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16 December 2011

Audit

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Dear Sir/Madam

Licensing of auditors and the registration of audit firms

Thank you for the opportunity to provide comments on the consultation paper that was recently issued by the Financial Markets Authority (FMA) explaining how it would license auditors and register audit firms.

Grant Thornton is globally recognised as one of the "large firms". Currently more than half our global revenue of approximately US$4 billion comes from the provision of assurance services. Because we continue to actively build and expand our audit practice both in New Zealand and around the world, we compared what is being planned for New Zealand with the audit registration and monitoring requirements in other countries. We were pleased to see a strong alignment in many aspects of the requirements; not only with Australia, but also with other jurisdictions around the world and so we commend the FMA for taking this into account.

Prior to sending this comment letter we were given the opportunity to review a final draft of the New Zealand Institute of Chartered Accountants (NZICA) submission to the FMA on the consultation paper. Generally speaking we support all the views, opinions and go-forward suggestions they have made.

However, there are some aspects of auditing that NZICA, as a professional body, is simply not in a position to comment on. In this submission we have provided comments and insight from a predominantly operational perspective to provide the FMA with an appreciation of what we think is reasonable.

Our view on audit is that every entity in New Zealand, and not just issuers, should expect a high quality audit. We believe the monitoring proposals the FMA has put forward in this paper will go a long way to ensuring that issuers in New Zealand will be properly audited.

The role of NZICA

We are aware that New Zealand Institute of Chartered Accountants (NZICA) has played a significant role in helping the FMA shape the proposals outlined in the consultation paper.

We wish to confirm with the FMA that we have also been involved in many discussions with NZICA over the last two years about how best to license auditors and register audit firms. We are pleased to see many of our views being reflected in the proposals.

Market segmentation

A danger that is recognised in the consultation paper is that issuers may have a limited number of choice of accounting firms to undertake their audit. We concur with this analysis. In a nutshell, if the audit practice is not large enough to support at least three full time audit partners, it will almost certainly fail to meet the proposed firm registration requirements. This will have implications in many regional centres around the country and so it would be helpful if the FMA and NZICA would work together on bringing this significant development to the attention of not only those in the accounting profession, but also the director community through the country.

Another observation we would make is that when these regulations come into force, the role of the "part-time" audit professional will almost certainly disappear. We believe those individuals who currently audit "part-time" will either transfer their responsibilities to a "full time" audit professional within their existing firm, or they will need to exit the audit market. We see this consequence as a sign of the times, and absolutely essential if the quality of audits in New Zealand is to be maintained over a prolonged period.

Audit competency

The cornerstone of any profession is trust, and the auditing profession is not exempt from this. The trust that investors place in an auditor is that the individual has a current and up-to-date knowledge of all the requirements to complete an audit. In a New Zealand context, an audit professional must therefore not only have a detailed working knowledge of all of New Zealand's auditing standards, they must have a detailed knowledge of all the New Zealand equivalents of International Financial Reporting Standards (NZ IFRS). We expect that hundreds of pages of new material on auditing and financial reporting matters will be issued by the External Reporting Board (XRB) every year. The time commitment needed to ensure that a licensed auditor properly understands the consequences of all this new guidance cannot be underestimated, and should be taken into account when assessing hours spent on the audit of issuers.

Our view is that any licensed auditor, whether resident in New Zealand or overseas, must be able to demonstrate and evidence their current competence and knowledge of New Zealand's laws and regulations.

For New Zealand resident auditors we believe, as a minimum, the registered auditor must be able to demonstrate a minimum of 50 hours over 2 years in either "structured" financial reporting, auditing or commercial and/or securities law courses. Furthermore, this time commitment should be included in the tally of audit hours recorded by each licensed auditor.

For licensed overseas auditors, we believe they must pass foundation papers on New Zealand tax and New Zealand's commercial and securities law before they are able to sign of an opinion on an issuer incorporated in New Zealand. They must also continue to

maintain their knowledge by having to observe the same on-going training requirements as a New Zealand resident auditor.

Minimum hours

The proposals currently require an auditor to demonstrate that they spend at least 1,000 hours doing audit work over a two year period. In addition, this time must be spent on the audits of issuers.

We consider this too high a threshold. We believe the recommendation from NZICA that 750 hours spent on the audit of issuers over a period of up to three years is far more reasonable.

While we wholeheartedly support the need for a minimum hours requirement over a three year period, we do not believe it should be restricted solely to audit hours spent on issuers. Our reasoning for this is that our auditing standards make no distinction between the audit of an issuer and any other type of entity, so why should the regulator introduce this?

Simply put, our view is that "an audit is an audit".

The only difference that exists between the audits of any type of entity is the level of risk inherent in the business activities and operations of the reporting entity. It is very clear in the XRB-approved auditing standards that if the auditor does not have the competency to undertake a particular type of audit engagement (eg audit of an issuer) then the audit opportunity must be declined. To issue licenses to auditors with conditions, in our opinion, completely undermines the role of audit and is fraught with many operational difficulties that will not easily be overcome.

A critical component to the success of the minimum audit hours regime is accurately defining in the regulations what an "audit hour" is and what an "audit hour" is not. Our view is audit hours should include any activity that is covered by standards issued the XRB's New Zealand Auditing and Assurance Standards Board (NZAAuSB). This means that time spent on interim reviews of listed companies (which is subject to review standards and not audit standards) should be included, whereas time spent on agreed-upon assurance engagements (which is not within the NZAAuSB's mandate) should be excluded. We also believe that structured professional training on auditing or financial reporting should also be included in the audit hour tally.

Pre-requisite experience

The consultation paper signals that the FMA believes that New Zealand should align its qualifying experience with Australia (ie 5 years experience, with a minimum of 3,000 hours of experience in auditing of which the last 1,000 hours in years 4 and 5 must be spent in the more complex and judgemental areas of the audit).

We have considered NZICA's recommendation to increase this to 8 years, and concur with their recommendation. Furthermore, we believe the 8 years should be full-time equivalent years, however the minimum number of hours spent auditing in the qualifying period of 8 years should be remain at 3,000 hours.

One aspect we do support is the Australian requirement to have in the two years immediately preceding an application to be become a licensed auditor, a minimum of 1,000 hours being spent in the more complex and judgemental areas of any kind of audit. The point we want to draw out is that this hours amount does not necessarily have to be solely on the audit of issuers – it should be for any entity that either reports under "full" IFRS or the proposed Reduced Disclosure Regime (RDR) as both regimes have identical recognition and measurement requirements.

Another important principle that we believe should be reflected in the FMA's audit guidelines is that the practical experience requirements for a New Zealand resident auditor and an overseas auditor should always be the same. This would mean that an Australian auditor who theoretically could be licensed with only 5 years of practical experience would be prohibited to sign off an opinion on any issuer in New Zealand until they had completed the 8 years of practical experience required. We do not want to create a circumstance where a gaming strategy could be employed to circumvent the New Zealand resident auditor requirements by becoming, a registered auditor in Australia.

Audit report sign-off

We have considered the Australian audit opinion sign-off requirements and do not believe they are necessary or appropriate for New Zealand. The principle difference is that in Australia, the name of auditor signing the opinion (in addition to the name of the firm) needs to be provided.

We justify our position because we are not aware of any issuer audit in New Zealand where an individual has been appointed in a personal capacity. What happens is that the audit firm, rather than the individual, is appointed, and this is confirmed through the audit engagement letters always being issued on audit partnership letterhead.

We note that International Standards on Auditing (which is the platform for auditing standards issued in New Zealand) do not require identification of the audit partner, only the name of the firm, so our recommendation to the FMA on this point is that New Zealand continues with its current sign-off practice. Doing this would then not create a difference between licensed auditors in the New Zealand market, and those that are not.

"Fit and proper"

We would ask the FMA to define with more precision its "fit and proper" test. As currently drafted, our understanding is that if anyone is brought before NZICA's disciplinary tribunal they will not pass the "fit and proper" test, even if their case is subsequently dismissed without any sanctions being placed upon the individual. We think this is unreasonable.

While is it essential that investors trust licensed auditors at all times, we do believe that some of the matters noted in the consultation paper that could be taken into consideration should be scaled back until it can be demonstrated that they are not providing the sanctions necessary to protect public investors.

Professional indemnity

It is appropriate for the FMA to seek regular assurance on professional indemnity matters, and even to confirm that a minimum level of professional insurance has been put in place. However, we do not believe it is appropriate for a regulator to assess whether the level of

insurance that has been taken out by the firm to cover claims against the audit work it conducts is appropriate. This is an area of commercial judgement because the level of insurance that is taken out is a reflection of many factors including:

- the audit firm's tolerance for risk
- the risks present in the type of audits that the audit partnership takes on
- the size of the clients' balance sheets
- previous claims history
- general economic conditions, and
- insurance pricing

Instead we would like to see the FMA develop an insurance declaration form that allows each registered audit firm to provide an overview of its insurance arrangement. To require more than that creates a dangerous precedent as we are not aware of any other profession (eg doctors, lawyers, engineers) where its regulators are in a position to determine whether or not the level of professional indemnity insurance they have at any point is adequate.

Any steps take by the regulator to promote the mistaken belief that audit firms have "deep pockets" and therefore able to withstand any claims against them would be completely inappropriate.

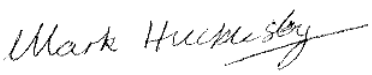
Closing remarks

In today's volatile capital markets, the need to create and promote trust in the audit process is essential. Many of proposals put forward by the FMA are sensible and will work well in the New Zealand market.

We certainly look forward to the second round of consultation that has been signalled by the FMA on this important topic.

Should you have any questions on this submission, please do not hesisate to contact the writer.

Yours sincerely



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