Enhanced auditor reporting

A review of the third year of the revised auditor's report

May 2020

EXTERNAL REPORTING BOARD
Te Kāwai Ārahi Pūrongo Mōwaho

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

Contents

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Introduction

In 2017 the XRB and the FMA jointly issued Key audit matters: A stock take of the first year in New Zealand. The report looked at the first year of the revised auditor's report, focusing on the reporting of key audit matters (KAMs). It included information on the number and types of KAMs, including those most common. It explored areas where some auditors were adding additional voluntary reporting in the auditor's report and also reflected some initial views of preparers, users, and those charged with the governance of entities on the impact of KAM reporting.

The new auditor's report was welcomed as an opportunity to promote the value and relevance of an audit. From the auditors' perspective it was noted that KAM reporting required audit firms to invest in additional resources. Different approaches were taken by each firm, resulting in less boilerplate reporting.

2019 review

The objective of this follow-up report is to review the evolution of trends in KAM reporting in the three years since being introduced. In this report, we only engaged with investors to consider whether the changes are achieving their objectives. This time we have not sought the views of auditors, preparers or those charged with governance.

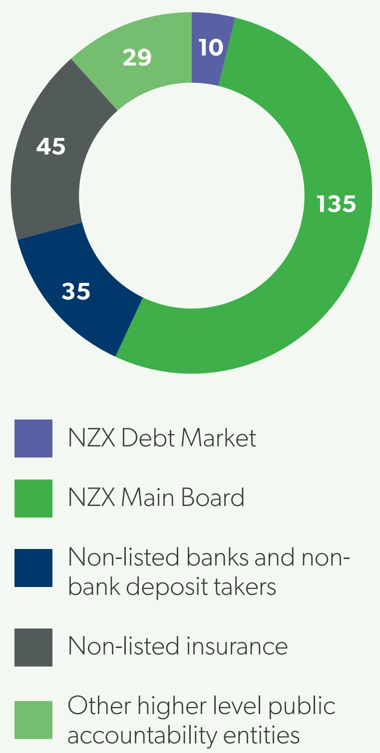
KAM reporting became mandatory for a wider population, extending to all FMC reporting entities with a higher level of public accountability (FMC HLPA entities) from December 2018. For our 2019 review we analysed a large sample of audit reports to determine what changes, if any, have been made since our 2017 review, and to identify any trends emerging from the additional reporting entities. As a result of the broader scope of KAM reporting we analysed trends by sector for banking and finance, and insurance, as well as common KAMs reported within other sectors.

We also conducted interviews with a handful of investors and analysts. Due to the small number of responses received, the views reflected in the report may not be representative of all investors and analysts. We thank those who shared their views with us.

Scope of research

In this review we analysed 254 audit reports. The sample included one entity which comprised of 31 investment funds with a common fund manager, financial year end, date of opinion, audit firm and KAMs.

Number of entities reviewed by market



From the XRB

Scrutiny of the audit profession is at an all time high. After high-profile corporate failures and scandals in the UK, various reviews were undertaken to consider ways to enhance audit quality.

The Australian Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the regulation of auditing released an interim report as part of the ongoing inquiry on how to raise audit quality standards in Australia. The XRB's purpose is to develop standards that engender confidence in the financial reporting of New Zealand's organisations. We adopted the revised auditor reporting standards in 2015 and have been actively monitoring the application of these changes over the transition period, which included a phased adoption of the reporting of KAMs by auditors, firstly for listed entities and subsequently for banks, insurers, and other entities of high public interest.

As we continue to monitor the adoption of the new standards, we are pleased to hear from investors that the new report is an improvement, and that the reporting of KAMs is considered useful while acknowledging the desire for even more information from the auditor. A key objective of the new auditor's report was to enhance its informative value.

The KAM reporting framework is based on strong principles that will serve preparers, auditors and users well through the COVID-19 reporting season. We encourage auditors to be innovative and consider ways to enhance the informative value of the auditor's report for the user. We expect that going forwards KAMs will reflect the unique and unprecedented challenges that COVID-19 has and continues to create. This will showcase how KAMs make the auditor's report less boilerplate and more entity and reporting period specific.

The XRB will be working with international standard setters and looking to facilitate collaborative mechanisms with all key players in the financial reporting chain as the debate on the future and relevance of audit reaches a pinnacle.

April Mackenzie
XRB Chief Executive

About the XRB

The External Reporting Board (XRB) is the independent Crown Entity responsible for accounting and assurance standards in New Zealand. The New Zealand Auditing and Assurance Standards Board (NZAuASB) has delegated authority from the XRB Board to develop or adopt, and issue auditing and assurance standards.

All XRB standards are designed to give New Zealanders trust and confidence in the financial reporting of our organisations, across the for profit, not-for profit and public sectors.

EXTERNAL REPORTING BOARD
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From the FMA

One of the FMA's overarching interests is the integrity of New Zealand's financial markets. The role of auditors in maintaining and improving this integrity is vital, and often overlooked. Auditors are there to check and challenge the processes and systems of FMC reporting entities, and to provide investors with a clear and independent view of whether these functions are sufficient to produce compliant financial statements. Where auditors are unable to rely on these systems, they should encourage directors to make improvements.

Last year, the FMA published research that showed a clear gap exists between what investors expect to receive, as end users of audit services, and what they believe auditors are delivering. We also saw perceived lack of auditor independence come through as a strong concern of investors and some directors.

48% of investors surveyed thought audit quality was of a high standard, which is not alarmingly low. But together, these findings add up to a strong likelihood that many investors have concerns about the value of auditor reporting. The revised auditor's report offers an ideal platform to, at least in part, bridge the expectation gap and improve investors' perceptions of the value of auditing.

In the current environment, investors will be particularly interested in the impact of COVID-19. COVID-19 may impact a number of key areas of the audit, which may mean an increase in the number of KAMs, rather than COVID-19 itself being a KAM.

We also encourage auditors to use the opportunity for voluntary reporting to cover issues that could help improve users' faith in the audit. This could include information about audit scope and procedures, and more details on the communication with those charged with governance on relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards. Of course, we expect this reporting will accurately reflect the actual work carried out, and this will be a focus of our ongoing audit quality monitoring work.

Rob Everett
FMA Chief Executive

About the FMA

The Financial Markets Authority (FMA) plays a critical role in regulating capital markets and financial services in New Zealand. They are the New Zealand government agency responsible for enforcing securities, financial reporting and company law as they apply to financial services and securities markets.

FMA also regulates securities exchanges, financial advisers and brokers, auditors, trustees and issuers – including issuers of KiwiSaver and superannuation schemes. Jointly, they oversee designated settlement systems in New Zealand, with the Reserve Bank of New Zealand (RBNZ).

The FMA's vision is to promote and facilitate the development of fair, efficient and transparent financial markets.

FMA
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What are key audit matters?

KAMs provide transparency about the matters that, in the auditor's judgement, were of most significance in the audit of the financial statements. KAMs are selected by the auditor from the matters communicated with those charged with governance.

What should be reported as a KAM?

Identifying a KAM is a matter of professional judgement. The auditor should consider the following when selecting KAMs:

- Areas with a higher risk of material misstatement.
- Significant auditor judgements relating to areas in the financial statements that involved significant management judgements.
- The effect on the audit of significant events or transactions that occurred during the period.

KAMs are not a substitute for the auditor expressing a modified opinion, nor are they intended to "fill the gaps" for disclosures viewed as incomplete.

Why do we need KAMs?

The objective of KAMs is to provide users of the financial statements with a better understanding of how the audit was conducted and complexities that arose, by disclosing information previously only available to those charged with governance at the entity. This information includes why a matter was identified as a KAM and how it was addressed. The information is intended to be less boilerplate and provide more entity- and period-specific information about the audit.

Investor perspective

"Audit reports are more useful now by listing issues where valuations may be judgemental and showing the audit methodology."

Some users we spoke to could not identify any auditor reports that were particularly useful, while others noted plenty of useful examples and commented that they always refer to KAMs now.

When is a KAM required?

Internationally, the reporting of KAMs is required for all listed entities. New Zealand goes beyond this and requires all FMC HLPA entities[1] to disclose KAMs. Under the Financial Markets Conduct Act 2013, various types of entities are considered to have a higher level of public accountability. These include registered banks, credit unions, building societies, licensed insurers, issuers of equity or debt securities under a registered offer, and managers of registered schemes.

A challenge we have seen for entities and auditors in this space is correctly applying the definition of an FMC HLPA entity. The responsibility to assess the definition lies firstly with the entity. However, the auditor is required to assess if an entity meets the definition of an FMC HLPA entity. As part of our review we found three entities that were not correctly identified as FMC HLPA entities and therefore had no KAMs reported. The FMA engaged separately with the FMC entities and the auditors regarding this matter.

1. Types of entities considered to be FMC HLPA entities can be found on the FMA website.

Findings by audit firm

The auditor's report is now more specific to the entity being audited, so there is more variation between reports.

This analysis shows that there is no standard length and no 'correct' KAMs.

Number of audit reports

Deloitte	EY	KPMG	PwC	Other	Total
35	26	55	73	65	254

Average length of auditor's report (pages)

Deloitte	EY	KPMG	PwC	Other	Overall average
3	4	4	5	4	4

Number of KAMs reported

	Deloitte	EY	KPMG	PwC	Other
Average	2	2	2	2	2
Highest	3	6	6	4	6
Lowest	0	1	0	0	0

Voluntary reporting themes

	Deloitte	EY	KPMG	PwC	Other	Total
Materiality	22	0	31	67	0	120
Outcome of audit procedures	4	0	19	57	5	85
Scope of audit	0	0	6	69	0	75

Non-standard reports

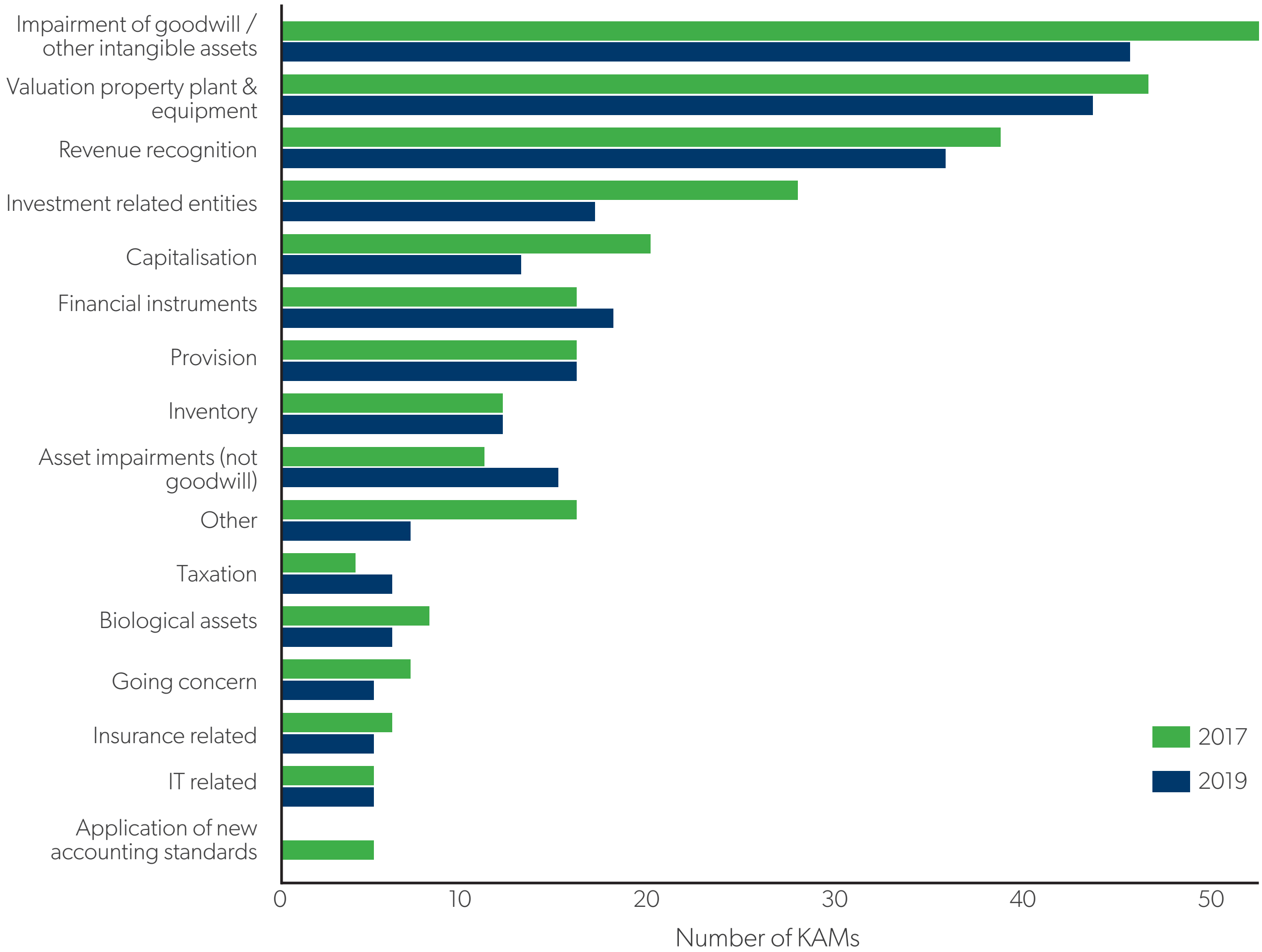
	Deloitte	EY	KPMG	PwC	Other	Total
Material uncertainty relating to going concern	2	0	3	2	7	14
Emphasis of matter	0	1	0	0	1	2
Qualification	0	0	0	0	3	3
Disclaimer on going concern	0	0	0	0	1	1
Disclaimer	0	0	0	1	1	2

NZX-listed entities

Most common KAMs

The chart below shows the number of KAMs in each main category in 2017 and 2019.

95% of the KAMs were in the same 16 main categories identified in the previous review.



The number of entities analysed impacts the number of KAMs reported. In 2017 our analysis included 161 listed entities whereas in 2019 our analysis included 145 listed entities.

The top three categories have not changed since our 2017 findings. **Impairment of goodwill / other intangible assets** was the most common KAM reported, which is consistent with our observations; we have seen numerous business combinations in recent years that resulted in goodwill and other intangible assets requiring an impairment assessment. This KAM was common in all sectors, but is especially noticeable in the Information Technology, Agriculture, and Service Solutions sectors.

Consistent with our previous analysis, **Valuation of property, plant & equipment** was the most common type of KAM in the Commercial Properties and Commercial Crown Entities sectors, representing 64% of KAMs reported. This is an area of judgement requiring auditors to challenge the assumptions of management and management experts when determining the value of investment properties and properties under construction. This is consistent with our understanding of the challenges in valuing properties under construction. This KAM may be reported in consecutive years as assumptions and market conditions will need to be reassessed annually.

Capitalisation was another frequently reported KAM (43%), mainly in the growing Information Technology sector, and the Energy and Healthcare sectors. This KAM was commonly linked to internally developed assets, an area usually requiring significant judgements. The nature of these KAMs includes both the recognition and measurement of capitalisation costs of internally developed assets, and impairment considerations of these assets.

An interesting KAM that emerged in this year's analysis was **Application of new accounting standards**, such as NZ IFRS 15 (Revenue from Contracts with Customers), NZ IFRS 9 (Financial Instruments) and NZ IFRS 16 (Leases). We saw five instances of this KAM, across various sectors, which indicates that the new standards did not have a significant impact on the level of judgements and audit work for most entities.

In three instances no KAMs were communicated. We do expect that this will happen in rare instances, based on the auditor's judgement.

Comparison with other jurisdictions

The 10 most common KAMs reported in New Zealand are generally in line with those observed internationally. However, while **Taxation** continues to be one of the most common KAMs in the UK (second most reported), South Africa (second most reported) and Sri Lanka (fifth most reported), it does not feature in the top 10 in New Zealand. Singapore and Hong Kong are very similar to New Zealand in this regard. Our analysis shows that the number of instances where taxation is identified as a KAM has increased compared to the first year of implementation, with the nature of the matter being recoverability of deferred tax assets and management judgements relating to future profitability forecasts.

Year to year changes

For those KAMs that remained the same as in 2017, we did not see any substantial change in the language, content and details of the KAM description or the way in which the matter was addressed by the auditor. This would suggest that the entity's operations did not change significantly and that the matter(s) of most significance for the audit remained the same as prior years.

In around 50% of entities reviewed, the auditor reported a different number of KAMs from 2017. This could be explained by legal provisions, business acquisitions or disposals, going concern assessments, impairments, and the implementation of new accounting standards impacting the entity. Such KAMs are usually one-off, specific to the year and relevant to a particular event.

Where an entity changed auditors we did not see any substantial change in the type of KAMs reported, although in some instances there was a different level of detail provided (more in some instances, less in others) about why the matter was a KAM and the audit procedures.

Investor perspective

"There is a risk of KAMs becoming boilerplate. If you compare the KAMs of the same entity year to year, or a type of KAM described by the same auditor, some are almost word for word the same."

There was a call from some to raise the bar further and comparisons were made to some auditor reports in the UK, where the KAM reporting includes indicating if the risks are increasing, decreasing or staying about the same.

Investor perspective

"It is good to see that where there is a change in auditor, the same KAMs are picked up."

Other KAM observations

Our review identified the following notable KAMs:

- The entity's strategic goals, or wider macro-economic or environmental factors.
- Compliance with financial covenants.
- Scoping of the audit and assessing sufficiency of audit evidence obtained for differing geographic locations and businesses.
- Significant events in the current year, e.g. fraud.
- The impact of accounting standards issued but not yet effective.
- Non-financial areas (particularly for public entities).

Use of auditor experts

Out of 269 KAMs reported across 145 listed entities, 119 KAMs included references to the use of an expert or specialist. The most common expertise sought within each KAM category is shown below:

KAM	Expertise
Capitalisation	Corporate finance and valuation
Disposals / acquisition	Corporate finance, accounting, valuation and tax
Financial instruments	Valuation
Impairment of goodwill / other intangible assets	Corporate finance and valuation
Insurance related assets / liabilities	Actuarial
IT systems & controls	IT
Revenue recognition	Valuation and accounting
Taxation	Tax
Valuation of property, plant & equipment	Valuation

Most experts used were in-house valuation specialists in the area of Valuation of property, plant & equipment, or related to Impairment of goodwill and other intangible assets. The implementation of new accounting standards also resulted in the increased involvement of internal accounting experts to respond to these KAMs.

Investor perspective

An investor noted that KAMs seemed focused on the "dollar value". This investor identified KAMs about governance or the control environment as especially useful.

Investor perspective

Investors have noticed "trailblazer" assurance reports that include sustainability information, and innovative approaches to cover both the financial statements and sustainability information in one assurance report.

Investors did note that auditors are "not helping themselves" by using double negative language in limited assurance conclusions related to sustainability information[2].

2. The negative language is required by the assurance standards.

KAMs by sector

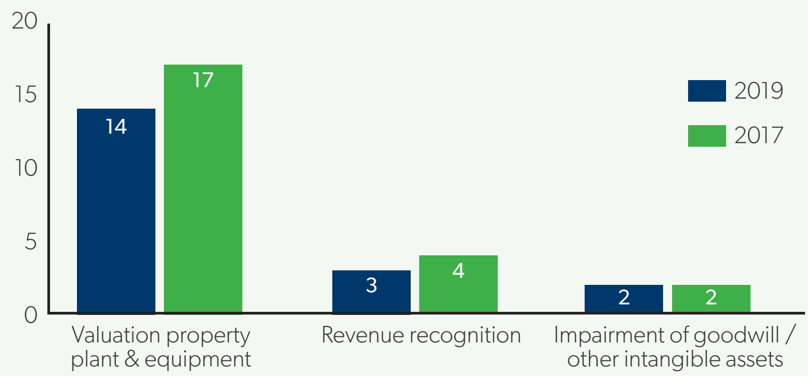
Overall, the analysis shows that in each of the six largest sectors in the listed space, the most common KAMs have not substantially changed from our previous review. This is in line with our expectations.

Where the KAMs have changed, these changes can be attributed to entities delisting since 2017 and therefore a change in the sample size.

1. Commercial properties

	2019	2017
Number of entities	18	20

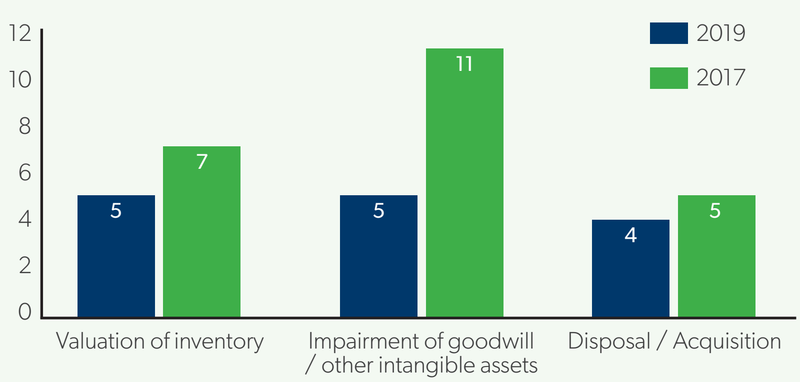
Number of KAMs



2. Consumer goods & services

	2019	2017
Number of entities	14	22

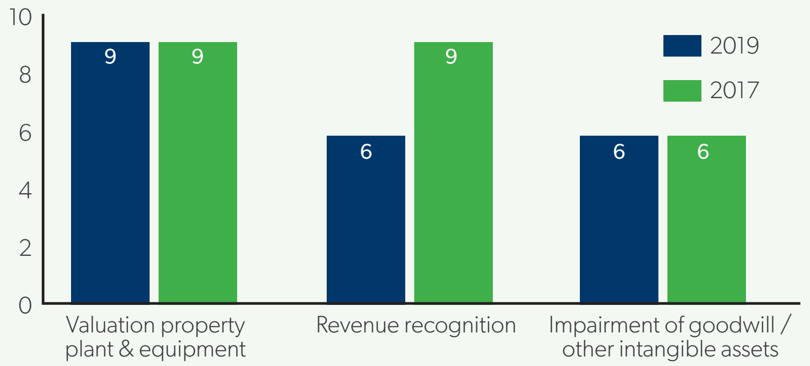
Number of KAMs



3. Information technology

	2019	2017
Number of entities	21	24

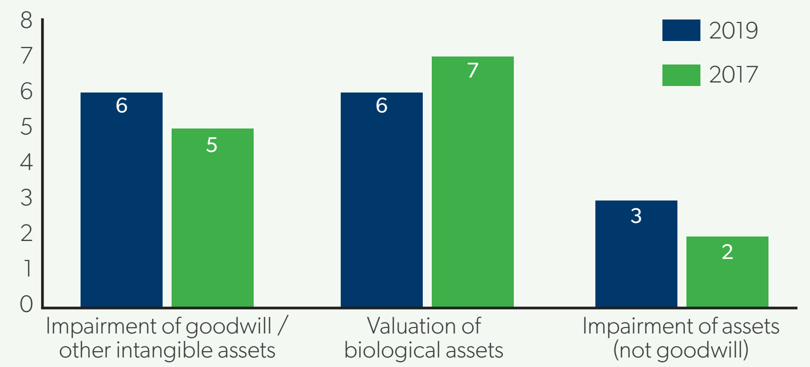
Number of KAMs



4. Agriculture

	2019	2017
Number of entities	13	13

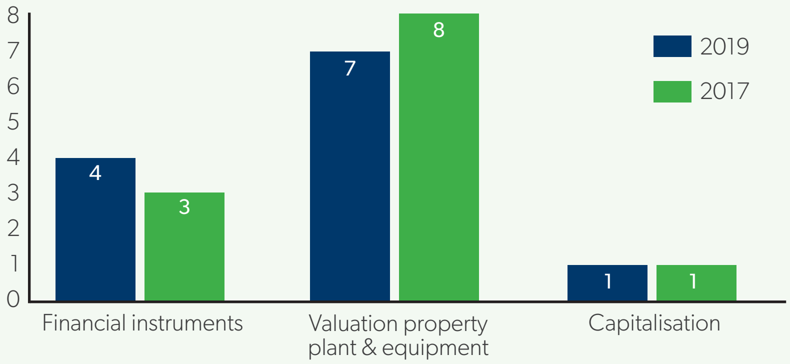
Number of KAMs



5. Energy

	2019	2017
Number of entities	12	12

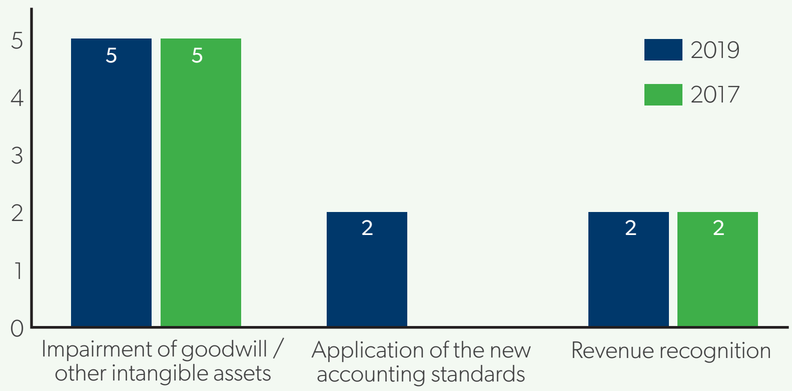
Number of KAMs



6. Healthcare

	2019	2017
Number of entities	9	7

Number of KAMs



Voluntary reporting

Examples of voluntary elements in audit reports included the materiality threshold applied and details of the audit scope, as well as auditors indicating the outcome or results of certain procedures within individual KAMs.

Feedback collected as part of the 2017 review encouraged auditors to be innovative, so we were looking for any changes in voluntary reporting. We saw a slight decline, as noted below.

	Materiality	Audit scope	Outcome of procedures
First year of implementation	61% disclosed	37% disclosed	50% indirectly provided outcome
Current year analysis	60% disclosed	35% disclosed	43% indirectly provided outcome

PwC remained the only firm to disclose all these voluntary elements in all their audit reports. KPMG and Deloitte reported materiality in more than 80% of audit reports, but had a less consistent approach to disclosing the audit scope or outcome of procedures. Other firms, unless performing work on behalf of the Auditor-General, did not disclose the above information, given that it is not required by the auditing standards.

The table on the following page shows how frequently firms reported additional elements relating to materiality.

Investor perspective

The reporting of the outcomes of procedures is especially useful.

It was noted that having materiality disclosed is particularly useful and some firms do this particularly well.

One comment noted surprise by how high materiality was.

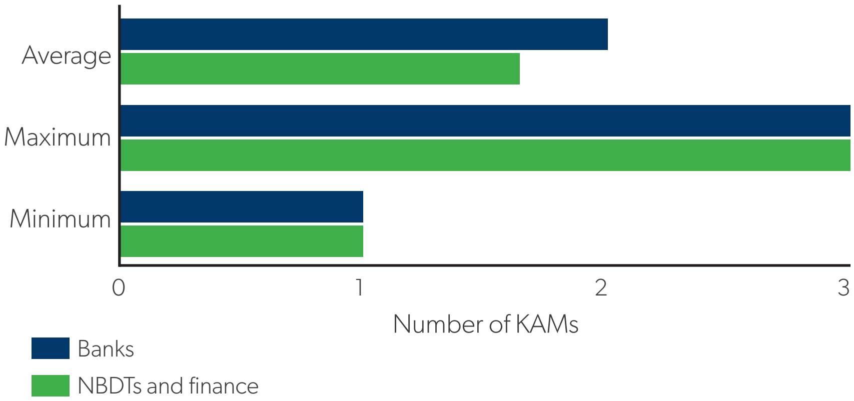
	PwC	KPMG	Deloitte	EY	Other
Materiality benchmark	100%	66%	8%	0%	8%
Rationale on the chosen benchmark	100%	66%	8%	0%	0%
Materiality value	100%	76%	88%	0%	0%
Materiality percentage	100%	0%	8%	0%	0%
Threshold for reporting unadjusted errors to audit committee	20%	0%	2%	0%	0%

Materiality benchmarks

The most reported materiality benchmark for NZX listed entities remained **profit before tax** or **adjusted profit before tax** (59% of entities). The rationale offered was that this represents the key measure of performance of the entity and is a commonly accepted benchmark. Other common benchmarks were **revenue** (21% of entities) and **net assets** (11% of entities) with no particular link between the benchmark and the entity's industry. Our analysis showed that entity-specific performance measures relevant to the entity's unique operations drive the materiality benchmark. The use of different benchmarks demonstrates the significant degree of judgement that is used by the auditor in determining the materiality threshold. The FMA analysis shows that this is appropriate.

Banking and finance sector

Our review included 37 entities in this sector – 15 banks, 20 non-bank deposit takers (NBDTs) and two finance companies.

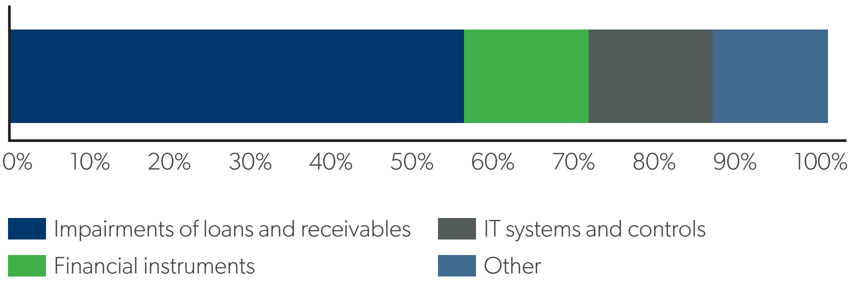


Number of KAMs

The average number of KAMs in this sector was consistent with other industries (two per entity). However, this was lower than the average of four[3] reported in the European Banking sector. This variation may reflect the size differences of the entities in both jurisdictions.

Most common KAMs

We categorised the 65 KAMs reported for the 37 entities into three main categories, representing 86% of the KAMs reported. KAMs that did not fall into one of the top three categories are included in "other" for the purpose of our review. These included more entity-specific matters such as Valuation, Property, plant & equipment, Insurance contract liabilities and Revenue recognition.



3. Key Audit Matters in the European Banking Sector

The top three recurring KAMs highlight the complexities and significant level of judgement required in assessing and valuing impairment of loans and receivables and financial instruments, as well as how critical IT systems are in this sector.

As expected, auditors of banks all reported **Impairment of loans & receivables** as a KAM. Auditors of three of the 'Big Four' banks also reported the valuation of **Financial instruments**, and **IT systems and controls** as KAMs.

Impairment of loans and advances

NZ IFRS 9 (Financial Instruments) introduced a new impairment model, the expected credit loss (ECL) model. Entities have developed new impairment models, requiring complex judgements and estimates to determine the ECL. While impairment assessments have always required a significant level of judgement and are therefore always likely to be a KAM, there has been increased focus on this area due to the new accounting standard, including assessing the appropriateness of new disclosure requirements in the first year of implementation.

IT systems and controls

The banking sector is heavily dependent on complex IT systems for the capture, processing, storage, and extraction of significant volumes of transactions. Control deficiencies in this area can significantly change the auditor's initial risk assessment and audit approach. Where the auditor identified IT systems as a KAM, the main focus was on the automated controls within the IT system, in particular internal controls on change management, IT systems, user access, monitoring controls and system-generated reports.

Financial instruments

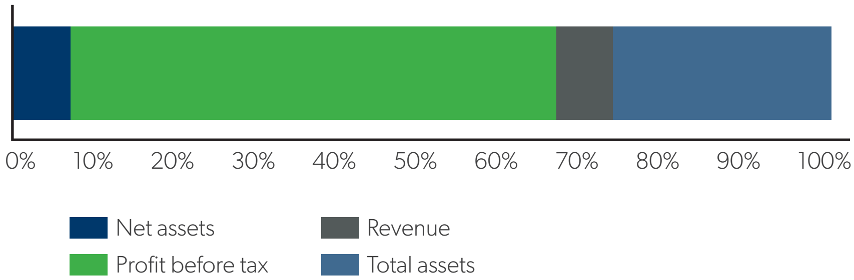
The majority of KAMs about financial instruments relate to valuation when measured at fair value. They were primarily identified as a KAM due to the material size of the balances as opposed to the risks of misstatement.

For six of the non-bank deposit taker entities, auditors reported impairment of the financial instruments held at fair value as a KAM. This particular KAM was specific to all six related entities, in response to a particular event during the year; we therefore expect this will not be a recurring KAM.

Materiality benchmarks

For banks, the most commonly reported materiality benchmark was 5% of **profit before tax**. The rationale provided was that this represents a key measure of performance and is a commonly accepted benchmark.

For non-bank deposit takers the most commonly reported benchmark was 1% of **total assets**. The rationale provided was that it is a key indicator of how the entity is performing and the key focus of the stakeholders.



Insurance sector

Our review included 46 registered insurance entities

Number of KAMs

The average number of KAMs reported was one, but for the 10 largest insurers the average was two. In three instances, no KAMs were reported.

Most common KAMs

Consistent with our expectation for this industry, the common KAMs were **Insurance contracts liabilities** (common to 90% of entities), and **Reinsurance assets** and **Reinsurance liabilities** (common to 15% of entities). Where reinsurance assets and liabilities were not reported as a separate KAM, they were described within the insurance contracts liabilities KAM.

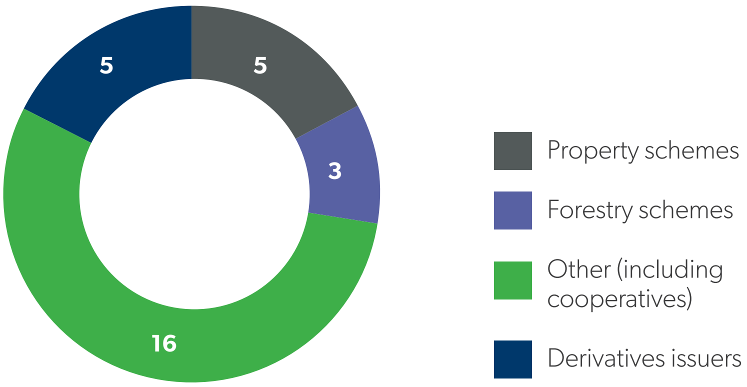
IT systems and controls was only identified as a KAM for three entities, with selection criteria related to how much the entity depends on IT systems that are relevant to the auditor. Other KAMs reported were entity-specific.

Materiality benchmarks

Materiality information was disclosed in only 30% of audit reports (14 of the 46 entities). **Profit before tax** and **premium revenue** were adopted equally as the materiality benchmark, and rationale disclosed by the auditors stated they are both commonly used and generally accepted benchmarks.

Other sectors

In addition to the NZX-listed entities, financial institutions and insurance companies, the reporting of KAMs is mandatory for various other FMC HLPA entities. We reviewed a sample of 29 of these entities as detailed below



Common KAMs

In total, 38 KAMs were reported for these 29 entities. The top three recurring KAMs were:

1. **Revenue recognition** (Derivative issuers and Others)
2. **Valuation of property, plant and equipment** (Property schemes and Others)
3. **Valuation of biological assets** (Forestry schemes)

An important factor in the selection of the Revenue recognition KAM could be the implementation of NZ IFRS 15 Revenue from Contract with Customers. Most auditors have communicated that the complexity of the standard and the significant level of judgement required in the first year of implementation (to determine the timing and quantum of the revenue to be recognised) resulted in Revenue recognition being identified as a KAM.

For eight of the KAMs reported, the auditor involved a valuation specialist. This related to the valuation of property plant and equipment and the valuation of biological assets.

Going concern as a KAM

Going concern can be a sensitive matter. Internationally there are calls for increased focus on going concern matters by those charged with governance, management and the auditor.

There are two different communication approaches where the audit opinion is not modified but the auditor still reports on going concern matters. The approach depends on whether the auditor concludes that there is a material uncertainty related to going concern (MURGC) or not. The following table analyses the different approaches:

	Where the auditor concludes that there IS a MURGC	Where the auditor concludes there IS NOT a MURGC, but the use of the going concern assumption is identified as a KAM
Reporting approach required by the standard	The MURGC is, by nature, a KAM but it is communicated in a separate section in the auditor's report.	Going concern can be a "close call". The auditor may have made significant effort to gain comfort that the use of the going concern assumption was appropriate and therefore identify going concern as a KAM.
2017	16 examples	7 examples
2019	14 examples	5 examples

The changes in the number of entities reporting MURGC or going concern as a KAM is attributed to:

- Entities delisting or ceasing operations.
- Improvement of the financial performance of the entity meaning going concern was not identified as a MURGC or a KAM.
- Deterioration of the entity's financial performance, meaning going concern went from a KAM to a MURGC.

Investor perspective

An investor commented that auditors are doing a good job on reporting going concern matters.

When going concern was reported as a KAM, the required information was provided to explain the entity's specific circumstances, including management's process to evaluate going concern and the audit procedures performed to address the risks. In some instances, the auditor also included the outcome of those audit procedures.

Consistent with the requirements of the auditing standards, we observed that when the auditor concludes there is a MURGC and it is reported as such, the information reported is limited to why a material uncertainty exists. In one of the 14 instances where the auditor concluded there was a MURGC, the auditor voluntarily disclosed additional information, similar to if it had been identified as a KAM, including listing the procedures.

Going concern is an important area of the audit and often requires significant auditor attention.

Reporting on independence

Investors we spoke to all mentioned the importance of auditor independence. Auditor independence is a prerequisite for an audit but is not related to reporting of KAMs.

Internationally, the new auditor's report includes an affirmative statement about the auditor's independence. This addition was included to emphasise the importance of complying with ethical requirements as a basis for the audit and increases the focus on independence.

New Zealand has adopted the most up-to-date revised and restructured international independence standards. The auditing standards require that all auditors' reports include a statement that the auditor is independent of the entity in accordance with those independence standards. In New Zealand auditors shall also include a statement as to the existence of any relationship (other than as auditor) or interest the auditor has in the entity in New Zealand. For all FMC HLPA entities, the auditor shall also state that they provide those charged with governance with a statement that the auditor complied with relevant ethical requirements regarding independence, and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, as well as, where applicable, related safeguards.

New Zealand also requires more disclosure about fees paid to the auditor in the financial statements than in other jurisdictions[4].

The results of FMA's recent Audit Quality Perceptions Research[5] highlighted that there are growing concerns around the provision of non-assurance services, and the relationship between an FMC HLPA entity and its audit firm.

Investor perspective

Investors may start to discount the value of the audit report and the work done to report KAMs if there are significant perceived concerns about auditor independence.

Investors appear to question the statement regarding independence within the auditor's report where significant fees are received for other services. They were also especially interested in the number of years the auditor has audited the entity.

What are auditors disclosing?

As part of our review we analysed the disclosure of independence for the 135 listed entities that had disclosed that the auditor provided non-assurance services.

All audit reports included a statement confirming auditor independence, and describing the nature of services provided and the

4. FRS 44 New Zealand Additional Disclosures
5. Audit Quality Perceptions Research

relationship between the entity and the auditor. The descriptions were consistent with disclosures of audit and non-audit fees in the notes to the financial statements.

Our review shows on average, the level of non-audit fees is 15% that of audit- and assurance-related fees. The international independence standards do not prescribe a fee cap for non-assurance services.

The FMA and the XRB are looking at ways to enhance these disclosure requirements to provide further clarity about the categories of services and associated fees.

International focus on independence

Auditor independence remains a challenging area for standards-setters, regulators and auditors. The XRB is currently seeking feedback on international proposals to tighten the independence standards on the provision of non-assurance services and fees.

The XRB and the FMA continue to monitor developments in individual jurisdictions, where there is significant variation, to inform decisions on additional requirements that may be needed in New Zealand. Some jurisdictions have gone, or are considering going, beyond the international requirements. Options that have been or are being considered by other jurisdictions include:

- A prohibition on the provision of any non-audit services unless these are closely linked to the audit engagement itself, or if required by law or regulation. There are some challenges in how to define what services are closely linked to an audit.
- A list of permitted services that the auditor can provide together with the audit.
- Disclosure of the hours spent conducting the audit by each grade of auditor.
- Disclosure of the duration of the firm's involvement in the audit of the entity.
- Mandatory firm rotation or mandatory retendering after a predetermined period.

Concluding summary

Our detailed analysis of 254 audit reports confirms similar trends as identified in our first report. There is consistent variation in the way in which the new requirements are being implemented, with some firms or auditors voluntarily including additional information not required by the standards. The variation is broadly consistent with the findings from our 2017 report.

We continue to see variation in how users are engaging with auditors' reports. Some users have found the inclusion of KAMs useful, although are still calling for more information. The expectation gap remains. There is an ongoing need to better engage shareholders with the value of audit.

Reporting on KAMs and independence continues to evolve.

Internationally, standard-setters are gathering information to inform a post-implementation review as to whether the objectives of the key audit matter project have been met. Developments in practice will inform the next steps in ensuring the content of the auditor's report is relevant and informative, within the scope and responsibility of the audit, and helps to communicate the value of the audit.

The FMA has included the review of the enhanced auditor's report in its audit quality reviews and noted a high level of compliance on:

- The process followed by the audit firm to conclude which matters were key audit matters.
- Consistency between the KAMs and the entity's disclosures in the financial statements about underlying judgements and assumptions.
- Whether the audit work performed fairly reflects what was disclosed in the audit report.

The impact of COVID-19 will also be a key event that auditors need to consider when deciding on the key audit matters for the current period. We expect auditors to consider this based on the specific circumstances of the entity and the environment it operates in.

The reporting of KAMs provides auditors with an opportunity to tailor the report for each individual entity and to reflect their view on those matters that required significant auditor attention. We have noted that auditors and firms have taken the opportunity to distinguish themselves

Investor perspective

Some investors commented that what they would value more would be more transparency about the level of challenge or the robustness of the debate between auditor and client. This is where the value of the audit is best communicated.

when applying this standard and encourage them to continue this in the future.

Users can expect to see much more variation in audit reports in response to the impact of COVID-19. This variation may include:

- New types of KAMs.
- Different responses to the KAMs identified.
- More paragraphs highlighting material uncertainty related to going concern (MURGC).
- Modifications to audit reports.
- The inclusion of emphasis of matter paragraphs where the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

The auditor will determine the best way to communicate to users based on the specific circumstances of the entity and the environment that it operates in.

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