the reporting requirements of both their home jurisdiction and New Zealand.

15 We have been advised by the FMA that in the event a New Zealand firm is able to audit an overseas issuer, it is costly and requires:

a. Sending a New Zealand licensed auditor to the issuer's overseas place of business; or

b. Having (likely to be unlicensed) auditor from an overseas firm do the work, with a New Zealand auditor signing off the audit report.

16 CPA Australia (a professional accounting body constituted in Australia) has recently been accredited by the FMA under the Auditor Regulation Act 2011 to license issuer auditors in New Zealand. However, this ban on incorporation means that some licensed auditors are unable to conduct audits in New Zealand as they are employed by incorporated firms.

Objective

17 This area of work seeks to:

- Allow auditors and audit firms to choose the corporate form that best suits their circumstances; while
- Ensuring that consumers of audit services are adequately protected, generally by maintaining auditor independence.

[1] Note that addressing remaining issues with liability is out of scope of this work. The Law Commission is carrying out a broad review, not limited to any particular sector, and expects to deliver its final report in June 2013.

Regulatory Impact Analysis

Issue 1: Allowing New Zealand audit firms to incorporate

Options and Analysis

Options	Allows flexibility of firm structure	Protects interests of consumers and investors
Retain the status quo	✗	✓
Recommended option: Allow an audit to be performed by a company	✓	✓ (given the appropriate restrictions)
Recommended option (for overseas bodies): Allow an audit to be performed by a limited liability partnership (LLP)	✓	✓ (given the appropriate restrictions)
Allow an audit to be performed by a limited partnership	✓	✗

18 *Retain the status quo:* The problems with retaining the status quo are outlined above. The benefit is that the additional costs associated with incorporation won't be incurred by audit firms.

19 *Allow an audit to be performed by a company:* As this would allow audit firms to incorporate as a company, audit firms would be able to overcome the limitations of the sole practitioner and partnership models listed above. This may lead to improved domestic competition between audit firms. We have been advised by NZICA that it expects that there would be good interest in the uptake of incorporation, primarily among smaller firms (which are the majority of practices). We have been advised by Inland Revenue that incorporation would not provide any tax benefits for the audit firm.

20 In December 2011, the Ministry of Economic Development released a targeted consultation document on this topic, and submissions were received from BusinessNZ, CPA Australia, FMA, Insurance Council of New Zealand, Marsh Limited (who consulted and received feedback from ACE Insurance, Chartis Insurance NZ and Vero Liability Insurance) and NZICA. There was unanimous agreement that there did not appear to be any reason to continue to prevent the incorporation of audit firms.

21 Providing flexibility in how auditors organise the structure of their business models is an opportunity that would give parity to auditing businesses in New Zealand with international practices, although we do not have data indicating whether incorporation is widely taken up by audit firms overseas.

22 Law firms are able to incorporate in New Zealand under the Lawyers and Conveyancers Act 2006. We are not aware of any other industry of professional services that prohibit the incorporation of its firms. Allowing auditors to provide services through a corporate structure would give them the benefit of limited liability. We do not believe this creates a significant risk. Auditors already include limitations of liability in their terms of engagement. In addition, auditors who practice through an incorporated entity would continue to be subject to the professional and ethical standards issued by the External Reporting Board and disciplinary oversight by their professional accounting bodies.

23 There would be no requirement for an audit firm to incorporate. Costs associated with incorporation as a company may include registration, on-going filing fees and other general costs associated with changing the structure of a business. However, decisions on costs and benefits would be made as part of business decision-making models. There is a possibility that the costs associated with incorporation would be passed on to clients and then customers.

24 *Allow an audit to be performed by a limited liability partnership (LLP):* An LLP is a partnership in which some or all of the partners (depending on the jurisdiction) have limited liability. In an LLP, one partner is not responsible or liable for another partner's misconduct or negligence.

25 There is currently no legislation enabling New Zealand businesses to incorporate as an LLP. Allowing audit firms to incorporate as an LLP would raise wider issues about the availability of this corporate form for providers of other professional services, such as lawyers and building sector professionals. Enabling incorporation as an LLP in New Zealand is a separate, wider policy issue not currently under consideration. Therefore, we do not recommend this option of allowing New Zealand audit firms to incorporate as LLPs.

26 However, we are aware that many audit firms overseas take on the LLP structure. In relation to the practice in paragraph 15(b), from a regulatory and accountability perspective, it would generally be preferable for the overseas firm to be registered and to provide the audit opinion, if it is conducting the majority of the audit work. If the problems in paragraphs 14 to 16 persist, it may impact on the willingness of foreign companies to do business or make investment available in New Zealand in the long term.

27 The recognition of overseas LLP audit firms may also assist with economic growth, as increased competition in the market may promote efficient provision and diversification of accounting and audit services.

28 Therefore, we believe there is merit in recognising overseas LLP audit firms, without enacting such LLP legislation in New Zealand at this time. Further work is planned to operationalise recognition of overseas LLP audit firms, so that only those firms that come from countries with appropriate LLP legislation would be able to operate in New Zealand.

29 *Allow an audit to be performed by a limited partnership:* Under the Limited Partnerships Act 2008, limited partners provide capital and general partners manage the business. Limited partners' details are not made publicly available on the Limited Partnerships Register and are not required to be qualified in the area of accounting or audit. In our view, this model is not suited to auditing because it would compromise the audit independence objective, which is paramount. Law firms in New Zealand are unable to take on the limited partnership model under the Lawyers and Conveyancers Act 2006.

30 We do not consider it relevant to allow audit firms of other corporate forms, such as trusts and incorporated societies, to conduct audits. This is because these other structures are either designed for a specific purpose or for not-for-profit entities.

Conclusion

31 In our view, the prohibition on incorporated firms to conduct audits appears to be unjustified and unnecessarily restricts how audit firms are constituted. We recommend that companies be allowed to conduct audits firms, thus allowing audit firms to incorporate. We also recommend that overseas LLP audit firms be recognised in New Zealand. These options meet the objective to enable greater business form flexibility.

32 To ensure the second limb of the objective is achieved, we propose to follow the example of other jurisdictions and other professional service industries (e.g. lawyers) in New Zealand by imposing certain restrictions when allowing incorporation. Such restrictions would ensure audit professionals can continue to operate with independence and in accordance with their ethical obligations.

Issue 2: Restrictions on audit firm incorporation

33 While there are benefits for firms who decide to incorporate, we believe that audit firm incorporation needs to have restrictions to provide the appropriate level of confidence in the audit process. Other jurisdictions and other professional service industries (e.g. lawyers) taking this step have imposed specific requirements on professional service firms when allowing incorporation, to ensure the professionals can continue to operate with independence and in accordance with their ethical obligations.

34 Submissions to the 2011 consultation document (referred to in paragraph 20 above) generally agreed that restrictions on audit firms are a good idea.

35 Any restrictions imposed on incorporated firms need to provide a balance: they should protect the interests of investors and consumers, whilst not creating disproportionate barriers for firms who wish to take advantage of the benefits of incorporation. The Australian Securities and Investments Commission (ASIC), FMA and NZICA already place restrictions on audit firms in relation to governance, ownership and voting, and professional indemnity insurance (PI insurance).

36 There are currently different regulatory approaches to those auditors and audit firms that conduct issuer audits[2], and those that do not. This, therefore, raises questions about:

a. Whether the same level of restrictions should be placed on classes of audit firms that conduct issuer audits and those who do not; and

b. Who should set these restrictions.

37 The following section addresses options in this area and is followed by analysis on the nature and detail of these restrictions.

Differentiation between issuer and non-issuer statutory audits

Status quo - Issuer audits and the Auditor Regulation Act 2011

[2] These are audits in respect of issuers of securities, banks, insurers and other major financial sector reporting entities.

38 The Auditor Regulation Act 2011 (ARA) came into force on 1 July 2012 and created a new regulatory regime for auditors who carry out issuer audits. The FMA accredits professional accounting bodies to carry out regulatory functions under the ARA such as licensing, registering and monitoring licensed auditors and New Zealand-based audit firms that conduct issuer audits. The FMA also has direct oversight over the performance of those regulatory functions.

39 Other audits required under statute are lower risk than issuer audits because the consequences of audit failure are generally much less serious. For this reason non-issuer statutory auditors have a self-regulation model: auditors are regulated by their professional body, with no independent oversight.

Options and Analysis - consistent or different requirements

Options	Allows flexibility of firm structure	Protects interests of consumers and investors
<u>Recommended option:</u> Apply *stricter* requirements to firms that conduct issuer audits	Limits flexibility (to a larger extent for those issuer audit firms)	Yes
Apply *consistent* requirements to those firms that conduct issuer audits and those that don't.	Limits flexibility (to all audit firms)	Yes

Apply stricter requirements to firms that conduct issuer audits than to those that conduct non-issuer statutory audits

40 The different risk profile between audits of issuers, and other audits required under statute is reflected in the creation of the ARA. It is particularly important that users of audited financial information have confidence in issuer audits and the financial information to which those audits relate. The higher the thresholds for qualified professionals in ownership and governance roles, the higher the assurance that auditor independence would be retained and be seen to be retained. Therefore, there may be a case to have stricter requirements around these areas for issuer audits.

41 There is a risk that any stricter requirements on audit firms that conduct issuer audits would impose barriers for those firms wishing to 'step-up' and become issuer auditors. However, we believe that the benefits of having a robust framework for audit firms that conduct issuer audits outweigh this cost. It is paramount that confidence in these audit firms is maintained.

Apply consistent requirements to those firms that conduct issuer audits and those that conduct non-issuer statutory audits

42 This option would minimise confusion about the level of requirements as they would be the same for all incorporated audit firms. However, the restrictions placed on audit firms that do not conduct issuer audits may be disproportionate to the level of risk these audits entail. We do not see any significant problem with setting consistent requirements to both issuer and non-issuer statutory audits.

Conclusion

43 Given the distinction between the risk profile of issuer audits and other audits required under statute, we believe that there is merit in setting higher requirements for those audit firms that conduct issuer audits. However, it is important to consider concurrently who should be responsible for setting these restrictions.

Options and Analysis – requirements set by regulator or in regulations

Options	Allows flexibility of firm structure	Protects interests of consumers and investors
Recommended option for issuers: Allow the relevant regulator to set requirements	More flexible	Yes
***Recommended option for non-issuers*:** Set the minimum requirements in regulations	Less flexible	Yes

Allow the relevant regulator to set requirements

44 One option is that the relevant regulator could set the levels for the requirements. The main advantage of this option is that regulators are close to the firms, have the expertise to set appropriate levels and can adjust levels in response to events. For issuer auditors, it would be the FMA. This would fit within the FMA's remit and the existing ARA regime, as the FMA has already prescribed minimum standards for registered audit firms who wish to conduct issuer audits. These are attached as Appendix 1. It is likely that the current restrictions would be translated to apply to audit companies as well. This option also allows for flexibility for the FMA to react to market changes.

45 As there is no government regulator for non-issuer audits, under this option it would be the auditor's professional body which would set the levels of restrictions for audit firms that conduct only non-issuer statutory audits. This creates the risk of inconsistent levels being applied by the different professional bodies, which may result in regulatory arbitrage.

Set the minimum requirements in regulations

46 This option is not as flexible as the preceding option, but in respect of non-issuer audits it would mean there is a consistent approach across all incorporated audit firms. It is likely that the professional accounting bodies would be responsible for monitoring and enforcing this legislation, as they must already assess audit firms against their own minimum requirements. Outlining minimum restrictions in legislation is used for the incorporation of law firms in the Lawyers and Conveyancers Act 2006.

Conclusion

47 For the reasons listed in paragraph 44, we believe the FMA is best placed to set the levels of restrictions for issuer auditors that wish to incorporate. However, due to the absence of a government regulator, this option is not suitable for non-issuer audit firms. Nonetheless, we believe it is important that minimum requirements be set for these firms if they incorporate, so recommend they be outlined in regulations.

48 The details of these restrictions that we intend to outline in regulations are discussed below. They are in relation to:

i. Governance;

ii. Ownership and voting; and

iii. Adequate and appropriate professional indemnity insurance (PI insurance).

Restrictions on governance

49 The board of directors in any company have primary responsibility to act in good faith and the best interests of the company. Directors may also have a role in the management of a company. This restriction looks at requiring an incorporated audit firm that conducts non-issuer statutory audits to have a minimum percentage of qualified professionals as directors.

Options and Analysis

50 We considered including 'licensed auditor' in the minimum requirement. These are auditors who are considered qualified to conduct issuer audits under the ARA. New Zealand auditors are issued licences by their professional bodies (which have been accredited and are overseen by the FMA), while overseas auditors are issued licences by the FMA directly.

51 Even though this would ensure that only the most qualified auditors are directors of an incorporated firm, we are of the view that this threshold is too high and is unlikely to be reached by both small and large practices in New Zealand. In our view, small firms are unlikely to conduct issuer audits and thus employ licensed auditors, while large firms deliver such a diverse range of services, such as tax and advisory, that it would be unlikely that every current partner is licensed. Also, the FMA's minimum standards for registered audit firms that conduct issuer audits don't include any reference to licensed auditors, so we do not view it is appropriate for non-issuer audit firms to include this requirement.

52 Comparability with Australia in this instance could be useful as it would contribute to achieving a single trans-Tasman market in auditing services. On the other hand, it is important that the auditor regulation framework be tailored to New Zealand conditions and the needs of users of audited financial statements.

53 There are different regulatory regimes for auditors in Australia and New Zealand. Australia's current requirement for shareholders of incorporated audit firms under the Corporations Act refer to registered company auditors (RCAs). RCAs are directly licensed and overseen by ASIC. However, in New Zealand, there is a distinction between those licensed auditors who can conduct issuer audits and those that can't. Therefore there is no group of auditors in New Zealand that is directly equivalent to Australia's RCAs in terms of qualifications and skills, and regulated by the government.

54 Taking this into account, and New Zealand's accounting and auditing environment where audit services are generally offered as part of a wider range of accounting services, our view is that the threshold of "members of an approved accounting professional body and holding a practising certificate from that body" is appropriate. This is the language used in the FMA's minimum requirements for registered audit firms that conduct issuer audits.

55 We have identified three options regarding the proportion of directors who must be **members of an approved accounting professional body and holding a practising certificate from that body**.

Options		Background	Allows flexibility of firm structure	Protects interests of consumers and investors
a	***Recommended option:*** At least 50%	• Part of the minimum standards for registration of an audit firm set by the FMA (refer Appendix 1). • Same as Appendix IX of the NZICA Rules for 'qualified principals' of practice entities.	Most flexible	To an extent
b	At least 50% Also, at least 75% of directors are required to be members of an appropriate professional body (not necessarily accounting-focussed).	• Same as the minimum standard for partners of registered audit firms set by the FMA.	To a lesser extent	To a larger extent
c	100%	• This 100% threshold is used in the Lawyers and Conveyancers Act 2006 for law firms providing regulated services • 100% threshold used in Australia for audit firms under Part 9.2A of the Corporations Act 2001.	Least flexible	Most likely

56 Consultation responses varied in relation to this threshold to maintain auditor independence, from preferring a simple majority of qualified professionals to 100% of licensed auditors. Small firms and some medium-sized firms are likely to already meet the threshold in option a. Option a and, to a lesser extent, option b allow some flexibility for multi-disciplinary audit firms that may wish to incorporate. We are unsure of how difficult it would be for professional accounting bodies to assess the appropriateness of a professional body that isn't accounting-focussed.

57 In addition, it is important to note that approved accounting professional bodies have their own minimum requirements for practising audit firms and Codes of Ethics to govern their members (including those that aren't auditors) to ensure their members meet their responsibilities to act in the public interest.

Cost of options

58 The higher the conditional threshold, the higher the potential cost models for those audit firms considering incorporation. However, as for options below about ownership of audit companies, sole practitioners would, and many of the smaller and medium-sized firms may, already meet the higher thresholds for accounting and/or other professional governance arrangements. No further costs of incorporation would be imposed in this context for these firms.

59 There may be some audit firms that would need additional suitably qualified individuals to serve as directors. This may increase the costs to those audit companies, which may be passed on to clients through the costs of audits.

60 We don't expect there to be an additional on-going cost for professional bodies, as they must already assess audit firms against their own minimum requirements (however, there may be an additional cost at the start of the re-processing period if the new imposed requirements differ from the professional bodies' current requirements). For example, NZICA is already required to carry out practice and quality reviews of firms from time to time to ensure that professional standards are being maintained. We would not expect there to be a change in the way professional bodies carry out their review and disciplinary processes.

61 No argument has been put forward for independent or additional monitoring of governance or ownership proportions for audit companies.

Conclusion

62 Our view is that option a is the most appropriate, noting that audit firms generally offer a range of services and may embrace different professions as directors (such as lawyers, actuaries and financial advisers).

Restrictions on ownership and voting

63 This restriction looks at requiring an incorporated audit firm that conducts non-issuer statutory audits to have a minimum percentage of qualified professionals as shareholders with voting rights. Restrictions on ownership can be criticised for preventing the emergence of multi-disciplinary firms which can offer a broader range of services to clients, and for reducing the ability of firms to expand by obtaining capital from investors outside of the profession. In particular, access to capital may be important for firms to expand into the market for issuer audits. Therefore, when considering options for restrictions on ownership it is important to remember, and not unduly restrict, the benefits of allowing incorporation in the first place.

64 That said, the purpose of restrictions on ownership and voting restrictions is to protect the interests of consumers and investors by promoting auditor independence, which is an indispensible element of audit.

Options and Analysis

65 The options below discuss the proportion of voting rights attached to shares in the company that must **be held and beneficially owned by members of an approved accounting professional body who hold a certificate of public practice issued by that body**.

Options		Background	Allows flexibility of firm structure	Protects interests of consumers and investors
a	***Recommended option:*** At least 50%	• Same as Appendix IX of the NZICA Rules for 'qualified principals' of practice entities. • 50% threshold is used in Australia's requirement for audit firms under Part 9.2A of the Corporations Act 2001.	Most flexible	To an extent
b	At least 50% Also, at least 75% of the voting rights attached to shares in the company must be held and beneficially owned by members of an appropriate professional body (not necessarily accounting-focussed).	• Same as the minimum standard for partners of registered audit firms set by the FMA.	To a lesser extent	To a larger extent
c	100%	• 100% threshold is consistent with the Lawyers and Conveyancers Act 2006, which allow only actively involved lawyers to hold voting shares[3].	Least flexible	Most likely

66 There was general agreement in submissions that a simple majority of qualified professionals (option a) would be appropriate, as there is no evidence that stricter restrictions are required. Setting such a high level of professional ownership would appear to conflict with objectives of business growth and ease of raising capital.

67 The argument for only a majority is that this provides maximum flexibility for audit firms to grow and offer a range of services by including different professions as owners and raise capital. Option b also provides this benefit, however it is more restrictive than option a.

[3] Non-voting shares are allowed to be held by actively involved lawyers or their relatives.

68 However, under option a, there is a risk that a single external owner with a little under 50% ownership may exert effective control over the company, particularly if the remaining shares are owned by several auditors, with no one individual having a large ownership interest. We do not have any evidence on the likelihood of this scenario.

69 Another issue to consider is whether there should be restrictions on who or what may be a shareholder of an audit company i.e. should it be restricted to natural persons only (as in Australia) or should corporate entities be allowed to be a shareholder.

70 There do not appear to be any grounds to restrict shareholders to natural persons. In fact, this may limit flexibility for the audit company to raise capital as significant input of capital from individuals on an on-going basis is less likely than from other higher capitalised entities. Issues of competition where audit firms could conceivably take over or control other audit firms can be addressed adequately under the current competition policy or takeovers regime. No argument has been raised that it needs to be addressed as a separate issue for audit companies only.

Cost of options

71 Firms with less than 100% audit professional ownership prior to incorporation may have to buy out current partners or make other arrangements with share parcels or seek new shareholders to meet the ownership threshold in the incorporated company. There would be variable costs depending on the difficulties involved and the options taken, which may be passed on to clients through the costs of audits.

72 In relation to professional bodies, the regime described for governance above would also apply here.

Conclusion

73 Our view is that option a is the most appropriate. It offers sufficient protection for consumers and investors, while allowing flexibility. This threshold for this option aligns with Australia's and NZICA's approach. We do not wish to apply a threshold that is too high to prevent firms from expanding to offer a broader range of services.

Restrictions on professional indemnity insurance

74 Most jurisdictions which provide for the incorporation of audit firms also require incorporated firms to have adequate levels of professional indemnity (PI) insurance. This obligation aims to protect clients by promoting that the limited liability offered by incorporation does not affect the ability of plaintiffs to obtain adequate redress in the case of auditor negligence.

Options and Analysis

75 There are a number of viable options identified in relation to setting amounts of cover for mandatory PI insurance:

Options	Background	Allows flexibility of firm structure	Protects interests of consumers and investors
a ***Recommended option:*** Self-assessment by audit firms	This is the status quo. • NZICA's Rules state that practice entities shall at all times have PI insurance over appropriate to the nature and scale of the accounting services it offers to the public. • Comparable to the FMA's approach to PI insurance.	Most flexible	To an extent
b Adopt the Australian approach	Under the Australian Corporations Act 2001, ASIC must be satisfied that the company has adequate and appropriate PI insurance for claims that may be made against the company. For more information, see paragraphs 76 and 77.	To an extent (a high level of mandatory PI insurance may discourage firms to incorporate)	To a larger extent
c Setting a mandatory level of insurance to be held by all firms	The FMA would set the requirements for incorporated practices that carry out one or more issuer audits. Accredited bodies would set the PI insurance requirements for incorporated practices that carry out other audits required under statute.	To an extent (a high level of mandatory PI insurance may discourage firms to incorporate)	Most likely

76 For option b, ASIC determines the amount by looking at the maximum estimated fee that could be charged by the authorised audit company. If the maximum engagement fee is estimated to be $50,000 or less, the insured amount will be not less than $500,000 for any one claim and in aggregate. If the maximum engagement fee is estimated to be more than $50,000 the insured amount will be not less than ten times the estimated maximum engagement fee up to a maximum figure of $20 million for any one claim or in the aggregate.

77 Audit companies themselves are required to estimate the largest audit fee that they are likely to charge for the purposes of this text. The estimate must be approved by a resolution of the board of directors of the audit firm and provided to ASIC when an application is made to register the company. The estimate is also required to be updated each year in the annual statement that audit firms are required to lodge with ASIC.

78 In regards to option b, there is no equivalent regulator for non-issuer statutory audits. This option would present a problem of identifying a suitable body to set the levels of restrictions for the audit firms that conduct these audits.

79 Option a is the most flexible option. Options a and b provide surety of cover to investors and, to a large extent, certainty of costs for the incorporated audit firm. In general, PI insurance may well be more affordable when linked to an incorporation model and limited liability.

80 However, neither option a nor b allows for discretion to be applied, in contrast with the status quo. No concerns about a lack of standardisation have been raised with the status quo. The Australian approach is also linked to limited liability schemes that cap maximum liability. Issues of limiting auditor liability by proportionate liability or capping maximum liability are not addressed in this paper.

81 Submissions have not identified any problems with the status quo and there was agreement that PI insurance should continue to be mandatory. However, the option of independent consideration of the appropriate scale and scope of PI cover for an incorporated audit firm has been considered. Taking into consideration the risk profile of the non-issuer statutory audits that are to be conducted by these audit firms, we consider it unnecessary.

Cost of options

82 In order for assessments by the FMA or accredited bodies to work, insurance assessment advice would need to be purchased and a system set up that would not disadvantage too many firms. This would be a cost that the FMA or accredited bodies would need to pass on to audit firms. The ‘averaging’ of insurance cover amount would run the risk of a “one size fits all” approach that may not be appropriate.

83 We don’t expect there to be additional costs for the FMA or accredited bodies under option a. The FMA currently expects accredited professional bodies to make an assessment of a registered audit firm’s PI insurance, having regard to factors such as the size and risk of the audit firm’s audit and assurance clients, its track record for claims under indemnity policies, and the conditions attaching to an indemnity policy.

84 There may be some firms that currently have low levels of PI insurance. The imposed levels of PI insurance to be held by incorporated audit firms may require firms to purchase the additional cover required to meet certain thresholds.

Conclusion

85 Our view is that option a is the most appropriate, as it provides sufficient protection to consumers and investors, while maintaining flexibility in relation to firm structure. This is the current approach used by ASIC, FMA and NZICA.

Consultation

86 As discussed above in paragraph 20, the Ministry of Economic Development released a targeted consultation document in December 2011.

87 There was unanimous agreement in submissions that there did not appear to be any reason to continue to prevent the incorporation of audit firms. There was a variety of responses as to whether and what sort of restrictions should be placed on governance and ownership of those firms ranging from simple majority to 100% licensed auditors.

88 For PI insurance requirements, there was a degree of pushback on whether there was a problem with the status quo of self-assessment by audit firms, and whether it was appropriate to prescribe a level of assessment, particularly if liability issues were not to be addressed at the same time.

Conclusions and Recommendations

89 We believe that the prohibition for body corporates to undertake audits in the Companies Act 1993 and Securities Act 1978 provides no benefits to investors and consumers. The partnership model creates a number of limitations for audit firms, including difficulties managing firm growth and enabling ease of ownership, and limiting access to business finance.

90 Nearly all of the jurisdictions we usually compare ourselves with allow for incorporation in one form or another, including Australia, the UK, Singapore, most Canadian provinces and U.S. states. Providing flexibility in how auditors organise the structure of their business models is an opportunity that would give parity to auditing businesses in New Zealand with international practice. It is possible that allowing audit firms to incorporate would contribute to New Zealand's economic growth, as it may improve competition between audit firms, both domestically and internationally, by promoting efficient provision and diversification of accounting and audit services. Submitters all supported the proposal to allow audit firms to incorporate.

Issue 1: Allowing incorporated firms to conduct audits in New Zealand

91 We believe audit firms should be allowed to incorporate, however, they should be able to take on the company structure only. We do not recommend that new limited liability partnership (LLP) legislation is needed or that audit firms should be able to operate under the Limited Partnerships Act as this model would compromise the audit independence objective. But we recommend that New Zealand recognise overseas LLP audit firms constituted in appropriate jurisdictions. This is because New Zealand's prohibition on incorporation makes it difficult for overseas issuers operating here to find a suitable auditor who understands the reporting requirements of both their home jurisdiction and New Zealand.

Issue 2: Restrictions on audit firm incorporation

92 We recommend imposing restrictions in relation to the governance, ownership and PI insurance of incorporated audit firms, to ensure there is sufficient flexibility for firms while protecting auditor independence and the interests of consumers.

93 We believe the FMA is best placed to set the minimum restrictions on those audit firms that conduct issuer audits. This reflects the different treatment of issuer and non-issuer statutory audits under the ARA, and fits in with the FMA's role overseeing the regulation of issuer auditors.

94 As there is no equivalent regulator for non-issuer statutory audits, it is more difficult to identify a suitable body to set the levels of restrictions for audit firms that conduct only non-issuer statutory audits. However, we believe it is appropriate that minimum requirements be set for these incorporated audit firms, and so recommend they be outlined in regulations. This would ensure that all incorporated audit firms meet the same minimum standards (and minimise the risk that professional bodies would apply differing standards).

95 Taking into consideration the current audit firm restrictions set by ASIC, FMA, professional accounting bodies, and the views of submitters, we intend to implement the following restrictions in relation to those audit firms that conduct non-issuer statutory audits:

- Governance – the **majority** of directors of the company must be members of a professional accounting body and hold a practising certificate issued by that body.

  Rationale: This option aligns with NZICA's current approach. It also takes into account the multi-disciplinary audit firms that may wish to incorporate, and embrace different professions as directors.

- Ownership and voting – the **majority** of voting rights attached to shares in the company must be held and beneficially owned by members of a professional accounting body who hold a practising certificate issued by that body.

  Rationale: This threshold for this option aligns with Australia's and NZICA's approach. We do not wish to apply a threshold that is too high to prevent firms from expanding to offer a broader range of services.

- PI insurance – **all** audit companies must have PI insurance cover that is adequate and appropriate for the scale and nature of the firm's business.

  Rationale: This is the current standard for ASIC, FMA and NZICA.

Implementation

96 The recommended options can be implemented by an amendment to the Companies Act 1993 (and other Acts and Regulations which adopt the Companies Act test) and the Securities Act 1978. This may also require amendments to the Auditor Regulation Act 2011.

Monitoring, Evaluation and Review

97 We intend to monitor the result of allowing audit firms to incorporate, and whether there are issues with the restrictions imposed. We would do this by noting any complaints to the Minister of Commerce or MBIE about audit quality and independence, and through regular communications with those close to the audit market, such as the FMA, NZICA and other accredited bodies and the Registrar of Companies.

Appendix 1: "The Auditor Regulation Act (Prescribed Minimum Standards and Conditions for Licensed Auditors and Registered Audit Firms) Notice 2012"

8. Prescribed minimum standards for registration as a registered audit firm

(1) For the purposes of section 25(1)(b) and section 26(1)(d) of the Act, the following minimum standards are prescribed under section 32(1)(d) of the Act in respect of each audit firm that applies for registration:

(a) at least 75% of all partners of an audit firm must be members of an appropriate professional body;

(b) 50% of all partners of an audit firm must be members of an approved professional accounting body and hold a practising certificate issued by that professional accounting body;

(c) all partners of an audit firm must be fit and proper persons, as assessed by the relevant authority;

(d) the audit firm must have systems, policies and processes which:

(i) comply with the requirements of PES1, PES2 and PES3; or

(ii) in the case of an overseas audit firm:

A materially comply with the requirements of PES1, PES2 and PES3; and

B comply with the requirements of the corresponding standards applicable in the audit firm's home jurisdiction;

(e) all audit firms must have any other systems, policies and procedures which are necessary or desirable to reasonably ensure compliance with the requirements of New Zealand auditing and assurance standards relating to issuer audits;

(f) key decisions and judgements involved in an issuer audit must be subject to engagement quality control review by another licensed auditor;

(g) each audit firm must have professional indemnity insurance that is adequate and appropriate for the nature and scale of the audit firm's business activities.