Regulatory Impact Statement

Restricted areas of statutory audit work

Agency Disclosure Statement

1 This Regulatory Impact Statement ('RIS') has been prepared by the Ministry of Business, Innovation and Employment.

2 It provides an analysis of options to promote an efficient audit market where suitably-qualified and competent accountants and auditors are allowed to undertake the appropriate level of work they are qualified to do.

3 There are some constraints on the analysis. We do not know whether the existing restrictions have actually deterred any additional New Zealand-based professional bodies from starting up, although we do know the restrictions are an actual barrier for New Zealand-based members of overseas bodies. There is also limited data on the effects of self-regulation in the audit industry to date. However, we have found no evidence that the existing self-regulation model is inadequate.

4 On the matter of audit pricing, we do not have data or models predicting the extent of a price increase if heavier regulation were imposed, nor on whether the price will decrease if the audit market is opened up to wider competition. We have assumed, however, based on generally accepted market principles, that there will be some increase and decrease in these respective situations.

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Summary

5 Existing regulatory barriers prevent some competent auditors from performing non-issuer statutory audits. In particular, the rule requiring members of overseas-based accounting bodies to be able to work in the body's home jurisdiction is problematic for New Zealand-based members of Australian bodies, due to the particular requirements of the Australian regime. The driver for considering this work now is that the New Zealand membership of Certified Practising Accountants Australia (CPA Australia) is steadily expanding but its members are restricted by this rule from performing certain audits they are capable to do.

6 This RIS examines alternative ways to recognise overseas professional bodies, to allow auditors to do the work they are competent for, while maintaining audit quality. In assessing how to ensure quality, we examine models of regulation from none to direct regulation. We recommend that self-regulation is the appropriate model.

7 We then assess practical ways to address the problem that some auditors are prevented from doing work they are qualified to do, and recommend that accreditation under the Auditor Regulation Act 2011 (ARA) is a suitable proxy to deem bodies qualified to approve members to perform statutory audits.

Introduction

8 This RIS identifies barriers which prevent some competent auditors from performing non-issuer statutory audits (as defined in Appendix 1) and examines regulatory options for an effective audit market which allows suitably-qualified auditors to do the work, while ensuring quality of audits is maintained. The first issue we consider is whether the existing self-regulatory framework for non-issuer statutory audits is the right level of regulation, or needs to be replaced. Following analysis we conclude that it is suitable. The second issue considers specific ways to address the problem, within the model of self-regulation. The status quo and technical terms used in this paper are explained in detail in Appendix 1.

Objectives

9 The overarching objective in this policy is to promote an efficient audit market where suitably-qualified and competent accountants and auditors are allowed to undertake the appropriate level of work they are qualified to do.

10 Our view is that there are three key criteria when considering any changes, with the first two being most significant:

- Promoting quality audits – users of financial information should continue to be confident that non-issuer statutory audits are high-quality and can be recognised by key trading partners. Several submitters emphasised to us that this is the critical factor for them.
- Flexibility to allow for future changes in the market – it is important to have a mechanism which allows qualified auditors (and thus their professional bodies) to enter the New Zealand non-issuer statutory audit market without the need for further legislative changes.
- Causes no or minimal disruption in the market – recognising that the Act's issuer audit model is in effect, we need to ensure that any changes impose minimal costs on auditors, businesses and taxpayers whilst achieving the above two criteria.

11 Submitters to the targeted consultation on this topic agreed the objective and criteria are appropriate.

Status Quo

12 New Zealand specifies in statutes which people may do certain types of audits. The types of audits and the regulatory regimes are explained in detail in Appendix 1, but may be summarised as:

- Issuer audits may only be done by licensed auditors, who are subject to a co-regulatory regime. They are overseen by their professional body and the Financial Markets Authority (FMA).
- Most non-issuer statutory audits may be done by someone who is either: a licensed auditor, a chartered accountant member of the New Zealand Institute of Chartered Accountants (NZICA), or an auditor eligible to work in another country who is directly approved or a member of an approved body. These auditors are subject to a self-regulatory regime, that is, they are regulated by their professional body.

Problem Definition

13 The current regulatory settings create barriers to entry to the non-issuer statutory audit market for auditors who belong to certain professional bodies. This prevents some auditors from performing audits for which they are capable and qualified. This has the potential to limit the pool of auditors available in New Zealand, which in turn is likely to result in higher audit costs for New Zealand firms.

How the status quo creates the problem

14 The problem with the status quo relates to company and other non-issuer statutory audits. Legislation restricts who may do certain accounting and auditing work, with the effect that some potentially competent and suitably qualified persons are barred from performing non-issuer statutory audits. There are 3 causes of this problem.

Cause 1: reliance on auditor being able to act in home jurisdiction

15 Individuals not belonging to NZICA or an accredited body may perform company audits if they are approved or a member of an approved association and eligible to act in another country.[1] This requirement aims to ensure that practitioners who are banned, or do not meet the required quality standard in their home jurisdiction cannot practice in New Zealand. The requirement relies on a presumption that such people also would not meet New Zealand's quality requirement. Usually, this is a legitimate presumption. However, other countries may bar auditors for reasons other than quality, which may restrict competent people.

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[1] Members of approved associations must be able to act in the country in which the association is constituted.

16 This is problematic for New Zealand members of Australian professional bodies. For example, only Registered Company Auditors (RCA) can do company audits in Australia. The Australian Securities and Investment Commission (ASIC) registers RCAs but has a statutory discretion to refuse registration to those not resident in Australia. New Zealand-based members of Australian professional bodies usually aren't resident in Australia, so cannot meet the Australian eligibility criteria and therefore our Companies Act criteria.[2] CPA Australia, an Australian-constituted professional body has reported this is an actual barrier for its New Zealand-based members. To perform audits in New Zealand, these members have to join NZICA and gain the chartered accountant designation. This duplication of membership is costly and inefficient.

17 As the provisions in the Companies Act are cross-referenced in many other statutes (as outlined in paragraph 84c below), this issue is not limited to company audits but applies to some other non-issuer statutory audits as well.

Cause 2: restriction to 'chartered accountants'

18 In some cases, legislation specifies that only 'chartered accountants' may carry out certain types of work. For example, the Lawyers and Conveyancers Act 2006 specifies that only a 'chartered accountant'[3] may be engaged to examine lawyers' accounts for irregularities. This requires some work to be performed by NZICA members, even though there are potentially members of professional bodies that are also suitably-qualified.

Cause 3: requirement for a body to be constituted outside New Zealand

19 There is not currently any way for another New Zealand-constituted membership body to become approved and allow its members to conduct non-issuer statutory audits. This does not promote an efficient audit market as it is a barrier to entry for this type of organisation. We do not know whether or how many bodies would have been started, if this provision didn't exist.

Non-audit functions

20 The types of work reserved for 'chartered accountants' extend beyond traditional audit or even accountancy functions in places, as the quality control measures which ensure NZICA meets its statutory obligation are used as a proxy to identify trustworthy people. For example, the Rates Rebate (Witnessing of Declarations) Notice 1977 authorises chartered accountants to witness declarations for the purposes of the Rates Rebates Act 1973. These roles pose a much lower risk than audit work as they do not require a particular skill. This has the same effect of excluding some competent people who choose to belong to a member organisation other than NZICA and thus cannot hold the 'chartered accountant' designation.

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[2] For other statutory audits in Australia that do not require registration as a company auditor, there is still uncertainty for New Zealand-based members in determining which audits they can undertake in New Zealand.

[3] Or an officer, member or inspector of the Law Society or Conveyancers Society – see section 109 Lawyers and Conveyancers Act 2006

Effect of the status quo

21 Overall, the status quo operates as a barrier to entry to new professional bodies, and with them, their members. This may have the effect of limiting the pool of auditors available in New Zealand. The range of entities from large charities to small companies need access to cost-effective audit and assurance services. The limitation is likely to particularly affect entities at the smaller end of the market, where assurance services may be disproportionately expensive to the size of the entity.

22 New Zealand-based members of CPA Australia are a significant group affected by the first and third cause of the inequality. CPA Australia has 993 members in New Zealand and is investing in its student program in New Zealand universities: it currently has 5,225 student members and projects this number to increase by 7,200 over 3 years. As mentioned above, CPA Australia is accredited by the FMA under the ARA to license auditors and approve the registration of audit firms in relation to issuer audits. Approximately one third of CPA Australia members based in New Zealand hold both ‘CPA’ and ‘CA’ designations (that is, they also maintain membership of NZICA) to enable them to freely undertake non-issuer statutory audits in New Zealand.

23 Overall, our view is that the existing statutory limitations of who may undertake audits and the statutory roles reserved for NZICA’s chartered accountants create an inefficient situation given that other professional bodies can meet the same high standards as NZICA. That is, the status quo excludes competent individuals from carrying out work that they are qualified to do.

Regulatory Impact Analysis

24 There are models across the regulatory spectrum for addressing the limitations of market access in the status quo while ensuring a high quality audit market. The first issue assesses whether there is a need to move away from the existing model of self-regulation. The available models considered are:

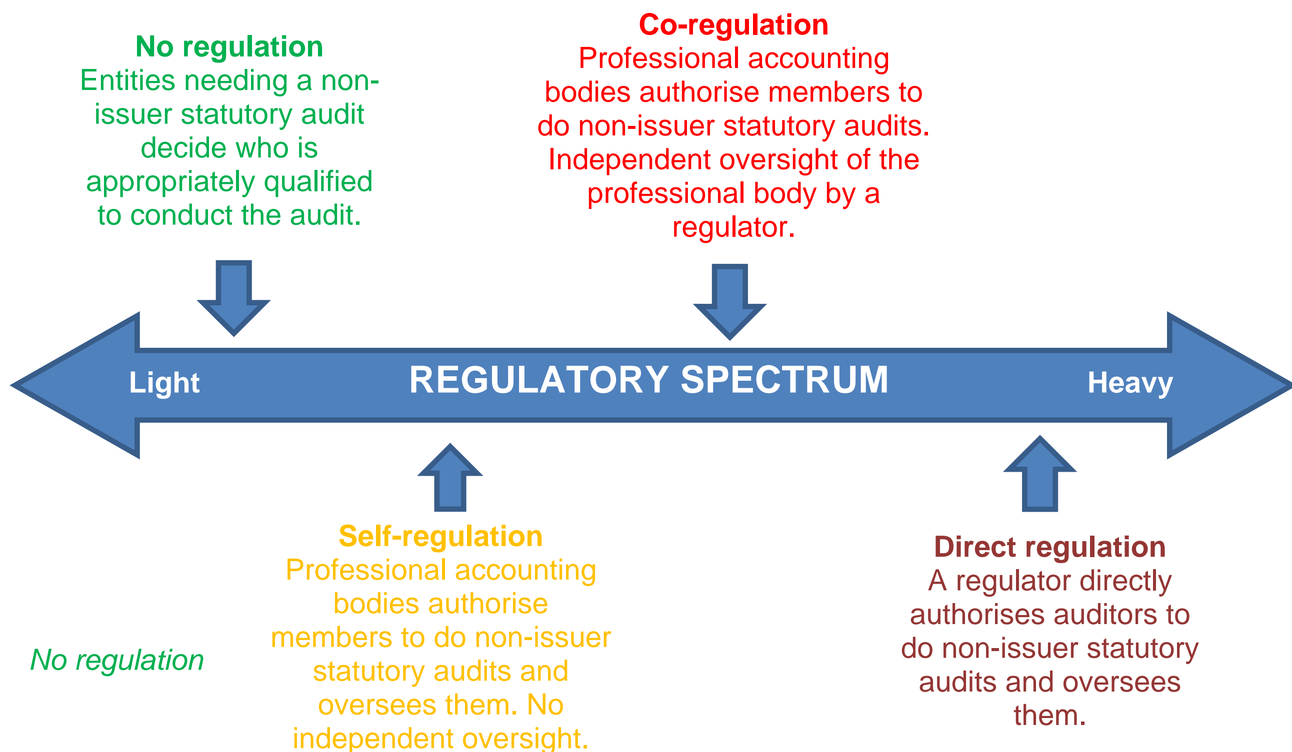
- No regulation.
- Self-regulation.
- Co-regulation.
- Direct regulation.

25 We conclude that greater regulation is not justified, and recommend to retain the self-regulatory model. The second issue then considers specific ways to address the problem, within the preferred model of self-regulation. These options are:

- Retain the status quo.
- List additional bodies in legislation.
- Deem professional bodies accredited under the ARA to be qualified.
- Remove the requirement to be eligible to act in the home jurisdiction.

i) Issue 1 – which regulatory model?

26 The spectrum of regulatory models is illustrated below, and then discussed in the text following. In considering what would be the most appropriate option, one issue is whether independent oversight of this area is warranted. Independent oversight can be used in both a co-regulatory and direct regulation regime.



27 This is included to show the extent of the spectrum, but is not being considered as an option. Having no regulation would fail to ensure auditors are suitably-qualified for the work and thus would not promote quality audits.

Option 1: Self-regulation

28 The existing model of regulation is self-regulation. Certain professional bodies are approved to authorise their members to perform non-issuer statutory audits, and are responsible for overseeing those members. This may incentivise professional bodies to appropriately regulate members who carry out non-issuer statutory audits to uphold their reputation, retain members and enhance public confidence in members.

29 On the other hand, there is a risk of professional bodies not maintaining the standard met at the time of approval. Self-regulation may result in variable approaches between professional bodies in ensuring their members are appropriately qualified, which may reduce confidence levels in the users of the information. While it is possible that an incentive exists for auditors to choose the body with the lowest standards, we have no evidence that this is an issue after 20 years of operation of the self-regulatory option.

30 Under this model the cost of regulatory oversight is borne by the professional bodies, which reclaim it from members as membership fees. As a continuation of the status quo, it would carry no implementation costs for the existing professional bodies. Any new professional body seeking approval may incur costs in implementing any systems and processes necessary to demonstrate sufficient regulation of members.

31 While the self-regulation model seems to be working well in practice in New Zealand, the self-regulation of audit functions is generally inconsistent with international norms. Australia has a direct-regulation model, for example, and the UK a co-regulatory model. More information on these models is provided in Appendix 2. New Zealand has already diverged from these jurisdictions in the higher-risk area of issuer audits. To re-align would require a significant overhaul of the entire audit regulatory system, which is not within scope of this review.

32 On balance, we consider the benefits of this model outweigh the risk and it remains an appropriate option.

Option 2: Co-regulation

33 In a co-regulatory model, independent oversight involves auditors being regulated by an approved professional accounting body, which is in turn overseen by an independent government regulator. The regulator would ensure that each professional body is applying sufficient systems in authorising, training, monitoring, investigating and disciplining its members. This would essentially widen the model that is in place for issuer auditors under the ARA, to apply to all statutory auditors, albeit perhaps with less stringent requirements to reflect the systemic risk difference between issuer and non-issuer statutory audits.

34 The rationale for including only issuer auditors in the ARA was that there is a special public interest in issuers, which does not exist for other types of statutory audits. As issuers take money from the public, there is a risk of widespread negative effects if these businesses fail. There is no suggestion that this situation has changed.

35 Independent oversight satisfies the first criterion listed in paragraph 10 of promoting audit quality, as there would be an additional level of checking, to ensure that the professional body allows only competent auditors to perform the audit, and checks that they perform them well. It reduces the risk that professional bodies would apply different levels of standards, as a common regulator would identify and reconcile this.

36 However, it does not of itself meet the main objective of ensuring auditors are allowed to perform the level of work they are qualified to do, nor allow for future changes in the market – it would need to work in conjunction with change to how professional bodies become approved to meet this objective.

37 This option fails to meet the criterion of minimising disruption to the market. Introducing oversight of professional bodies' role in regulating non-issuer statutory auditors would add a significant level of complexity and cost to the professional bodies and their members, which we think would ultimately be passed on to their clients.

38 A co-regulatory approach with independent oversight has been adopted in other jurisdictions. In the UK, recognised qualifying and supervisory bodies (RQBs and RSBs) regulate statutory auditors, and are in turn supervised by the Financial Reporting Council.

39 The two main professional accounting bodies in New Zealand, NZICA and CPA Australia, will already be subject to oversight under the ARA. The extent to which this oversight for non-issuer statutory auditors would overlap with that under the ARA is uncertain. Some professional bodies' systems for non-issuer statutory auditors will be the same as those already checked by the FMA for issuer auditors. However, not all will be and the FMA does not assess those systems with non-issuer statutory auditors in mind. The FMA is unable to estimate the cost of extending their oversight to non-issuer statutory audits without significant exploratory work.

40 There is no existing regulator which is a natural fit with this type of oversight. Although the FMA already have oversight of professional bodies in respect of issuer auditors, their responsibility is the conduct of financial markets; a role of overseeing non-issuer statutory auditors would be outside its core focus. Several submitters commented to this effect. Similarly, the Registrar of Companies has an existing role assessing overseas bodies for Gazettal, but on-going oversight is not suited to the Registrar's capabilities. The lack of a natural-fit regulator means the set-up costs for a regulator would be significant.

41 In targeted consultation, we received mixed responses about the costs and benefits of independent oversight in a co-regulatory model. Some submitters suggested oversight was warranted (but not necessarily at the level of ARA oversight) to ensure high audit quality and to keep pace with international partners. However, no evidence was provided of any regulatory failure with the existing approved bodies, nor any evidence that such a failure might arise if more bodies were added.

42 Most submitters also noted that independent oversight would add extra cost. Several also noted that ensuring audits were accessible was important - increasing the supply of auditors is one factor of accessibility, but keeping costs proportionate to the size of the audit or of the audited entity is another. We have not scoped the cost to government and the accounting industry of independent oversight, but submitters thought the cost would be high. We note the accreditation and oversight costs for professional bodies under the ARA are high. As an indicator, CPA Australia reports it spent more than $250,000 on external advisors during the accreditation process – as well as the application fee, the cost in time and money of travelling to meetings with the FMA, and the staff hours involved in the process.

43 In summary, oversight would achieve the criterion of promoting quality audits, would achieve the extra benefits of aligning New Zealand's regulation with other jurisdictions and may reduce inconsistencies or variable levels of self-regulation across professional bodies. However, alone it fails to meet the main objective of enabling competent auditors to do the work they are qualified for. It also fails to meet the Government Statement on Regulation requirement to introduce new regulation only when we are satisfied that it is required, reasonable, and robust. We believe there is not sufficient evidence of a regulatory failure in the existing market, or indication that there will be a failure, to warrant the cost and market disruption that oversight would bring. Moreover, oversight is not the only way to achieve the criteria listed above, as the other options indicate.

Option 3: Direct regulation

44 One option is to remove professional bodies from the equation and require a government regulator to directly regulate auditors. This form of independent oversight is the approach taken in Australia. ASIC directly regulates auditors through regular inspections of audit firms' quality control systems, auditor independence and quality reviews of audit working paper files.

45 Despite the Australian precedent, we have discounted this option as it has already been considered in depth in relation to issuer audits in New Zealand, in the creation of the ARA Issuer audits are widely considered higher risk than non-issuer statutory audits because of the systemic risk they pose, yet it has been decided that even they do not warrant direct regulation. Therefore, logically this option should not be adopted for lower-risk non-issuer statutory audits.

Conclusion on which regulatory model

46 We have found no compelling evidence of a problem with the existing self-regulation regime to justify a move along the regulatory spectrum to co- or direct regulation. While co-regulation would ensure high audit quality and maintain consistency with the regulatory regimes of international partners, it would also impose significant set up and maintenance costs. These costs would need to be borne either by government or by the audit industry, which we expect would in turn be passed on to their business clients.

47 Therefore, we propose to maintain the current self-regulatory regime.

ii) Issue 2 – how to address the problem?

48 There are a number of options to address the problem at hand, within the model of self-regulation. These are summarised in the below table with the preferred option highlighted, and discussed in detail in the text following.

	Auditors can do the work they are qualified for	Promote quality audits	Allow for future changes in the market	Minimal disruption to market
1A: Retain the status quo	✗	✓	✗	✓
1B: List additional professional bodies in legislation	✓	✓	✗	✓
1C: (Preferred option) Professional bodies accredited under the ARA are deemed qualified	✓	✓	✓	✓
1D: No need to be eligible to act in the home jurisdiction	✓	✗	✓	✓

Option 1A: Retain the status quo

49 An option is to maintain the status quo, as summarised in paragraph 12 above - that only NZICA chartered accountants, licensed auditors and members of approved overseas auditor associations eligible to act in the association's home country may conduct non-issuer statutory audits. Overseas auditors associations are approved by the Registrar of Companies by notification in the Gazette, following an application process in which the applicant provides information that will enable the Registrar to consider whether it warrants approval.

50 Although this option on its own does not support the objective that all competent auditors are able to undertake the appropriate level of work, the application and gazettal process does work for many organisations whose home country's laws do not operate as a barrier. This process does allow for future changes and does not disrupt the market. On balance, we consider it is an appropriate option for the bodies it works for, but on its own is not sufficient to solve the problem.

Option 1B: List additional professional bodies in legislation

51 The professional accounting bodies that may authorise members to undertake non-issuer statutory audits could be directly specified in primary or secondary legislation. Each body would be responsible for ensuring its members are appropriately qualified. This would be an extension of the status quo, but allow for the approval of other professional bodies.

52 This option would meet the objective of ensuring competent auditors can do the work they are qualified for. As Parliament would have to satisfy itself of a body's suitability, this option would promote audit quality at the approval stage. Specification in primary legislation would not be very flexible in allowing for future changes in the market, however, as each new approved entity would require a legislative amendment for approval and revocation if necessary. This would be time and resource intensive. Secondary legislation would be more flexible, but would still require the resources of the advising department, Cabinet and parliamentary drafters. In particular, a new process would be needed to assess professional bodies seeking to be added to legislation. In practice, officials would consider the same matters as the FMA does in assessing for accreditation, but without the FMA's budget, resources or expertise. If approval needed to be revoked, the equivalent legislative instrument would again be required.

53 The option would address the problem, but would require a significant new process and resources to implement and manage. Given the resource issue involved this is not our preferred option.

Option 1C: Professional bodies accredited under the ARA are deemed qualified

54 Professional accounting bodies accredited under the ARA could be deemed qualified to authorise members to undertake non-issuer statutory audits. The FMA already checks the professional bodies' systems, processes and rules in assessing their competency to license issuer auditors and then monitors accredited bodies, creating a robust quality assurance framework for licensed auditors.

55 The accreditation would act as a proxy or indicator, with non-issuer statutory audit 'piggybacking' on the issuer auditor regime. The accredited body would regulate its members and decide which are competent to undertake non-issuer statutory audits, but would not have to implement a licensing system. The FMA would continue to oversee the professional bodies in relation to issuer audits only.

56 While we believe this option would promote quality audits it relies on an assumption that a body that meets the very high ARA standards would not fall short in other parts of its business, e.g. ensuring the quality of non-issuer statutory auditors. We think it is reasonable to place significant weight on this assumption: the governance and many of the systems in place in audit firms are likely to cover both issuer and non-issuer statutory auditor regimes.

57 A factor which gives additional weight to this assumption is that the ARA regime requires accredited bodies to be members of the International Federation of Accountants (IFAC). IFAC requires bodies to comply with its Statements of Member Obligations (SMO) for both issuer and non-issuer statutory auditors. These Obligations ensure the body maintains certain regulatory systems. For example, SMO 1 requires "a mandatory quality assurance review system shall be in place for firms performing audits of financial statements".[4]

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[4] SMO1, para 15. https://www.ifac.org/sites/default/files/publications/files/Statements-of-Membership-Obligations-1-7-Revised.pdf

58 Key advantages of this option are that it leverages off an existing process, has minimal implementation and ongoing costs, does not require the FMA to move outside its core function of regulating financial markets, nor take on extra work or re-examine entities already accredited. If a body's standards drop in relation to issuer auditors, the FMA may cancel or suspend accreditation and any licenses the body has granted are correspondingly cancelled or suspended. This proposal would create the same corresponding effect for non-issuer statutory auditors: their ability to act would be automatically suspended or cancelled with the accreditation. We believe this is appropriate as a cancellation or suspension would only occur in serious circumstances and the ARA has provisions designed to forewarn of such moves.

59 There is a risk in the assumption that a body that meets ARA standards would not fall short in other parts of its business. The FMA believes this is a real risk and that there is no basis to assume a body would have similarly robust systems and processes to regulate issuer and non-issuer statutory auditors. The impact if this risk materialised would be that a low-quality membership body may allow incompetent auditors to undertake non-issuer statutory audits, with a consequential risk of shareholders relying on the auditor's assessment to their detriment. This would damage the reputation of the accountancy profession.

60 However, we consider the likelihood of this risk to be low. There is no indication that the existing professional bodies operating in New Zealand are substandard. Any accredited body would have demonstrated it has the governance structures and financial stability to put strong registration, monitoring, disciplinary and oversight systems in place with sufficient resources to operate them. The bodies involved would have an incentive to regulate robustly to prevent reputational damage and thus retain members, particularly in a competitive environment. Lastly, the requirements of IFAC membership are an additional safeguard against this risk.

61 This option also creates an 'expectation gap' risk. In its assessment under the ARA of an applicant body's ability to license and regulate issuer auditors, the FMA does not consider any factors specific to the body's ability to regulate non-issuer statutory audits. This creates a risk that people may believe non-issuer statutory audits are subject to independent oversight when this would not be the case. For example, shareholders who rely on an auditors' work may believe that they would have recourse to the FMA over a professional body's investigation of a substandard non-issuer statutory auditor, when they would not. This creates a reputational risk for the FMA. This risk could be mitigated with a clarifying statement in legislation and a pro-active communications programme aimed at auditors and vulnerable parties, although the FMA believes it is not clear whether this would have any effect.

62 This option also prevents a professional body from specialising only in non-issuer statutory auditors, without taking on the extra work needed to license issuer auditors. Our view is that it is unlikely that a professional body willing to invest in entering the New Zealand market will undertake strictly this line of work. Foreign bodies would still have the option to use the existing approval process, if their home jurisdiction does not have problematic rules such as those outlined in paragraph 16 above.

63 While we recognise the risks with this option, on balance we believe they are low and that the option addresses the problem in the most efficient manner. For this reason it is our preferred option.

Option 1D: Remove the requirement to be eligible to act in the home jurisdiction

64 One option to specifically address the third cause of the problem – the limitation on professional bodies arising within New Zealand – is to remove the second limb of the test in s 199(1)(c), that is, the requirement that the auditor is "eligible to act as an auditor in the country, State, or territory in which the association is constituted". This would allow more auditors the ability to act in the New Zealand market, but it removes a key safeguard, as outlined in paragraph 88. Without this safeguard a banned auditor, or one who is not yet at the level to perform non-issuer statutory audits in their home country, could be eligible to act in New Zealand. Therefore, this option does not meet the criterion of promoting quality audits and for this reason we do not recommend it.

Other matters: non-audit functions

65 The same problem that some competent auditors are prevented from performing particular roles applies to some non-audit functions. This is because statutes restrict the ability to perform these functions based on factors other than competency, for example, they are instead based on membership of a particular professional body. We consider there are three options in relation to non-audit functions. First, retain the status quo – that is, usually non-audit functions are restricted to "chartered accountants", restricting these roles to NZICA members. This option has no implementation costs and gives certainty to users – it is easy to identify who it applies to. However, it does not meet the objective of enabling suitably-qualified auditors to undertake work regardless of which body they belong to and thus we do not recommend it.

66 Second, any professional body allowed to authorise its members to perform non-issuer statutory audits could authorise members to perform non-audit functions. This option would allow accountants to perform these roles regardless of which professional body they belong to. It would also allow the pool of authorised accountants to be wider than merely those able to perform non-issuer statutory audits, which mirrors the status quo where all chartered accountants can do this role. However, this option might create uncertainty for potential clients seeking an accountant authorised to perform non-audit functions – the classes of people authorised to perform these roles would not be explicit in legislation as it is under the status quo. On balance, we believe the benefits of this option outweigh this risk and it best meets the objective.

67 A third option is to consider each type of non-audit function on its merits and apply a relevant threshold depending on the complexity and risk of the function being undertaken. This option would create inconsistent approaches and may increase complexity. We consider that this is a disproportionate response to the relatively low level of risk in non-audit functions and do not recommend it.

Conclusions and Recommendations

68 The main issue is that the existing legislative regime requires members of an approved membership body to be eligible to act in another country. This requirement is intended as a safeguard, to ensure audit quality. We believe it does achieve that objective, and is not a barrier for most competent members of overseas organisations wishing to operate in New Zealand. However, it does bar some competent auditors, and is not the only safeguard that can achieve the aim of audit quality.

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69 Therefore, we propose to add an additional, alternative test into s 199. Our proposed alternative is to require the auditor to be a member of a body accredited under the ARA, and designated by that body to be able to perform the type of audit at hand. The safeguard that this test provides to ensure quality audits is that the body has shown through its accreditation that it has sufficient systems, processes and rules in place to license issuer auditors. We believe this justifies an assumption that it would also have adequate systems to regulate non-issuer statutory auditors.

70 This option causes no disruption in the market. It harnesses an existing process, and will not incur any compliance costs for the current industry players. Nor will it impose any cost on the taxpayer.

71 It also has the flexibility to allow for future changes in the market. New entrant bodies into the auditor market will be able to choose whether to join through the gazettal route if their home state's laws are suitable, or through the accreditation route if the laws are not suitable or they do not have a home state (for example, new bodies arising within New Zealand). The latter will incur costs for that body if it had not otherwise intended to seek ARA accreditation, but it does give them an option. We think this cost is justified to ensure a safeguard for audit quality is retained.

72 We believe this option is sufficient to address the third cause of the problem. It will allow for increased competition by creating a way for New Zealand-constituted membership bodies to enter the market (by becoming accredited under the ARA). We recognise this is a high threshold to reach, but believe this response with its lack of implementation cost is proportionate to the (low) probability of such a body emerging.

73 This option contains a risk that that despite accreditation, a professional body will not be competent in the area of regulating non-issuer statutory auditors. We have assessed that there is a low risk of this situation occurring.

74 We assessed whether independent oversight is necessary to ensure audit quality. Several submitters suggested this would be a good idea. However, we have found no evidence that the existing self-regulation model is inadequate. Imposing independent oversight would have resulted in substantial cost to the industry and government. This would be exacerbated by the fact that the role does not neatly fit with any existing regulator, so would have incurred substantial set-up and maintenance costs.

75 This recommendation does mean New Zealand would continue to operate a different regime to its close trading partners. However, we note that Australia's direct regulation model for company auditors is further along the regulation spectrum than New Zealand's co-regulatory model for the higher-risk issuer auditors. Thus alignment with Australia would have created a domestic misalignment with the way we have chosen to regulate higher-risk issuer auditors.

76 Most submitters could see no reason why non-audit functions should be subject to different requirements. We agree and propose to amend any references to 'chartered accountant' to allow any professional body allowed to authorise its members to perform non-issuer statutory audits to similarly authorise its members to perform non-audit functions.

Consultation

77 We issued a targeted consultation on this topic in February 2013. We received responses from NZICA, CPA Australia, the External Review Board, FMA, Deloitte and Hayes Knight. We also discussed these proposals with the Companies Office, FMA, Treasury, MFAT and the Auditor-General in departmental consultation.

78 Common themes in the consultation responses were:

- Submitters agreed with our assessment of the problem definition, the objective and criteria. They believed that opening up the restrictions on who may undertake non-issuer statutory audits would promote competition and may improve audit quality.
- Submitters believed independent oversight would contribute to audit quality and several suggested it be implemented. However, submitters were anxious that this should not impose excessive cost on the industry nor distract the FMA from its core role. They did not provide any evidence to support a need for independent oversight nor suggest a more suitable regulator.
- Some submitters (Hayes Knight) believed that existing oversight provided by the professional body was sufficient.
- Deloitte noted that keeping pace with international trading partners was important.
- Most submitters preferred that accreditation under the ARA be recognised as an indicator that a professional body has high-quality regulatory systems.
- Most submitters could see no reason why non-audit functions should remain restricted to NZICA's chartered accountants. CPA Australia thought the requirements for these should be aligned so that professional designations demonstrating the same competencies as that of a chartered accountant (e.g. a CPA) can perform the function.

Implementation

79 The recommended option can be implemented by an amendment to the Companies Act[5] and other Acts which impose restrictions on non-issuer statutory audits, inserting an additional subsection to s 199 (and its equivalents in other Acts).

80 There is an implementation risk noted in paragraph 61 above, that people may believe non-issuer statutory audits are subject to independent oversight by the FMA when this would not be the case. This creates a risk of an expectation gap, and consequential reputational risk for the FMA. We propose to mitigate this risk by clarifying in legislation that this is not the case, and by undertaking a communications campaign to prevent this misconception.

Monitoring, Evaluation and Review

81 We will monitor whether our assessment that there is no regulatory failure in the existing system remains accurate. We will do this by noting any complaints to the Minister of Commerce or MBIE about non-issuer statutory auditor quality, and through regular communications with those close to the audit market, such as NZICA, other accredited bodies, the Registrar of Companies and the FMA.

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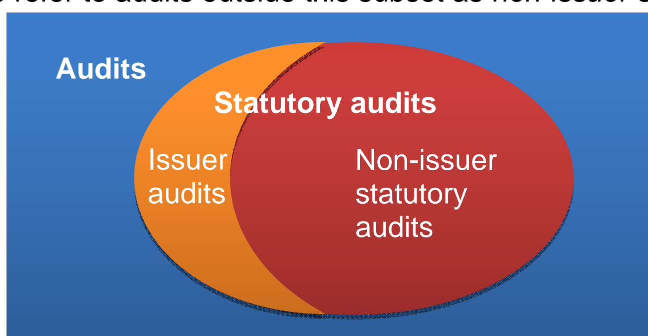
[5] Or the Financial Reporting Act if the proposed Financial Reporting Bill is passed by Parliament.

Appendix 1: Current regulatory setting

Terms used in this paper

82 A multitude of statutes set requirements for entities to undertake financial audits. Any audit required by statute (rather than undertaken voluntarily by an organisation) is called a *statutory audit*. A subset of statutory audits is *issuer audits*. These are audits of organisations which offer securities to the public, including issuers of equity or debt securities, life insurance companies, trustees of superannuation schemes, contributory mortgage brokers, and managers of unit trusts. Issuer audits warrant special treatment because they take public money and therefore have a high impact if they fail. In this paper we refer to audits outside this subset as *non-issuer statutory audits*.



83 The different qualifications of auditor are listed below:

Title	Qualification needed to use the title
Licensed auditor	Must have been granted a licence by an accredited body (currently only NZICA or CPA Australia) to audit issuers.
Non-issuer statutory auditor	Must meet the requirements to conduct one or more types of non-issuer statutory audit, as set out in the relevant statute. For example, they may conduct company audits by meeting one of the tests in s 199 of the Companies Act.
Chartered accountant (CA)	Must be members of NZICA and must have been approved to use the designation 'Chartered Accountant'. Use of this designation is controlled by the New Zealand Institute of Chartered Accountants Act 1996.
Certified Practising Accountant (CPA)	Must be a member of CPA Australia or another CPA organisation and approved by that organisation to use the designation.

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Status Quo

Current regulatory settings

84 Various statutes in New Zealand specify that particular accounting and auditing services can only be undertaken by suitably qualified persons. This is to ensure that those who perform this work meet appropriate standards, and to ensure quality and reliable financial information. The three legislative approaches stating who can work as an auditor are:

a. Issuer audits: Issuer auditors are regulated under a co-regulation model, as these audits are considered higher risk. Under the ARA the FMA grants accreditation to professional bodies, which allows those bodies to license their members as issuer auditors. The FMA also oversees how the accredited professional body regulates its issuer auditor members. So far only CPA Australia and NZICA are accredited bodies.

b. Company audits: Section 199 of the Companies Act 1993 provides that the following groups may conduct company audits:

- NZICA's chartered accountants.
- Auditors licensed under the ARA.
- Members of bodies constituted in another country, where the body is approved by the Registrar and the member is eligible to act in that country.
- Overseas-qualified persons eligible to act in another country and approved directly by the Registrar.

c. Other non-issuer statutory audits:

- Various Acts cross-reference s 199 of the Companies Act. These include the Public Audit Act 2001, which enables the Auditor-General to appoint a person to act as an auditor on the Auditor-General's behalf if they are qualified under s 199. Other examples include the Building Societies Act 1965 and the Friendly Societies and Credit Unions Act 1982.
- Various Acts adopt some elements of s 199 of the Companies Act in their auditor requirements. In some cases, an Act specifies that only a "chartered accountant" may do an audit, for example of the Lawyers' Fidelity Fund under the Lawyers and Conveyancers Act 2006.
- Various Acts leave qualification of an auditor at the discretion of the entity requiring the audit. This includes, for example, the Pork Industry Board Act 1997.

85 The current regulatory regime is one of self-regulation, where professional bodies regulate their members, with no independent oversight. Professional accounting bodies in New Zealand provide both regulatory and professional services, such as education, representation and dispute resolution mechanisms, to their members. There is a competitive market between professional bodies for members.

Rationale for existing restrictions

86 The existing restrictions are intended to ensure audits are of a high quality. The legislation uses membership of a suitable professional body or ability to act in another state, with the consequent requirement to meet that body's or state's standards, as proxies to indicate quality.

87 The first proxy (membership of a suitable professional body) harnesses the professional bodies' pre-existing quality measures, avoiding duplication and minimising the work required of government. It also allows for industry-driven updates in quality standards to be reflected without legislative change. We consider this is a reasonable proxy to apply. However, if the group of 'suitable membership bodies' is not set appropriately or with sufficient flexibility to allow for new bodies to be recognised, this proxy can arbitrarily preclude competent people. It also creates a risk of differing quality requirements between bodies, and consequent regulatory arbitrage.

88 The second proxy (ability to act in another state), as an additional factor for members of professional bodies constituted in that state, is a safeguard intended to prevent practitioners operating in New Zealand who are either banned, or do not meet the required standard in their home jurisdiction. The proxy relies on a presumption that such people also would not meet New Zealand's quality requirement. In many cases, this is a legitimate presumption. However, practitioners may be barred for reasons other than lacking quality, as other countries' laws are not designed with New Zealand's use of them in mind. We cannot counteract this disadvantage as we cannot control other states' laws.

Potential change to status quo – Financial Reporting Bill

89 The Financial Reporting Bill (currently at Select Committee) proposes transferring s 199 of the Companies Act to the new Financial Reporting Act,[6] and standardising the s 199 test to apply to all statutory audits other than issuer audits and public entities under the Public Audit Act 2001. That is, the varying approaches to auditor requirements mentioned above in the Lawyers and Conveyancers Act 2006, the Pork Industry Board Act 1997 etc, would no longer exist. Submissions on the Bill did not oppose this proposal for a consistent approach to auditor qualification. However, the proposed change will widen the problem outlined above: it will impose the s 199 constraints on more types of non-issuer statutory audits, and will restrict some individuals from doing audits they would likely have been able to do previously.

90 A further proposed change is that the term 'issuer' will be replaced by 'FMC reporting entity'. The definition will be broader: audits of credit unions, building societies and friendly societies with an insurance component will move out of the category of 'non-issuer statutory audit', and will instead require a licensed auditor under the ARA. This is proposed under Supplementary Order Paper 93 to the Financial Reporting Bill.

91 These two proposed changes will affect the scale of the problem: the first will widen the scale significantly, the second will reduce it marginally. However, the problem exists whether or not this change occurs, and therefore the below analysis is valid regardless of the outcome of the Bill.

[6] Clause 35, Financial Reporting Bill

Appendix 2: Section 199 of the Companies Act 1993

199 Qualifications of auditors

1 A person must not be appointed or act as an auditor of a company unless—

- a. The person is a chartered accountant (within the meaning of section 19 of the New Zealand Institute of Chartered Accountants Act 1996); or
- ab. The person is a licensed auditor; or
- *b. [Repealed]*
- c. The person is a member, fellow, or associate of an association of accountants constituted outside New Zealand where—
  - i The association is, by notice in the *Gazette*, approved for the time being for the purposes of this section by the Registrar; and
  - ii The person is eligible to act as an auditor in the country, State, or territory in which the association is constituted; or
- d. The person, not being a person to whom paragraph (c) applies, is—
  - i Eligible to act as an auditor in a country, State, or territory outside New Zealand; and
  - ii Approved for the time being for the purposes of this section by the Registrar by notice in the *Gazette*.

1A However, if the company is an issuer, a person must not be appointed or act as an auditor of the company unless he or she is a licensed auditor.

2 None of the following persons may be appointed or act as auditor of a company:

- a. A director or employee of the company:
- b. A person who is a partner, or in the employment, of a director or employee of the company:
- c. A liquidator or a person who is a receiver in respect of the property of the company:
- d. A body corporate:
- e. A person who, by virtue of paragraph (a) or paragraph (b), may not be appointed or act as auditor of a related company.

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Appendix 3: Overview of the auditor oversight regimes in other countries

Australia

92 Australia has in place a direct-regulation audit oversight model. The Australian Securities & Investment Commission (ASIC) is an independent Commonwealth Government body and is Australia's corporate, markets and financial services regulator. Among other things, ASIC conducts regular inspections of Australian audit firms focusing on quality control systems, auditor independence and, through reviews of audit working paper files for individual entities, audit quality. The quality review arrangements in Australia are such that small audit firms may not be reviewed and auditors not connected to a firm will never be subject to a quality review. Membership of a professional body is not required in order to become a RCA in Australia.

93 The three major professional accounting bodies in Australia are:

- The Institute of Chartered Accountants in Australia (ICAA).
- CPA Australia.
- The Institute of Public Accountants (IPA).

The United Kingdom

94 The UK has in place a co-regulatory model. The Financial Reporting Council (FRC) is an independent regulator responsible for, among other things, the independent oversight of the regulation of statutory auditors by the recognised qualifying and supervisory bodies (RQBs and RSBs). RQBs must have effective arrangements in place to ensure that their qualifications meet the statutory requirements and RSBs must have in place effective arrangements for the registration, monitoring and disciplining of auditors.

Current RQBs

- Association of Chartered Certified Accountants (ACCA)
- Chartered Accountants Ireland (CAI)
- Institute of Chartered Accountants in England and Wales (ICAEW)
- Institute of Chartered Accountants of Scotland (ICAS)
- Association of International Accountants (AIA)
- Chartered Institute of Public Finance and Accountancy (CIPFA)[7]

Current RSBs

- Association of Chartered Certified Accountants (ACCA)
- Chartered Accountants Ireland (ICA)
- Institute of Chartered Accountants in England and Wales (ICAEW)
- Institute of Chartered Accountants of Scotland (ICAS)
- Association of Authorised Public Accountants (AAPA)

[7] CIPFA's status as an RQB is currently in abeyance.

95 The FRC has statutory powers delegated to it by Government for the recognition, supervision and de-recognition of those accountancy bodies responsible for supervising the work of auditors or offering an audit qualification. Audit firms must be registered with, and subject to supervision by, an RSB and persons responsible for company audit work at a firm must hold a recognised qualification.