

## **Auditor Regulation Oversight – 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.