

The Chair
CABINET ECONOMIC GROWTH AND INFRASTRUCTURE COMMITTEE

AUDITOR REGULATION OVERSIGHT

PROPOSAL

- 1 I am proposing the introduction of independent oversight, which would involve monitoring and reporting on the adequacy and effectiveness of professional accounting bodies' auditor regulatory systems and processes. I am also recommending the establishment of a system that would limit the carrying out of statutory audits to individuals with demonstrated auditor-specific capabilities.

EXECUTIVE SUMMARY

- 2 At present, the Institute of Chartered Accountants of New Zealand is the only professional accounting body that is directly able to regulate accountants and auditors offering services in New Zealand. There are two main problems with the current self-regulatory system for auditors.
- 3 First, auditors are not regulated as a specialist profession. Rather, they are regulated as accountants. This approach does not adequately reflect the specialised skills, knowledge and experience that auditors need to have. This problem has been most evident in relation to finance company failures. Company receivers have advised the Registrar of Companies that some audits of failed finance companies were not carried out to the required standard. Consequently, some finance companies carried on business for longer than they ought. This tends to suggest that audit failure has contributed to the size of investor losses. To deal with this problem, I consider that statutory audits should be restricted to practitioners who have demonstrated auditor-specific capabilities. Therefore, I am recommending that licensing be introduced and a register of licensed auditors be established.
- 4 Secondly, the Institute has a dual role of regulating in the public interest and promoting the interests of the profession. This places the Institute's Council in a difficult position when those interests conflict. I consider that it would be easier for the appropriate level of regulation to be maintained if a body that was independent of the interests of the profession had the power to require the Institute to change those systems and processes where necessary. I am proposing that the responsibility for oversight be given to the Accounting Standards Review Board (ASRB), which is an independent crown entity.

BACKGROUND

The Policy Framework for Occupational Regulation

- 5 The policy framework for occupational regulation, which was approved by Cabinet in 1999 states that the Government should only regulate an occupation where it is necessary to reduce the risk of significant harm and the industry or market is unable to regulate itself adequately. Significant harm is defined as significant harm to one person, or moderate harm to a large number either from one event or from the aggregated actions of different providers of a service.

The purpose of an audit

- 6 The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. An unqualified audit is a signal to users that they can rely on the financial statements to help them make sound business decisions (e.g. whether to buy, hold or sell shares. Without an audit the financial statements are of less value because users do not know whether they can rely on them. It is worse if an auditor mistakenly issues an unqualified audit opinion because investors and users will have been misled into thinking that the financial statements are more reliable than they actually are.

Auditing and finance company failures

- 7 Earlier this year, Mr Neville Harris, the Registrar of Companies submitted a report to the Commerce Select Committee on the causes of 27 finance company failures. The report pointed to systemic failure, with three major contributing factors:
- Business model issues, including a failure of corporate governance. Among other things, the Registrar expressed concerns about dominant chief executives who were not being properly held to account by directors. He stated that many directors did not understand the finance company business environment, were not adequately informed, were misled or failed to take sufficient interest in the affairs of the company.
 - Weaknesses in the trustee supervisory regulatory model. The Registrar stated that the trustee companies agreed to circumscribe their powers through relatively weak and potentially ineffective trust deeds. He also stated that some trustee companies were slow to react and responded timidly.

- Concerns that auditors did not have sufficient capability and experience to audit such complex and elaborate company and business structures. Only five of the 27 finance company audits listed in the Registrar's report were carried out by the Big 4 accounting firms. The Registrar stated that::

... the audits of many of [the failed] finance companies lacked a rigor and analytical depth one would expect for entities managing substantial public investments. There is a view among receivers that if they had been rigorously audited, it is unlikely many of the failed finance companies would have continued in business for as long as they did.

- 8 The feedback from receivers suggests that substandard audits were a component in the delay in the demise of some finance companies. If the auditors had issued qualified rather than unqualified opinions then there would have been a strong imperative for the trustee companies to step in earlier. Therefore, it is not unreasonable to assume that the size of the deposits at risk would have been lower than the \$3.7 billion total stated by the Registrar. It is not possible to state how much lower at present. That might become clearer if civil actions are to be taken by parties who have incurred losses.
- 9 The Registrar's report also noted that::
- The High Court made adverse comments about the quality of an audit of financial statements prepared by Capital + Merchant Finance 2000 Ltd¹; and
 - The auditors of National Finance Ltd pleaded guilty to the Institute's Disciplinary Tribunal for failure to exercise due care and diligence and failure to comply with auditing standards.
- 10 In addition, some finance company audits are being carried out by small accounting firms in which the audited entity is a major client of the audit firm. It is doubtful that any accounting firm that has a high degree of dependence on the one source of income could meet the Institute's Code of Ethics independence-related requirements.

THE PROBLEMS

- 11 There are two problems with the status quo. The main problem is that the current self-regulatory system for regulating auditors is weak. The other problem is that self-regulation is no longer internationally acceptable. For this reason, New Zealand auditors can not carry out company audits in Australia. There is also an increasing risk that New Zealand auditors will not be able to perform the audits of overseas-owned New Zealand entities if self-regulation is retained.

¹ Capital + Merchant Finance Ltd and Anor v Fortress Credit Corporation and Ors HC AK CIV 2007-404-007298 [29 November 2007]

THE MAIN PROBLEM – THE CURRENT SYSTEM FOR REGULATING AUDITORS IS WEAK

- 12 The finance company experience calls into question the effectiveness of the self-regulation of auditors in New Zealand. The Institute allows any Chartered Accountant with a Certificate of Public Practice to carry out an audit as long as:
- a The person self-assesses that he or she is competent to do the audit; and
 - b A confidential practice review report carried out by the Institute does not restrict the practitioner from accepting audit engagements.
- 13 There are two main weaknesses with this system.
- 14 First, auditing has become increasingly specialised and complex. Many of the core knowledge and skill requirements for auditing are not needed in other branches of accountancy. Among other things, an auditor needs to have a thorough understanding of the principles and practices of audit quality and the detailed set of auditing and assurance standards. Auditing should be regulated in a way that treats it as a specialised activity.
- 15 Secondly, self-assessments can be very unreliable. Numerous studies in the field of psychology have shown that many people grossly overestimate their capabilities and achievements compared with other people. The problems with self-assessment mean that considerable reliance is placed on practice review to identify practitioners who are incapable of carrying out major and complex audits. The finance company experience suggests that those expectations are difficult to meet. To be clear, I am not criticising the Institute's practice review system *per se* or the people involved in practice review. The issue is that practice review by itself cannot deliver what is expected in relation to auditing.
- 16 In addition, there can be tensions between the professional body's functions to promote the interests of the profession and regulate in the public interest. Independent monitoring and reporting would provide a higher level of confidence that the Institute's regulatory systems and processes are focussed on the public interest.

OPTIONS FOR STRENGTHENING AUDITOR REGULATION

- 17 Two sets of solutions are required to deal with the problems identified above:
- To introduce auditor-specific regulation; and
 - To introduce either government regulation or co-regulation.

Auditor-specific regulation

- 18 There is a need to recognise that statutory audits need to be carried out by individuals who have auditing-specific skills, experience and knowledge that are not required in other branches of accountancy. An individual should be required to demonstrate competence in advance to obtain registration and demonstrate ongoing competence as a condition for retaining registration.

Government regulation versus co-regulation

- 19 The two approaches that have been adopted in overseas jurisdictions in recent years are as follows:
- *Government regulation*: Under this approach an independent government agency is responsible for regulating auditors, auditing firms or both. For example, in Australia company audits can only be carried out by auditors and audit companies that have been approved by the Australian Securities and Investments Commission (ASIC); and
 - *Co-regulation*: Under this approach, professional accounting bodies have the front line responsibility for regulating auditors and auditing firms. However, a body that is independent of the interests of the profession is responsible for monitoring and reporting on the adequacy and effectiveness of the professional bodies' regulatory systems and processes for regulating auditors and auditing firms and having powers to direct a body to improve those systems and processes. Most notably, independent oversight is the minimum requirement for European Union Member States.
- 20 Both approaches are internationally acceptable. I prefer co-regulation for the following reasons:
- The Institute's regulatory boards and committees include highly experienced and respected members of the profession. I am confident that the Institute will, under effective oversight, perform the frontline role well;
 - The financial costs will be lower. With the exception of the lay members of the Disciplinary Tribunal, the members of the Institute's boards and committees that contribute to the system for regulating Chartered Accountants and auditors provide their time free of charge. In addition, there are economies of scope by regulating auditors and other accountants within the same system; and
 - The transition would be smoother. There would be no need to dismantle the existing institutional arrangements within the Institute or create new frontline regulatory systems within a government agency.
- 21 The two bodies that could perform the oversight role to a high standard are the Securities Commission and the ASRB, because there are synergies with both bodies' current statutory functions. The Commission regulates stockbrokers and is currently in the process of gaining responsibilities to regulate financial advisers. The ASRB is responsible for approving financial reporting standards.
- 22 My view is that a reconstituted ASRB, to be called the External Reporting Board (XRB) should be the overseer for one major reason. Information is more likely to flow freely from accredited accounting bodies to the overseer if they know that the information will not be used for other regulatory purposes that are unrelated to oversight. The Commission has a wide range of regulatory functions but the ASRB does not.

23 The ASRB has expressed a willingness to take on the oversight function.

The scope of the oversight and licensing systems

Non-statutory audits

- 24 Most audits are not reserved to professional accountants. In particular, there are no such restrictions in relation to audits of financial statements prepared by most non-profit sector entities, the great majority of which are very small. There is anecdotal evidence that some unregulated audits are not carried out well. However, regulating such audits would be likely to cause more problems than it would solve. Most non-profit entities rely on having an audit completed on an honorary basis and Chartered Accountants are often not available to do the work.
- 25 It would be better to retain the current position of having variable standards of auditing practice than to introduce new regulation that is unlikely to work. Therefore, I am recommending that no changes be made in relation to non-statutory audits. The Institute's Code of Ethics would continue to apply where a Chartered Accountant did carry out an audit that is not limited to Institute members.

Statutory audits

- 26 I consider that the feasible options for the scope of the licensing and oversight systems are as follows:
- a Option A: To limit the regulatory systems to all "public interest" audits. The requirements would apply to entities that are of significant public relevance because of the nature of their businesses or their size. This option would cover all issuers (including banks, other financial institutions and providers of insurance), other entities which may hold substantial amounts of members' deposits (e.g. non-issuer building societies) and large non-issuer companies; and²
 - b Option B: To include all statutory audits. The requirements would apply to all audits that may, at present, only be carried out by members of the Institute and, in some cases, suitably qualified overseas persons. 50-odd statutes include such restrictions. The most important are audits of issuers and companies. In addition, some special purpose audits are required to be performed by qualified accountants. Examples are compliance audits of levy accounts under the Commodity Levies Act 1990 and the audit of the New Zealand Law Society Special Fund.
- 27 An argument in favour of Option A is that it focuses on the audits where the largest amount of harm is likely to occur in the event of individual audit failures. Another argument is that public interest audits tend to be the most complex of audits. Therefore, it is important to reserve such audits to skilled practitioners.

² The Financial Reporting Act 1993 includes a definition which could be used for this purpose. It states that a company is large if it meets or exceeds two out of three of the following tests: (i) \$20 million of annual revenue; (ii) \$10 million of assets; and (iii) 50 full-time equivalent employees.

- 28 An argument in favour of Option B is that there are substantial risks in relation to all statutory audits. Audit quality requirements have been substantially raised in recent years. So have the volume and complexity of auditing and assurance standards. However, significant numbers of statutory audits are being carried out by holders of Certificates of Public Practice who offer a range of accountancy services. It is questionable whether many practitioners who only do audits from time to time are carrying the work out to the required standard. The combined actions of those general practitioners have the potential to cause significant aggregate harm to owners, other investors and creditors.
- 29 I consider that both sets of risks (i.e. the single large entity risk and the multiple small entity risk) should be addressed. Therefore, the licensing and oversight systems should cover all statutory audits. That said, the XRB should have the flexibility to focus its efforts on the highest risk classes of audits such as banks and publicly listed companies. The XRB should also be able to set graduated licensing requirements for different classes of audits.

Audits under the Public Audit Act 2001

- 30 The Auditor-General is responsible for carrying out audits of general purpose financial reports prepared by about 4,000 public sector entities. However, I do not consider that the Auditor-General should be subject to the licensing system. The Auditor-General is an Officer of Parliament and it would be unsatisfactory for him or her to be formally accountable to a Crown Entity.
- 31 Nevertheless, the Institute completes practice reviews of Audit New Zealand from time to time, by the invitation of the Auditor-General. From an international credibility perspective, it is essential for this and other arrangements to continue given that the Auditor-General is responsible for auditing public interest entities such as Kiwi Bank and Air New Zealand.
- 32 In addition, a consequential amendment would need to be made to the Public Audit Act 2001. That Act permits the Auditor-General to appoint Chartered Accountants to carry out public sector entity audits. The relevant statutory provision would need to be consequentially amended to narrow the application to Licensed Auditors.

A safety valve

- 33 The other major element of the European Union oversight system is to allow the oversight body to initiate or take over the investigation of a complaint against an auditor or auditing firm and to take appropriate action. This power is seen to be necessary to deal with the following situations:
- Concerns that the professional body may not rigorously carry out particular investigations due to conflicts between the objectives of regulating in the public interest and promoting the interests of the profession; and
 - Concerns that the professional body may not have the resources to carry out very large or complex investigations.

- 34 As noted in Paragraph 26(a), the EU oversight system only applies to financial institutions and other “public interest” audits because of the concern that investors can potentially lose substantial amounts of money if there is audit failure. That risk is equally valid in relation to public interest entity audits in New Zealand.
- 35 I consider that the proposal outlined elsewhere in this paper for the XRB to be able to set different minimum qualifications for audits of different complexity will deal with this risk in large measure. Nevertheless, there is a residual risk and an EU-type safety valve should be introduced in New Zealand. That said, I would anticipate that the safety valve would rarely be used. The mere fact of its existence will provide strong incentives for accredited professional accounting bodies to complete their investigations to an acceptable standard.

The responsibility for the safety valve

- 36 I do not consider that the safety valve role would suit the XRB. None of its other proposed functions involve front line investigations of this kind. This function is more akin to the type of investigations that the Securities Commission and Registrar of Companies carry out and both would be suited to this function. If the safety valve were to relate to all statutory audits, I would favour the Registrar because of his broader regulatory responsibilities. However, on balance the Securities Commission is more suited to this role because the safety valve would only apply to public interest audits. Almost all public interest entities (including banks and insurance undertakings) are issuers. Regulating issuers is a core Securities Commission function.

Other features of oversight and licensing

- 37 Other details of the proposed oversight and licensing systems appear in the Appendix.

THE SECONDARY PROBLEM – NEW ZEALAND AUDITORS’ QUALIFICATIONS NOT BEING RECOGNISED BY OVERSEAS JURISDICTIONS

The problem

- 38 Ten years ago, self-regulation was the international norm for auditors. However, in recent years most of the countries that New Zealand typically compares itself to have either replaced self-regulation with government regulation or introduced oversight by an entity that is independent of the interests of the profession. These changes were a response to audit failures associated with large corporate collapses (e.g. Enron) early this decade.

39 Internationally, self-regulation is no longer regarded as being within the range of acceptable regulatory systems and New Zealand is now an outlier. There is no evidence that this has harmed New Zealand's financial markets. However, New Zealand's self-regulatory system raises concerns that:

- It may be increasingly difficult for New Zealand auditors to work overseas. It is already an issue in Australia. Institute members may contribute to the audits of Australian companies. However they cannot obtain registration as Company Auditors in Australia, which means that they cannot accept Australian company audit engagements; and
- In future, overseas regulators may bar New Zealand auditors from performing the audits of overseas-owned New Zealand entities. The reason for this is that overseas regulators have an interest in the quality of all the audits that contribute to the audit of a set of consolidated financial statements of a public interest entity that is incorporated in its jurisdiction. Thus, if an overseas public interest entity has New Zealand subsidiaries or branches then the overseas regulator will want to ensure that the relevant audits are being carried out by a suitably qualified practitioner. Although, the degree of risk is difficult to assess, the longer New Zealand retains self-regulation, the more likely it is that a major overseas jurisdiction will stop recognising audits carried out by New Zealand auditors.

The options

40 There are two ways of ensuring that New Zealand auditors' qualifications will be recognised overseas:

- Option A: Set the New Zealand requirements at a high enough level to ensure that our system is recognised in all overseas jurisdictions; and
- Option B: Set the New Zealand requirements at the level needed to deal with the domestic problem but allow the XRB to add to the core statutory requirements to meet the demands of specific jurisdictions in a targeted way.

41 I prefer Option B because it is a lower cost option and deals with the problem in an effective manner. For example, if an overseas jurisdiction decided that it would only recognise New Zealand auditors if they are subject to practice review undertaken by a government entity, the XRB could take on that role in relation to the New Zealand auditing firms that wished to be recognised in that jurisdiction.

OVERSEAS-QUALIFIED AUDITORS

42 The Securities Act and the Companies Act allow the Registrar of Companies to approve overseas qualified auditors to carry out New Zealand issuer and company audits. The Registrar can approve overseas professional accounting bodies (meaning that members of that body may perform New Zealand issuer and company audits) and specific individuals who are members of an overseas professional accounting body.

- 43 There are problems with this system. First, it assumes self-regulation in the overseas jurisdiction. This is no longer the case in many countries. Secondly, those Acts include no criteria. For example, there is no requirement for the Registrar to be satisfied that overseas-qualified persons would be subject to an effective disciplinary system in the event that issues of competence or honesty arose in relation to an overseas-qualified auditor.
- 44 I propose that the system governing overseas-qualified auditors be strengthened accordingly. This would include placing an onus on overseas-qualified auditors to demonstrate to the Registrar that they are qualified and remain qualified to be listed on the New Zealand Register, in accordance with the minimum criteria set by the XRB. Subject to receiving reciprocal treatment, Australian-qualified auditors would be able to be recognised in New Zealand under the Trans-Tasman Mutual Recognition Agreement.

CONCLUSIONS

- 45 Some statutory audits are being performed by practitioners who do not have the skills to do them satisfactorily. The proposals outlined above are aimed at improving audit quality by limiting statutory audits to suitably skilled practitioners. However, the proposals are not a guarantee that there will never be audit-related problems in future. Regulation of business activity, no matter how stringent, will never prevent all incompetence or dishonesty. The trade-off that needs to be made relates to the extent to which undetected material misstatements in financial reports are tolerable given that additional regulation will impose costs on society.
- 46 The main benefit of establishing auditor registration and auditor regulation oversight will be to reduce the risks that investors will incur large audit-failure-related losses. Another benefit will be to increase the likelihood that New Zealand auditors can practise in overseas jurisdictions and continue to perform the audits of overseas-owned New Zealand entities.
- 47 There are three sets of costs, which are as follows:
- a The costs of establishing and running the proposed oversight and registration systems. Those costs are outlined in the “Fiscal Implications” section below;
 - b The professional body will incur costs when the oversight body instructs it to change its regulatory systems and processes. Those costs are unknown for two reasons. First, the changes cannot be anticipated. Secondly it will be difficult to know which of those changes would have been made by the professional body even if the oversight system had not been introduced; and
 - c The costs associated with regulatory systems generally, including the possibilities of regulatory creep, regulatory capture and unintended consequences.

- 48 The risks associated with (b) and (c) above can be managed by requiring the oversight body to satisfy itself that the benefits of systems changes will exceed the costs. This will require the overseer to follow due process.
- 49 To conclude, I consider that the marginal benefits clearly exceed the marginal costs in this case given the scale of investor losses that can occur where there is audit failure and the reduced risk of audit failure if the relatively low cost changes outlined in this paper are implemented.

CONSULTATION

- 50 The Treasury, Ministry of Justice, Securities Commission, Reserve Bank, Registrar of Companies, Office of the Auditor-General, Accounting Standards Review Board, State Services Commission and the Institute of Chartered Accountants of New Zealand have been consulted on the contents of this paper. The Department of Prime Minister and Cabinet has been informed.

FISCAL IMPLICATIONS

- 51 The one-off costs of establishing the oversight system and a register of licensed auditors will be approximately \$0.4 million. The ongoing costs will be approximately \$0.7 million a year. It would be consistent with the Treasury's *Guidelines for Setting Charges in the Public Sector* to fund the oversight system through levies or fees imposed on registered auditors, accredited accounting bodies and beneficiaries as appropriate.
- 52 The proposed safety valve power for the Securities Commission is not anticipated to be used frequently and no extra amount will need to be voted to the Commission. Any major external expenses could be resourced through the Commission's litigation fund subject to the new function being added to the criteria for use of that fund.

HUMAN RIGHTS AND PRIVACY IMPLICATIONS

- 53 The proposals contained in this Cabinet paper appear to be consistent with the New Zealand Bill of Rights Act 1990, and the Human Rights Act 1993. However, the proposal to require an accredited professional accounting body to forward its investigative records to the Securities Commission appears to raise a prima facie issue of consistency with section 21 of the Bill of Rights Act (the right to be free from unreasonable search and seizure). Officials from the Ministry of Justice and the Ministry of Economic Development will work together on this issue to promote consistency with the Bill of Rights Act. A final view as to whether the proposals in this paper will be consistent with the Bill of Rights Act will be possible once the legislation has been drafted.

- 54 The proposal to require an accredited professional accounting body to forward its investigative records to the Securities Commission raises concerns under the Privacy Act 1993. Officials from the Ministry of Economic Development will work with the Office of the Privacy Commissioner to ensure that this proposal and the other information sharing proposals contained in this paper are developed in a manner that is consistent with the Information Privacy Principles in the Privacy Act.

LEGISLATIVE IMPLICATIONS

- 55 The changes proposed in this paper can only be implemented by way of primary legislation. The 2009 Legislation Programme includes an Accountants and Auditors Bill, which has a Category 5 priority, Instructions to Parliamentary Counsel Office to be provided in 2009.

REGULATORY IMPACT ANALYSIS

- 56 A Regulatory Impact Statement (RIS) has been prepared, and the regulatory impact analysis (RIA) and RIS have been independently reviewed by the Treasury's Regulatory Impact Analysis Team (RIAT). RIAT considers the analysis to be adequate according to the adequacy criteria.
- 57 MED confirms that the Code of Good Regulatory Practice and the RIA requirements, including the consultation RIA requirements, have been complied with. The final RIS was circulated with the Cabinet paper for departmental consultation purposes.

PUBLICITY

- 58 The main stakeholders and some business journalists are aware that I have been considering this matter. They will be expecting decisions to be announced. I propose to issue a media statement.
- 59 The Ministry of Economic Development will publicise the decisions in its monthly newsletter and, subject to agreement to Recommendation 15, will place this paper on its website. I understand that the Institute will publicise the decisions in the Chartered Accountants Journal.
- 60 In addition, the European Commission has written to New Zealand and 33 other countries enquiring about whether they have a public oversight system that is equivalent to the supervision required in European Union Member States. I will write to the Commission outlining the Government's decisions.

RECOMMENDATIONS

61 I recommend that the Committee:

- 1 **Note** that the Institute of Chartered Accountants of New Zealand is responsible for regulating its members under the Institute of Chartered Accountants of New Zealand Act 1996;
- 2 **Note** that 50-odd statutes restrict various entity and account audits to members of the Institute and, in some cases, overseas accountants whose qualifications are recognised by the Registrar of Companies;
- 3 **Note** that the Registrar of Companies, in a report to the Commerce Select Committee, stated that the audits of many failed finance companies lacked the rigor and analytical depth one would expect for entities managing substantial public investments;
- 4 **Agree** to introduce an auditor-specific licensing system;
- 5 **Agree** that the licensing system will not apply to the Auditor-General or her staff;
- 6 **Agree** to introduce independent oversight of auditor regulation;
- 7 **Agree** that the oversight and licensing systems will apply to statutory audits and that such audits may only be carried out by licensed auditors;
- 8 **Agree** that non-statutory audits, including most audits in the non-profit sector, will not be subject to the oversight and licensing systems;
- 9 **Agree** that the oversight role will be carried out by a reconstituted Accounting Standards Review Board, to be called the External Reporting Board;
- 10 **Agree**, in relation to public interest audits only, that the Securities Commission will be able to investigate or take over an investigation by an accredited professional accounting body of an auditor or auditing firm and, if considered necessary, take a disciplinary case to the District Court;
- 11 **Agree** to the detailed design features appearing in the appendix to this paper;
- 12 **Agree** that the Minister of Commerce can approve any minor additions and modifications to the matters specified in the Appendix during the process of drafting the Bill;
- 13 **Agree** that the establishment and ongoing costs of oversight and registration of licensed auditors will be funded from fees or levies on auditors, accredited professional bodies and others as appropriate;

- 14 **Invite** the Minister of Commerce to issue drafting instructions to Parliamentary Counsel Office to give effect to the above recommendations;
- 15 **Agree** to establish a new Non-Departmental Other Expense appropriation “Regulation of Auditors” in Vote Commerce;
- 16 **Agree** that the appropriation scope shown in the Estimates will be “This appropriation is limited to the oversight and regulation of professional accounting bodies, auditing firms and auditors for the purposes of promoting audit quality”;
- 17 **Approve** the following changes to appropriations to implement auditor regulation changes, with no impact on the operating balance and debt:

Vote Commerce Minister of Commerce	\$m increase/(decrease)				
	2009/10	2010/11	2011/12	2012/13	2013/14 & outyears
Departmental output expense: Registration and Provision of Statutory Information	-	-	-	0.100	0.100
Non-departmental output expense: Regulation of Auditors	-	-	0.400	0.600	0.600

- 18 **Agree** to the Ministry of Economic Development publishing this paper on its website.

Hon Simon Power
Minister of Commerce

Date signed: _____

APPENDIX: SPECIFIC DESIGN FEATURES

Oversight

- 1 The XRB will set the strategy for auditor regulation within the framework provided by the empowering legislation.
- 2 The XRB will be able to accredit bodies of professional accountants.
- 3 The Institute will obtain automatic accreditation when the oversight system is brought into effect.
- 4 Each year the XRB will publish a three to five year plan describing how it will supervise the Institute and any other accredited bodies.
- 5 Accredited accounting bodies will be required to submit an annual report to the XRB. The XRB will prescribe the manner and form for the annual report.
- 6 New Zealand accountants will not be allowed to carry out statutory audits unless they are (a) members of an accredited professional body, and (b) licensed by that professional body to carry out audits.
- 7 The XRB will be able to recognise overseas auditor qualifications.
- 8 The XRB will have ultimate responsibility for overseeing:
 - a The approval and registration of auditors and audit firms
 - b The adoption of standards on ethics, and internal quality control of audit firms and auditing
 - c The continuous education, quality assurance and investigative and disciplinary systems
- 9 The XRB will monitor and report on the adequacy and effectiveness of the profession's regulatory system
- 10 The XRB will be able to direct a professional body to change its systems and processes to deal with identified weaknesses.
- 11 The XRB will have the information gathering powers it needs to carry out its statutory responsibilities effectively. Those powers will be consistent with human rights legislation.
- 12 Accredited professional accounting bodies will be able to both inspect auditing firms and audits. Accredited bodies will have the power to access and review audit working papers.
- 13 Unnecessary duplication with overseas regulatory systems will be avoided by enabling the XRB to take the impact of those systems on audit practice in New Zealand into account.

- 14 The XRB will be able to suspend or withdraw accreditation, or censure an accredited body.
- 15 The XRB will be able to enter into cooperation, coordination and dispute avoidance and resolution agreements with accredited professional bodies.
- 16 The XRB would be able to liaise with other New Zealand bodies and overseas bodies with similar or related responsibilities.
- 17 The XRB's powers will be consistent with its role as an accreditation agency. It will not be able to alter the annual and medium term plans prepared by accredited professional accounting bodies. Nor will it be responsible for approving professional bodies' rules. However, it will be able to direct a body to change rules that are inconsistent with the XRB's three to five year plan.

The investigation system safety valve for public interest audits

- 18 In addition to using its existing powers to obtain information and investigate, the Securities Commission would be able to:
- Require an accredited professional accounting body to forward its investigation records to the Commission.
 - Receive information from the Reserve Bank under the bank's existing powers to pass information to other regulators under the Reserve Bank of New Zealand Act 1989.
- 19 The Commission would not be able to intervene in relation to the proceedings or the outcome of a Disciplinary Tribunal process of an accredited professional accounting body.
- 20 In the event that the Commission concluded that disciplinary action was needed, it would take proceedings in the District Court. It could seek the orders against an auditor or audit firm including de-licensing, banning, suspension, supervised practice, censure, and removal from carrying out a specific public interest entity audit.

The Register

- 21 There will be a single Register of Licensed Auditors. The Registrar of Companies would establish and maintain the Register.
- 22 The minimum requirements for obtaining and retaining registration would be determined by the XRB. The XRB would also make the rules for Chartered Accountants to transition into the auditor licensing system.
- 23 An individual would be required to demonstrate competence in advance to obtain registration and demonstrate ongoing competence as a condition for retaining registration.

- 24 Each accredited professional accounting body will be required to advise the Registrar with up-to-date information about additions, amendments and deletions to the Register.
- 25 Overseas auditors whose qualifications are recognised by the ASRB will be required to provide the Registrar with evidence that they are entitled to be registered, and annually thereafter to show that they remain entitled to be registered.
- 26 Australian company auditors would be able to practise in New Zealand under the Trans-Tasman Mutual Recognition Agreement, subject to obtaining reciprocal treatment from Australia.
- 27 The Registrar would be able to take enforcement action against contraventions of the registration system (e.g. There would be offence provisions in relation to an unregistered person carrying out a statutory audit).

Regulatory Impact Statement

EXECUTIVE SUMMARY

- 1 50-odd statutes reserve specified audits to by Chartered Accountants and, in some cases, certain overseas-qualified persons. The key restrictions are on audits of issuers (under the Securities Act) and companies (under the Companies Act).
- 2 It is likely that some statutory audits are being carried out by individuals who are not up to the required standard, although it is difficult to know how many. This has been most evident in relation to some audits of financial statements prepared by failed finance companies. A report by the Registrar of Companies to the Commerce Select Committee noted that substandard audits were a cause of delay in the demise of some finance companies. That raises questions about whether the amount of deposits at risk would have been less than the \$3.7 billion total stated by the Registrar. It is not possible to state how much lower at present. That might become clearer if civil actions are to be taken by parties who have incurred losses.
- 3 In addition, New Zealand's system of self-regulation for auditors is inconsistent with international norms. There is no evidence that this has adversely affected confidence in New Zealand financial markets. However, New Zealand's self-regulation system is not recognised in Australia, meaning that New Zealand auditors are unable to accept engagements to carry out company audits in Australia. In addition, there is an increasing risk that New Zealand auditors will be barred from performing the audits of overseas-owned New Zealand entities of self-regulation were to be retained.
- 4 The preferred option has two main parts. The first is to start regulating auditors in their own right to recognise audit is a specialist activity. Statutory audits would only be able to be carried out by licensed auditors. The second part is to introduce independent oversight of auditor regulation by accredited professional accounting bodies. The Institute and any other accredited body would to regulate its members. However, the Accounting Standards Review Board (ASRB), which is an independent crown entity, would monitor the adequacy and effectiveness of the Institute's regulatory processes and systems and require changes to be made to systems and processes that are inadequate.
- 5 The main impact would be to increase audit quality.

ADEQUACY STATEMENT

- 6 Treasury's Regulatory Impact Analysis Team has reviewed this Regulatory Impact Statement and considers it to be adequate according to the adequacy criteria.

STATUS QUO AND PROBLEM

- 7 Statutory audits may only be carried out by members of the Institute and, in some cases, certain overseas-qualified persons. The Institute is responsible for self-regulating its members. Overseas-qualified auditors can carry out some classes of statutory audits if they have been approved to do so by the Registrar of Companies or are members of overseas professional accounting bodies that have been approved by the Registrar.
- 8 The main problems with this system are:
- Failure to treat auditing as a specialised profession even though auditing includes complex core skills and knowledge that are not needed in other branches of accountancy. In particular, an auditor needs to have a thorough understanding of the principles of audit quality, how to apply those principles to an audited entity's business and regulatory environment, and have an in-depth knowledge of the increasingly lengthy and complex set of International Standards on Auditing;
 - Too much reliance on the Institute's practice review system to deal with auditor competence issues;
 - The risk that the public interest will not always prevail when there is conflict between the Institute's roles to regulate in the public interest and promote the interests of the profession; and
 - The inconsistency of self-regulation with international norms. For this reason, Institute members are unable to obtain registration as company auditors in Australia. There is also an increasing risk that New Zealand auditors will be prevented from performing the audits of overseas-owned New Zealand entities.

OBJECTIVES

- 9 The main objective is to increase audit quality and thereby reduce the risk of future audit failure in relation to important audits. A secondary objective is to bring New Zealand's auditor regulation system into the range of international acceptability, thereby ensuring that New Zealanders can work overseas and continue carrying out audits of overseas-owned New Zealand entities.

ALTERNATIVE OPTIONS

- 10 The only other feasible option is to transfer responsibility for regulating auditors and audit firms from the profession to an independent regulator, such as the Securities Commission. The main benefit of this approach would be to maximise the perception that auditors are being regulated independently of the interests of the profession. However, it is not clear that the quality of the regulation or the outcomes would be better than that achieved under the preferred option. In addition, the fiscal cost would be about double the likely cost of the preferred option. The members of the Institute's Committees and Boards contribute to the system of regulation provide their time free of charge. That would no longer happen. Economies of scope associated with regulating auditors and other accountants together would also be lost.

PREFERRED OPTION

- 11 The key features of the preferred option are as follows:
- The profession will retain the responsibility for frontline regulation. However, a body that is independent of the profession (a reconstituted ASRB, to be called the External Reporting Board or XRB) will monitor and report on the effectiveness of the profession's regulatory systems and processes, including having the power to require an accredited accounting body to make changes to deal with identified weaknesses;
 - To introduce auditor-specific regulation for statutory audits and have a register of licensed auditors. Under this system the XRB will set the minimum licensing standards. The XRB will have the flexibility to set different minimum licensing for different classes of audits. For example, complex audits, such as audits banks, might be reserved for persons with practical experience of financial institution audits. The XRB will also set the requirements for practitioners to transition from the current to the proposed regulatory system. The Registrar of Companies would operate the register; and
 - To include an investigation safety valve in relation to public interest audits only (as opposed to all statutory audits). Under this system, the Securities Commission would be able to take over an investigation from an accredited professional body where there is concern that investors could lose substantial amounts of money in relation to an audit failure. The expectation is that the safety valve would rarely be used. The mere fact of its existence will provide strong incentives for accredited professional bodies to complete all major investigations to an acceptable standard.

12 This is the preferred option because:

- There is no indication that government licensing will deal with the problem any better than independent oversight. Therefore, it is proportionate to the size of the problem; and
- The financial costs will be lower than government licensing (i.e. the alternative option) because almost all the members of the Institute's regulatory boards and committees provide their time free of charge. In addition the economies of scope associated with regulating auditors and other accountants together will not be lost.

13 The impacts of the preferred option are:

- To reduce the risk that statutory audits will be carried out by accountants who do not have the necessary knowledge and skills to complete them to the required standard. This will, in turn, increase audit quality and reduce the risks of investor losses due to audit failure;
- To allow New Zealand auditors to obtain registration as Company Auditors in Australia. This will mean that they will be able to accept Australian audit engagements. This has the potential to increase export income and is consistent with the objectives of the Single Economic Market;
- To ensure that New Zealand auditors can continue to perform the audits of overseas-owned New Zealand entities; and
- To increase the fiscal cost of regulating auditors by about \$700,000 a year. However, other than the status quo, this is the lowest cost option.

14 There are no records of the number of accounting firms or practitioner currently carrying out statutory audits and we do not have reliable ballpark estimates of either number. It is also unclear how many Chartered Accountants that are currently carrying out audits will no longer be able to do so. However, the proposals in this paper are likely to significantly reduce the number of Chartered Accountants entitled to carry out statutory audits. Assuming constant demand, the price of audits is likely to increase. That is not a concern, to the extent that the price increase reflects an increase in audit quality. Part of the price increase could feasibly reflect market power. However, the risk of excessive pricing is small for two reasons. First, New Zealand auditors will face potential competition from overseas. Secondly, the barriers to entry (i.e. the costs to accountants who want to acquire the skills needed to qualify as a licensed auditor) will be low.

15 The main risk is that the ASRB will require accredited accounting bodies to add to or modify their regulatory systems without commensurate gains being achieved. This could occur, for example, as a consequence of political incentives on regulators to over-regulate. This risk will be mitigated by requiring the ASRB to satisfy itself that the benefits of any changes are likely to exceed the costs. This would require the ASRB to follow due process.

- 16 Another risk is that international norms could change, meaning that the system that is proposed to be introduced in New Zealand would no longer be acceptable. That risk can be ameliorated in two ways. First, international developments can be monitored. Secondly, the ASRB will be able to carry out additional regulatory functions (e.g. practice review) that might be needed to for auditors to practise in specified overseas jurisdictions.
- 17 There would be a consequential need to amend the Institute of Chartered Accountants of New Zealand Act. In addition, the Institute would need to consequentially change its codes and rules. Consideration will also need to be given to transferring the responsibility for making and approving auditing and assurance standards from the Institute to the ASRB. This issue is being addressed in a discussion document that the Ministry of Economic Development proposes to release later this year. The Ministry's preliminary view is that such a transfer of responsibilities should take place.

IMPLEMENTATION AND REVIEW

- 18 The intention is to include the proposed changes in the Accountants and Auditors Bill, which has a Category 5 priority, Instructions to Parliamentary Counsel Office to be provided in 2009. The Bill would be introduced in 2010 with a view to enactment in 2011. Once enacted, it would be necessary to have a six month transition period for the ASRB and the Institute to change their systems. The aim would be to bring the changes into force in late 2011.
- 19 At this stage it is unknown whether there will be sufficient resources to monitor the outcomes of the changes after they come into effect in 2-3 years' time. This matter will be reassessed closer to the time. However, if a review were to be carried out, we would envisage that the focus would be on:
- The impact of the licensing system on the numbers of practitioners able to provide auditing services;
 - The systems changes required by the XRB and their compliance costs;
 - Stakeholder perceptions of the impact of the changes on audit quality and confidence in the system;
 - The ability of New Zealand auditors to practise in overseas jurisdictions and carry out audits of overseas-owned New Zealand businesses; and
 - Identifying improvements to the system.
- 20 Such a review would be likely to require 0.5 of an FTE for six months.

CONSULTATION

- 21 In late 2007 and early 2008, the Ministry of Economic Development carried out targeted consultation with the ASRB, Australian Treasury, the Big 4 accounting firms, the Institute of Directors, the New Zealand Institute of Chartered Accountants, the Office of the Auditor-General, the Reserve Bank, Securities Commission and the TransTasman Accounting and Auditing Standards Group. This involved preparing and circulating an ideas paper, meeting with some of these parties and receiving and analysing submissions.
- 22 There was general support for the introduction of independent oversight. However there was no consensus on the form that it should take. The Securities Commission wanted the oversight system to be more interventionist than is being proposed (for example, the Commission wanted to include rules approval). The Institute wanted the oversight body to have fewer powers than was proposed. In particular, the Institute wanted the oversight body's powers to be limited to recommending changes to the Institute's regulatory systems and processes and leaving it to the Institute to decide whether to implement the changes.
- 23 The Treasury, Ministry of Justice, Securities Commission, Reserve Bank, Registrar of Companies, Office of the Auditor-General, Accounting Standards Review Board, State Services Commission and the Institute of Chartered Accountants of New Zealand were consulted on the Cabinet paper. The only significant dissent is that the Institute does not agree with the approach proposed in relation to the investigation safety valve. It considers that this should be an optional measure as a protection in the event that New Zealand auditors are unable to practise overseas.