

**Audit failure of New Zealand finance companies
– An exploratory investigation**

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Audit failure of New Zealand finance companies

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Abstract

Purpose – The setting of private finance companies that failed in New Zealand during 2006-12 was characterized by weaker corporate governance and enforcement of securities law. This paper explores audit failure in this setting and examines whether auditors erred in their audits of the failed finance companies and whether the audit failure rate of Big N auditors was different from that of non-Big N auditors.

Design/methodology/approach – This paper adopts the archival research method, and utilizes three sets of evidence to assess audit failure – the frequency of going concern opinion (GCO) prior to failure, misstatements in the last audited financial statements, and the violation of the Code of Ethics.

Findings – The study finds that only 41% of the sample companies received the GCO in their last audit prior to failure, and provides evidence of material misstatements in the financial statements of a number of failed finance companies that received clean audit opinions prior to failure and breaches of the Code of Ethics by a number of auditors. These results strongly indicate audit failure for a number of failed finance companies. The audit failure rate, however, appears less for Big N auditors than for non-Big N auditors.

Practical implications – The study draws attention of the stock market regulator and the accounting profession to an area, the audit of private finance companies, that needs better quality audits.

Originality/value – This paper provides systematic evidence of audit failure in failed finance companies in New Zealand. It also furnishes preliminary evidence of Big N auditors compensating for weaker corporate governance.

Key words – Audit failure, Audit quality, Finance companies, Institutional environment

Paper type – Research paper

1. Introduction

Between 2006 and 2012, more than sixty finance companies failed in New Zealand.

According to one estimate, the amount and the number of deposits that were put to risk

as a result of these failures were NZ\$8.71 billion and 205,878, respectively.¹ Many of the

directors of these failed companies were sentenced to jail and home detention.² The

¹ The first and the last finance company failures happened in 2006 and 2012, respectively. The list of failed finance companies and the magnitude of deposits that were put to risk are available at: <http://www.interest.co.nz/saving/deep-freeze-list> (accessed 21 October 2014).

² For example, Bridgecorp directors were found guilty of making dishonest presentation in the prospectus and misleading investors, and were sentenced to various jail terms. The jail terms were six and a half years for Rodney Michael Petricevic and Robert Roest (R v. Petricevic, 2012b; R v. Roest, 2012), and two years

sheer number of failures and the magnitude of loss borne by investors outraged the investors, media commentators³ and regulators, and prompted commentators and regulators to criticize external auditors of the failed finance companies for failing to warn the investors (Gaynor, 2007; Harris, 2009). For example, the Registrar of Companies made the following observations on the quality of audit of failed finance companies (Harris, 2009, p. 11):

... audits of many of these finance companies lacked the rigour 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.

While there have been allegations of audit failure in the case of failed finance companies, there is little systematic evidence on this. Therefore, the first objective of this paper is to inquire whether the auditors of the failed finance companies failed to perform their duties adequately. A related objective of this paper is to shed light on audit failure by Big N and non-Big N auditors separately. Given the allegation of audit failure in the audit of the failed finance companies, it is important to ask whether both Big N and non-Big N auditors failed equally in the case of the failed finance companies.

The failed New Zealand finance companies provide a unique setting for exploring audit failure. These companies were private companies with poor corporate governance (Harris, 2009). Further, while New Zealand is a well regulated common law country, its securities law enforcement at the time of the finance company failures was weaker than

for Gary Urwin (R v. Urwin, 2012). Both Bruce Davidson and Peter Steigrad were sentenced to nine months of home detention and ordered to do 200 hours of community work (R v. Roest, 2012; R v. Davidson, 2011).

³ For example, Sheather (2011) commented on the huge magnitude of loss borne by the investors in failed finance companies. In commenting on the series of finance company failures, Chaplin (2010) asked what the message in the finance companies' failures was. On the other hand, the New Zealand Herald commented that the failure of South Canterbury Finance shook the financial foundation of the Canterbury region ("Finance Failure", 2010).

that of other common law countries (La Porta *et al.*, 2006). Such a setting reduces the auditor's business risk by lowering the cost of poor quality audit, which may motivate the auditor to behave opportunistically (Causholli and Knechel, 2012; Francis, 2011). It is not clear, however, whether the negative impact of such a setting on audit quality would be uniform across auditor types.

While the credence view of auditing suggests that the private finance company setting would lead the auditor – both Big N and non-Big N – to behave strategically (Causholli and Knechel, 2012; Francis and Wang, 2008), the Big N auditor reputation explanation would suggest that the negative impact of the private finance company setting on audit quality would be more severe for non-Big N auditors than for Big N auditors (Becker *et al.*, 1998; Francis *et al.*, 1999). Given the opposing predictions regarding the impact of the private finance companies setting on audit failure by Big N and non-Big N auditors, this study explores this issue empirically.

The study uses three related sets of evidence – the going concern opinion (GCO) prior to failure, misstatements in the last audited financial statements, and the violation of the Code of Ethics (“the Code” only) – to assess audit failure in the case of the failed finance companies.

The sample of this study is comprised of 37 failed finance companies. The study finds that only 15 of the sample firms received GCOs on their last financial statements prior to failure. It also finds evidence of financial misstatements by a number of failed finance companies that received a clean audit opinion in their last financial statements. This paper further finds that nine individual auditors of eight audit firms that audited the financial statements of the failed finance companies were disciplined by the then New Zealand Institute of Chartered Accountants (NZICA) Disciplinary Tribunal for breaching the Code during their audits. Interestingly, seven of these audit firms gave unmodified

audit opinions on the last financial statements of failed finance companies. Finally, the study observes that four finance companies claimed damages against their auditors for negligence in audits and two of these cases resulted in payments by the auditors. Taken together, these results strongly suggest audit failure in a number of failed finance companies. However, the paper observes that the audit failure rate appears less for Big N auditors than for non-Big N auditors.

The paper makes three contributions to the literature. First, while prior studies examine predictors of finance company failure (Douglas *et al.*, 2014; Kabir and Laswad, 2014), related party transactions (Roudaki and Bhuiyan, 2014; Wu and Malthus, 2012) and debt risk premium (Lally and Prasad, 2014), this paper examines audit failure in the case of the failed finance companies and therefore extends the New Zealand finance companies' failure literature. Second, while prior audit failure studies focus on listed companies (Chaney and Philipich, 2002; He et al., 2015; Numata and Takeda, 2010), this paper provides evidence of audit failure from a private companies setting with weaker corporate governance and weaker enforcement of securities law. Third, the study provides preliminary empirical evidence regarding Big N auditor reputation acting as a motivator of higher quality auditing services in the finance company setting.

Audit quality and audit failure have been issues of continuing concern for regulators, investors, the accounting profession and academics (IAASB, 2015; Sikka, 2009). Therefore, by focusing on audit failure in the private company setting, this study provides insights for regulators and the accounting profession on where to put their efforts to enhance the audit quality of private companies.

Finally, a caveat is in order. The small sample size of this study raises generalizability concerns for its conclusions. However, the sample covers more than 50% of the finance companies that failed during the period 2006-12 in New Zealand.

Furthermore, small sample size is common in corporate bankruptcy studies (Blacconiere and DeFond, 1997).

The remainder of the paper is organized as follows. The second section lists the research questions and the third section lays out the institutional environment of New Zealand finance companies. The fourth section briefly reviews the literature and the fifth section discusses measures of audit failure. The sixth and seventh sections discuss the research method and the sample and data, respectively. The eighth section presents the findings, and the last section summarizes the findings and discusses their implications.

2. Research questions

This paper examines the following research questions (RQ):

RQ1. Did the auditors fail in their audits of the financial statements of the failed finance companies?

To answer this question, the authors more specifically ask:

RQ1a. Were the audit opinions issued in the last financial statements prior to the failures appropriate?

RQ1b. Did the audited financial statements contain material financial misstatements?

RQ1c. Did the auditors follow the Code in their audits of the financial statements?

RQ2. Was the audit failure rate higher for non-Big N auditors than for Big N auditors?

3. Institutional setting

Two prominent characteristics of the institutional environment in which the failed finance companies operated are: (a) the finance companies were not listed on a stock

exchange and lacked strong corporate governance (Harris, 2009), and (b) the securities law enforcement in New Zealand was weaker than that of other common law countries at the time the finance companies collapsed (La Porta *et al.*, 2006). This section discusses these two characteristics along with their implications for audit quality.

3.1 Poor corporate governance

The finance companies were small⁴, private companies.⁵ Therefore, they were not subject to the monitoring usually applied to listed companies. For example, unlike listed companies, unlisted companies do not have to comply with the stock market regulations (e.g., the continuous disclosure regime) and are not monitored by analysts.

Consistent with the small firm size, the mean (median) size of the board of directors of the failed finance companies was 3.89 (3). The minimum and maximum size of the board was 1 and 6, respectively. Such a small board does not allow for the constitution of a separate audit committee. The authors found only one failed finance company, Bridgecorp, had an audit committee (R v. Petricevic, 2012a).

In a number of cases, affiliated directors dominated the boards of directors. For example, all of the four board members of Nathans Finance were the board members of its parent VTL at some point in time (R v. Moses, 2011). One of the three directors of National Finance 2000 was also the sole shareholder of the company (National Finance 2000 Limited, 2005). The Managing Director of Bridgecorp was also the majority shareholder in Bridgecorp Holdings Limited (BHL) – the parent of Bridgecorp (R v. Petricevic, 2012a). Orange Finance had only one director and he was the trustee of a trust

⁴ The median total assets of the sample companies in the year prior to failure was NZ \$0.957 million. In contrast, the corresponding figure for the NZX-listed company in 2009 was NZ \$152.552 million.

⁵ The finance companies did not disclose much about their governance in their annual reports. In most of the cases, their governance disclosures were limited to the names of the directors only.

that owned all the shares of the company (Orange Finance, 2012). Further, the authors found only three companies that had independent directors on their boards.⁶

According to section 33(2) of the New Zealand Securities Act 1978, no issuer can offer debt securities to the public unless it has appointed a trustee for the securities and both the issuer and the trustee have signed a trust deed. While the main responsibility of the trustee was to protect the interests of the security holders, the trustee model suffered from several weaknesses. For example, it was not mandatory for the finance companies to consult the trustee before the appointment of the auditor. Nor was it mandatory for the auditor to report separately to the trustee, furnish the trustee with a copy of the management letter and meet the trustee separately without any representative of the issuer being present.⁷

Two trustees, Perpetual Trust Limited and Covenant Trust Limited, served as the trustees of a large majority of the failed finance companies. This concentration of trustees raised questions about the quality of diligence exercised in monitoring the companies (Harris, 2009). Harris (2009) also notes the lack of expertise of the trustees in monitoring the financial condition of the finance companies and believes that the trustees were slow to detect the development of adverse financial condition.

In sum, the corporate governance picture of the failed finance companies was one of small firm size, small boards, non-independent directors and ineffective trustees. This corporate governance environment has several implications for auditing. First, the above

⁶ Bridgecorp, IMP Diversified Fund and NZF Money had 2 independent directors on their boards (Fletcher, 2012; Nordqvist, 2010; R v. Petricevic, 2012a, para 388; IMP Diversified Income Fund Limited, 2007; NZF Money Limited, 2010).

⁷ As a result of the Securities Amendment Regulations 2007, which amended the then existing Securities Regulations 1983, these were made mandatory.

governance attributes potentially create an environment that makes domination of the board by the CEO/owner-director possible and leaves the auditor open to the pressure of the CEO/owner-director. In the absence of independent boards and audit committees, auditors of failed finance companies might have found it difficult to shield themselves from the pressure of the CEO/owner-director.⁸ Second, given that New Zealand auditors compete in a small market, the expected loss from the loss of audit clients resulting from the auditor's decision not to appease the CEO/owner-director is larger than in larger audit markets. Third, the small firm size and the unlisted status of finance companies reduce the auditor's business risk by reducing the consequence of poor quality audit as the number of shareholders affected by the poor audit quality is much fewer than that in the case of listed companies. Fourth, as these companies are not listed on the stock exchange, their financial reporting quality is not subject to the monitoring of analysts. This reduces the probability of detecting poor quality audit.

3.2 Securities law enforcement

New Zealand is a common law country and has a joint and several liability regime. However, both private and public enforcements of the securities law are weaker in New Zealand than in other English-speaking countries (La Porta *et al.*, 2006). While private enforcement indicates the recovery of losses by investors from issuers, directors and auditors, public enforcement refers to the enforcement of the securities law by a public enforcement body such as the securities commission (La Porta *et al.*, 2006, pp. 7 and 11).

⁸ Carcello and Neal (2000) find that the higher the percentage of affiliated (i.e., non-independent) directors on the audit committee of a financially distressed firm, the lesser the likelihood of receiving a GCO. Relatedly, Carcello and Neal (2003) find that auditors are less likely to be dismissed following the issuance of a going concern report if independent directors dominate the audit committee. Taken together, the evidence suggests that when affiliated directors dominate the audit committee, management often can pressure the auditor to issue an unmodified audit report and dismiss the auditor if he/she refuses to issue an unmodified report (Carcello and Neal, 2003).

La Porta *et al.* (2006) develop a liability index that measures the procedural difficulty in recovering losses from the issuers, directors and auditors and a public enforcement index measuring the effectiveness of the public enforcement mechanism. Among the five English-speaking countries (i.e., Australia, Canada, New Zealand, the United Kingdom, and the United States of America), New Zealand has the lowest liability standard index (0.44) and public enforcement index (0.33) (La Porta *et al.*, 2006, p. 15). In fact, its liability standard and public enforcement indices are lower than the corresponding averages (0.58 and 0.62, respectively) of La Porta *et al.*'s (2006, p. 15) sample of countries having the English-origin legal system.

The weaker enforcement of securities law in New Zealand may weaken the incentives of the auditor to provide higher quality auditing services. This is because weaker enforcement of securities law reduces the auditor's business risk by reducing the cost of low quality audit (Francis, 2011). Consistent with this argument, research shows that audit quality is increasing in litigation risk (Khurana and Raman, 2004). For example, the 1995 Private Securities Litigation Reform Act significantly reduced the liability exposure of the auditor in the United States of America (Francis, 2011). Consistent with the decline in liability exposure, Francis and Krishnan (2002) report evidence of a decline in audit quality.

3.3 Impact on audit quality

There are two possible impacts of this institutional environment on audit quality. The first possibility arises from the view that auditing is a credence good/service (Causholli and Knechel, 2012). The credence perspective suggests that auditing is a complex process with unobservable outcomes. The idiosyncratic and uncertain nature of auditing suggests that the auditee cannot be certain, even on an *ex post* basis, whether the level of assurance

received equals the level of assurance promised by the auditor or the level of assurance required by the auditee (Causholli and Knechel, 2012). In a setting, where no information exists about the level of assurance supplied and no monitoring of the auditor is possible, auditors have incentives to behave strategically (Causholli and Knechel, 2012). This argument suggests that the institutional setting of failed finance companies – small firm size, the unlisted status of the failed finance companies, the lack of independent boards and audit committees, and weaker enforcement of the securities law – may lead auditors to strategically lower the audit quality.

However, the credence view of auditing critically depends on whether poor quality auditing can be detected and punished (Causholli and Knechel, 2012). Prior evidence suggests that egregious audit failure is detected⁹ and cause reputational and financial loss to the auditor (Chaney and Philipich, 2002; He et al., 2015; Numata and Takeda, 2010).

Big N auditors enjoy more than 90% of the audit market share in New Zealand and have greater reputational capital at stake than the non-Big auditors (Francis and Wang, 2008). Given their large market share, Big N auditors can afford the loss of a small client like a finance company. Further, prior research suggests that Big N auditors suffer reputational loss as a result of discovered audit failure (Chaney and Philipich, 2002; He et al., 2015; Numata and Takeda, 2010). This evidence on the cost of audit failure along with the demise of Big N auditors such as Arthur Andersen in the USA, ChuoAoyama in Japan and Zhongtianqin (ZTQ) in China following the discovery of major audit failure is likely to make the Big N auditors more aware of the negative consequences of audit failure and provide greater incentives to them to provide higher quality auditing services

⁹ Many large global companies disclosed financial misstatements. Examples include US firms like Adelphia Communications, Sunbeam Corporation, Xerox, Enron, Waste Management, and WorldCom (GAO, 2002), Japanese firm Kanebo (Numata and Takeda, 2010), and Chinese firm Yinguangxia (He et al., 2015).

than ever before. On the other hand, given the small audit market size in New Zealand and the less than 10% of the market share of non-Big N auditors, they may be tempted to appease the management of failed finance companies and compromise their audit quality. This line of argument suggests that the impact of the finance company setting on audit quality will not be uniform – non-Big N auditors' audit quality is likely to suffer more than the Big N auditors', and therefore, the audit failure rate is likely to be higher for non-Big N auditors than for Big N auditors.

4. Literature review

This paper relates to two streams of literature, the literature on failed finance companies and the audit failure literature. This section briefly discusses these two streams of the literature.

4.1 Failed finance companies

The failure of New Zealand finance companies spawned several studies. Two papers, Kabir and Laswad (2014) and Douglas et al. (2014), examined whether financial statement variables could predict finance company failure. Kabir and Laswad (2014) find that earnings and accruals declined but loan impairment loss increased in the last two annual financial statements prior to failure. Douglas et al. (2014), on the other hand, report that failed finance companies had lower capital ratio, inferior asset quality, more earnings and lower cash flow than a sample of non-failed firms.

Roudaki and Bhuiyan (2014) and Wu and Malthus (2012) examined related party lending by the failed finance companies. Roudaki and Bhuiyan (2014) find that around half of their sample of failed finance companies were engaged in related party transactions. Wu and Malthus (2012) studied the characteristics of related party loans by

13 failed finance companies and found four characteristics of related party loans—excessive related party lending without adequate security, management fraud, non-disclosure of related party loans, and breaches of statutory requirements and agreement.

Yahanpath and Cavanagh (2011) investigate what caused the finance company failure and who was to be held accountable for the loss of the investors' money. Lally and Prasad (2014) examine the debt risk premium of the failed finance companies and find that the debt risk premium did not reflect the then prevailing default risk. They further observe that depositors continued to keep their deposits with the finance companies, thus suggesting that there was no significant contagion effect.

In contrast with the above papers, this paper examines audit failure in the failed finance companies and thus extends the finance company literature.

4.2 Audit failure

There is an extensive literature on auditor litigation, primarily in the USA. Palmrose (1988) uses auditor litigation as an indication of audit failure and finds that Big N auditors faced less litigation than their non-Big N counterparts. She concludes that litigation can be used as a way of auditor quality distinction. St. Pierre and Andersen (1984) report that corporate bankruptcy increases the risk of auditor litigation. However, since auditor litigation in New Zealand is infrequent, its absence cannot be used as an indication of the absence of audit failure.

Another set of studies examine the cost of audit failure in listed companies. Chaney and Philipich (2002) examine the impact of Enron audit failure on the reputation of its auditor Arthur Andersen and find that Andersen's other clients suffered negative market reaction following the audit failure. More importantly, clients of Andersen's Houston office that audited Enron suffered a more severe decline in abnormal return than other

clients. Similarly, Numata and Takeda (2010) observe that following the discovery of fraud by the Japanese cosmetics maker Kanebo, clients of its auditor ChuoAoyama and other Big N auditors suffered negative stock market return. He et al. (2015), on the other hand, report that partners of former Zhongtianqin (ZTQ), the then largest Chinese audit firm, suffered reputational loss in the form of loss of clients and reduced likelihood of their future employment on the discovery of earnings manipulation by its audit client Yinguangxia (YGX).

In contrast with the prior studies that focused on audit failure in listed companies, this study examines audit failure in a sample of private companies.

5. Measures of audit failure

DeAngelo (1981, p. 186) defines audit quality as “the market assessed joint probability that a given auditor will both discover a breach in a client’s accounting system, and report the breach”. This definition suggests that an audit failure occurs when the auditor cannot discover a breach in the client’s accounting system, or discovers a breach but fails to report it in the audit report (Francis, 2011). Consistent with this definition of audit failure, this study uses three signals of audit failure – the non-issuance of a GCO prior to failure, material misstatements in the last audited financial statements and the violation of the Code.

The first measure of audit failure, the non-issuance of a GCO prior to failure, is based on the requirement of ISA (NZ) 570. ISA (NZ) 570 requires the auditor to assess the appropriateness of the use of the going concern assumption in the preparation of financial statements and conclude whether there is a material uncertainty about the audit client’s ability to continue as a going concern (NZAuASB, 2014, para 6 and 9). The auditor’s assessment of the going concern assumption should cover at least 12 months

from the date of the auditor's report (NZAuASB, 2014, para NZ13.2). If the going concern assumption is appropriate for the preparation of financial statements but a material uncertainty exists as to the entity's ability to continue as a going concern, the auditor would issue an unmodified audit opinion with a GCO in case the uncertainty is adequately disclosed in the notes to the financial statements (NZAuASB, 2014, para 18-19). In case management does not disclose the uncertainty adequately, the auditor would render a qualified audit opinion or adverse opinion, as appropriate and state in the audit report that there is significant uncertainty about the entity's ability to continue as a going concern (NZAuASB, 2014, para 20). Given the above requirements, the failure to issue a GCO prior to a business failure could arguably be viewed as an audit failure (Francis, 2011).

The second measure of audit failure, financial misstatement, is based on the idea that auditors are required to "identify and assess risks of material misstatements, whether due to fraud and error", and "obtain sufficient appropriate audit evidence about whether material misstatements exist" (NZAuASB, 2015, para 7). Further, the overall objective of the auditor is to obtain reasonable assurance about whether financial statements are free from material misstatements (NZAuASB, 2015, para 11). Therefore, the existence of misstatements in the last audited financial statements would suggest audit failure.

Finally, the Code, issued by the NZICA, stipulates five fundamental principles that express the minimum standards of professional behaviour expected of all NZICA members. These are integrity, objectivity and independence, competence, quality performance, and professional behaviour (NZICA, 2006). The Code also contains specific rules supporting each fundamental principle. These rules "prescribe aspects of the professional and ethical behaviour expected of members" (NZICA, 2006, para 11).

Compliance with the Code is mandatory for all members of NZICA, who must be able to demonstrate that their actions, behaviour and conduct comply with the Code (NZICA, 2006, para 5). Failure to comply with the Code is punishable by NZICA disciplinary bodies (NZICA, 2010) and would constitute audit failure.

6. Research method

The paper first calculates the frequency of GCOs prior to failure and compares the sample GCO rate with that observed in the literature. It also tests whether auditor types (i.e., Big N vs. non-Big N) and audit opinions are associated. It then examines the appropriateness of the audit opinion prior to failure using both univariate and multivariate tests.

To gather evidence on financial misstatements, the study employs the case study method. It chooses Nathans Finance (NZ) Limited (hereinafter “Nathans” only) as the case as it failed but received a clean audit opinion prior to its failure. This paper uses analytical procedures to identify misstatements in its financial statements. The use of such procedures is based on the premise that ISAs (NZ) recognize analytical procedures¹⁰ as an audit procedure for collecting audit evidence (NZAuASB, 2013, para A7 and A21). If analytical procedures uncover misstatements in Nathans’ financial statements, it could be argued that Nathans’ auditor should have identified the misstatements because they had privileged access to the inside information of their client to conduct tests of control and substantive audit procedures. Besides Nathans, the paper also reports evidence of financial misstatements by other failed finance companies from secondary sources.

¹⁰ Analytical procedures “consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data” (NZAuASB, 2013, para A21).

Finally, the paper examines breaches of the Code by auditors. NZICA had three permanent bodies – the Professional Conduct Committee (PCC), the Disciplinary Tribunal (DT), and the Appeals Council (AC) – to consider complaints of breaches of the Code against members (NZICA, 2010, Appendix VI)¹¹. The DT normally heard complaints of a serious nature. If it found the member guilty of a charge, it could take disciplinary actions against the member, which included, but were not limited to, (a) censure, (b) membership suspension, (c) removal of the member's name from the register of members, (d) cancellation or suspension of any Certificate of Public Practice held by the member, (e) ban on taking specified assignment for a specified period, and (f) monetary penalty (NZICA, 2010, Rule 21.31). This study analyses disciplinary actions, if any, against auditors of failed finance companies to collect evidence of breaches of the Code by these auditors.

7. Sample and data

The population for this study is 67 New Zealand finance companies that failed during 2006-12. To include a company in the sample, this paper requires that its last annual report published immediately prior to its failure be available on the website of Companies Office New Zealand.¹² Out of the 67 failed finance companies, annual reports of 30 companies are not available. This leaves us with a sample of 37 failed finance companies. Table I reports the sample selection process.

¹¹ The PCC was the first body to consider and investigate complaints against members (NZICA, 2010, Rule 21.2). The DT normally considered complaints referred to it by the PCC, and the AC considered appeals against the decision of the DT and could confirm, vary or reverse the DT's decision (NZICA, 2010, Rule 21.3 and 21.47).

¹² The website of Companies Office New Zealand is: <https://www.business.govt.nz/companies>

Table I about here

The authors hand-collect financial statement data, audit opinions and audit report sign-off dates from the annual reports of the failed finance companies and the data on breaches of the Code from documents of disciplinary decisions by DT and PCC of NZICA available on its website,¹³ and the websites of New Zealand Herald¹⁴ and Stuff New Zealand¹⁵.

8. Findings

8.1 *Going concern opinions*

Table II reports the names of the finance companies, the date of failure, the auditor who audited the last financial statements prior to failure, the balance date of the last financial reporting period prior to failure, the audit report signing date, the audit opinion rendered on the last financial statements, and the failure lag (i.e., the difference between the audit report sign-off date and the failure date). As Table II reveals, three of the Big N audit firms audited the last financial statements of 14 failed finance companies (i.e., Ernst & Young = 4, KPMG = 6 and PWC = 4).

The study finds that only 41% (i.e., 15 of 37) of the sample companies received a GCO in their last audit reports. The GCO rate is much lower in the sample (i.e., 41%) than in the US. Carson et al. (2013) report a GCO rate of 60.10% during 2000-10 in the US. The

¹³ The disciplinary decisions by DT and PCC of NZICA are available at: <http://www.nzica.com/Technical/Professional-conduct-and-complaints/Recent-disciplinary-decisions/Disciplinary-decision-archive.aspx>

¹⁴ The website of the New Zealand Herald is <http://www.nzherald.co.nz/>

¹⁵ The website address of Stuff New Zealand is <http://i.stuff.co.nz/>

results hold for sub-samples of failed finance companies audited by Big N and non-Big N auditors. The GCO rates are 50% and 35% for Big N and non-Big N sub-samples, respectively. The GCO rate of Big N auditors is much higher than that of non-Big N auditors, suggesting higher quality audits by Big N auditors. However, the χ^2 test suggests that auditor type (i.e., Big N vs non-Big N) and auditor opinion are not associated at conventional levels of significance.

Table II about here

Table II also shows that 31 finance companies failed within less than 12 months after the audit report sign-off date. Fourteen of these 31 companies received a GCO in their last audit reports, yielding a GCO rate of 45% (i.e., 14 out of 31). The corresponding percentage for the sub-sample of firms that failed after more than 12 months after the audit report sign-off date is 17% (i.e., 1 out of 6). This suggests that companies that fail within 12 months of the auditor sign-off date are more likely to receive GCOs than those that fail after more than 12 months of the report sign-off date.

8.1.1 Appropriateness of the last audit opinion

Strictly speaking, the failure to issue a GCO prior to a failure may not be an audit failure. Because of inherent uncertainty surrounding future events and conditions that may cast doubts on the audit client's ability to continue as a going concern, the auditor cannot adequately predict a business failure (Francis, 2011; NZAuASB, 2014). However, Douglas et al. (2014) find that, using financial and non-financial data, the finance company failure could have been predicted one year before failure with a high degree of accuracy (i.e.,

88.7%). This along with the low GCO rate (i.e., 41%) casts significant doubt on the appropriateness of the last audit opinion.

To probe the issue, this paper examines the financial condition and performance of the sample firms in the year immediately prior to failure (i.e., year t-1) to assess whether the issuance of an unmodified audit opinion prior to failure was appropriate. Drawing on ISA (NZ) 570 and the literature (Carson et al., 2013; NZAuASB, 2014), it examines four ratios – (a) net income to total assets (ROA), (b) Cash flow from operation to total liabilities (CFO_TL), (c) current assets to current liabilities (CR), and (d) total liabilities to total assets (LEV) – in the last financial statements for two sub-samples – the unmodified audit opinion sub-sample (i.e., GCO = 0) and the going concern opinion sub-sample (i.e., GCO = 1). The study also examines the differences in audit lag (AUDLAG) and discretionary loan loss provision¹⁶ (DISCPROV) between the two sub-samples as audit lag is observed to be positively associated with GCO in prior research (Carson et al., 2013), and the management of loan loss provision may invite audit opinion modification.

¹⁶ Based on prior research (Collins et al., 1995) and the disclosure guidance for New Zealand financial institutions (FRSB, 1997), the authors run the following regression model using data for three years from t-4 to t-2 and predict the residual for year t-1 using the estimated coefficients:

$$\text{PROV} = \alpha + \beta_1 \text{LOAN} + \beta_2 \text{PASTDUE} + \beta_3 \text{IMPAIRED} + \beta_4 \text{INTREC_INTREV} + \varepsilon \quad (1)$$

Where:

PROV = loan loss provision scaled by gross loans and receivables,

LOAN = natural logarithm of gross loans and receivables,

PASTDUE = past due assets deflated by gross loans and receivables,

IMPAIRED = impaired assets divided by gross loans and receivables,

INTREC_INTREV = interest received divided by interest revenue.

The predicted residual for year t-1 is termed discretionary loan loss provision (DISCPROV). A past due asset is any asset which has not been operated within its key terms by the counter-party for at least 90 days and which is not an impaired asset (FRSB, 1997, para 4.38). Impaired assets are the sum of non-accrual assets and restructured assets. A non-accrual asset is any asset for which the financial institution will not be able to collect all the amounts owing in accordance with the contract with the counterparty and a restructured asset is an asset which is not a non-accrual asset and whose original terms have been changed to give a concession to the counterparty (FRSB, 1997, para 4.32 and 4.40).

As expected, IMPAIRED is positive and significant at less than 1 percent, and INTREC_INTREV is negative and significant at less than 5 percent. The adjusted R-square is 67% and the overall model is significant at less than 1 percent.

The paper examines Big N auditors to see whether there is any significant difference in GCO rates of Big N and non-Big N auditors. The authors drop Chancery Finance from the analysis because its total assets in the last financial statements were so low that its leverage and ROI were 308 and -30936% respectively, which are far outside the sample range. The inclusion of this finance company in the analysis would unduly affect the results. The authors also drop four companies due to lack of data. This leaves 32 observations for the analyses in this section.

Table III reports the results of comparison of the ratios in both level and change forms between the two sub-samples. The paper finds that the only variables that are significantly different between the two groups are ΔLEV and ROA. The going concern sub-sample (i.e., GCO = 1) had experienced greater increases in their leverage than the non-modified opinion sub-sample (i.e., GCO = 0) in their last audited financial statements. Furthermore, the GCO sub-sample had a much worse profit performance than the non-modified sub-sample in their last financial statements. The percentages of GCO and non-GCO sub-samples audited by Big N auditors were 53.80% and 26.30%, respectively, suggesting that the vast majority (i.e., 73.70%) of unmodified audit opinions were rendered by non-Big N auditors. However, consistent with the results of the χ^2 test, there is no significant difference in the BigN variable between the two sub-samples.

Table III about here

Interestingly, as reflected in the mean and median CFO_TL and ΔCFO_TL , the cash flow of both sub-samples was positive and increased in the year immediately prior to failure. This is in contrast with the decline in profit performance (i.e., negative ΔROA) of both groups of companies and the incurrence of loss (i.e., negative ROA) by GCO firms

prior to failure. Finally, both groups of firms had reasonably healthy liquidity (i.e., CR) prior to failure although the difference between the sub-samples is not statistically significant.

8.1.2 Determinants of GCO

To check the robustness of the results of univariate test, the authors run the following two logit models of the determinants of GCO.

$$GCO = \alpha + \beta_1 AUDLAG + \beta_2 BIGN + \beta_3 DISCPROV + \beta_4 \Delta ROA + \beta_5 \Delta CFO_TL + \beta_6 \Delta CR + \beta_7 \Delta LEV + \varepsilon \quad (2)$$

$$GCO = \alpha + \beta_1 AUDLAG + \beta_2 BIGN + \beta_3 DISCPROV + \beta_4 ROA + \beta_5 CFO_TL + \beta_6 CR + \beta_7 LEV + \varepsilon \quad (3)$$

Where:

<i>GCO</i>	=	1 if the failed finance company received a going concern opinion on its last financial statements and 0 otherwise.
<i>AUDLAG</i>	=	audit lag (in days) for the last audit report deflated by 365
<i>BIGN</i>	=	1 if a Big N auditor audited the last financial statements of the company, 0 otherwise.
<i>DISCPROV</i>	=	discretionary loan loss provision
<i>ΔROA</i>	=	change in net income divided by total assets
<i>ΔCFO_TL</i>	=	change in cash flow from operation divided by total liabilities
<i>ΔCR</i>	=	change in current ratio
<i>ΔLEV</i>	=	change in total liabilities divided by total assets
<i>ROA</i>	=	net income divided by total assets
<i>CFO_TL</i>	=	cash flow from operation divided by total liabilities
<i>CR</i>	=	current ratio
<i>LEV</i>	=	total liabilities divided by total assets
<i>ε</i>	=	error term

If the audit opinions prior to failure were appropriate, following prior literature (Carson et al., 2013; NZAuASB, 2014), leverage variables (i.e., ΔLEV and LEV) would have statistically significant and positive signs but other firm performance variables (i.e., ΔROA , ROA , $\Delta\text{CFO_TL}$, CFO_TL , ΔCR and CR) would have negative signs. This is because higher leverage, poor profit and cash flow, and lower liquidity would suggest financial trouble and a higher probability of receiving a GCO (Carson et al., 2013; NZAuASB, 2014). However, if the audit opinions were not appropriate, the firm performance variables would not be significant or would be significant but with unexpected signs.

A positive and significant coefficient of BigN would suggest that Big N auditors are more likely than their non-Big N counterparts to issue a GCO and would be consistent with Big N reputation acting as a motivating factor for higher quality audit even in the finance company setting. Therefore, the positive sign would be inconsistent with the credence theory of auditing.

Table IV reports the results of models (2) and (3)¹⁷. Only ΔLEV is significant with the correct sign at less than 10% in model (2) and the overall model is significant at less than 5%. Two other performance variables – $\Delta\text{CFO_TL}$ and ΔCR – are significant with the incorrect sign. However, neither model (3) nor any independent variable in it is significant. Thus, financial performance variables (i.e., profit, cash flow and liquidity) that are observed to explain GCO in the prior literature fail to explain the GCO in the failed

¹⁷ Un-tabulated results show that the maximum correlation coefficient is 0.709 (between DISCPROV and ΔLEV) for model (1) variables and 0.630 (between DISCPROV and LEV) for model (2) variables. Therefore, multicollinearity does not pose any serious problem.

finance companies sample. Taken together, all these results cast doubt on the appropriateness of audit opinions prior to failure.

BigN has a positive sign in both models but the coefficient is not significant at conventional levels. This is consistent with the results of univariate tests. As far as GCO prior to failure is concerned, these results suggest no significant difference in audit quality between Big N and non-Big N auditors in the finance company setting.

Table IV about here

8.2 Financial misstatements

The section examines the second measure of audit failure, financial misstatements. Sub-section 8.2.1 provides detailed evidence of potential misstatements in the financial statements of Nathans. The study then provides evidence of financial misstatements by other failed finance companies in sub-section 8.2.2. Evidence in this sub-section is based on secondary sources.

8.2.1 Nathans

Nathans was incorporated as a limited liability company on 23 July 2001 and had its registered office in Auckland. The company was a 100% owned subsidiary of VTL Group (VTL), a vending machine operator and technology development company. It failed on 20 August 2007 despite the fact that it received an unmodified audit opinion on its last financial statements that covered the period ended 30 June 2006. Staples Rodway, Nathans' auditor, signed the audit report on Nathans' financial statements on 5 September 2006. Thus, the company failed within less than 12 months of receiving a clean audit opinion.

But analytical procedures would provide ample evidence of deep financial problems in Nathans' last audited financial statements. Table V shows that receivables and advances constituted more than 85% of Nathans' total assets, intercompany advances and receivables constituted more than 90% of its receivables and advances, and interest from intercompany advances and receivables was more than 90% of its operating revenue in 2006. This was alarming in light of the fact that three of Nathans' directors were also the directors of its parent, VTL and the high concentration of Nathans' advances and receivables exposed it to the risk of one line of business, namely, vending machine business. Therefore, the survival of Nathans was tied to recoverability of its intercompany advances and receivables.

Table V about here

However, the quality of its advances and receivables deteriorated in 2005 and 2006. For example, Table V shows that interest revenue exceeded interest expense in each of the four years 2003-2006 but interest collected fell short of interest paid in 2005 and 2006, suggesting that the company was having difficulty collecting its interest revenue in 2005 and 2006. This is also reflected in the fact that the company earned profit in each of the four years 2003-06 but had negative cash flow from operation in 2005 and 2006. Further, interest revenue from intercompany advances in 2005 and 2006 (NZ \$ 10.007 million and NZ \$ 13.300 million, respectively) was not collected in the respective years. Relatedly, cash collection from loans and receivables in 2005 and 2006 (NZ \$ 6.975 million and NZ \$ 11.848 million) fell far short of the current portion of receivables at the end of 2004 and 2005 (NZ \$ 39.024 million and NZ \$ 85.824 million), respectively. All these statistics suggest that intercompany advances and receivables in its last financial

statements were highly likely to have been impaired. Hence, the reported profit in 2006 seems to be illusory. If all of the intercompany advances and receivables were written off as impairment loss, the reported profit of 2006 would have been turned into a huge loss. Yet the auditor rendered a clean audit opinion on the last financial statements of Nathans.

Although Nathans reported profit in each of the four years 2003-06, simple analytical procedures reveal deep financial trouble of the company. All these numbers, which are available from Nathans' annual financial statements, should have raised doubts in the mind of the auditor about the company's ability to continue as a going concern in the future. More importantly, the auditor has privileged access to the internal control system and source documents of the company. Yet instead of probing deeper, Nathans' auditor seemed to have relied on reported financial statement numbers. This is in contrast with the requirement of maintaining professional scepticism throughout the audit and recognising the possibility of a material misstatement (NZAuASB, 2015, para 15).

8.2.2 Other finance companies

Nathans was not alone in its understatement of loan loss provision and overstatement of its loans, advances and receivables, nor was the manipulation of loan loss provision the only type of financial misstatement committed by the failed finance companies. The receivers of a few other failed finance companies suggested in their first reports¹⁸ that the loan loss provision was materially understated. The list includes Western Bay Finance (Ferrier Hodgson, 2006), Five Star Consumer Finance Limited (PWC, 2007), National Finance 2000 (PWC 2006a), Lombard Finance & Investments Limited (PWC, 2008),

¹⁸ Pursuant to Section 23 of the Receiverships Act 1993, a receiver must prepare, not later than two months after his/her appointment as a receiver, a report of the state of affairs with respect to the property in receivership.

Provincial Finance Limited (PWC, 2006b), and Capital+Merchant Finance Limited (Grant Thornton, 2008).

While the failed finance companies were engaged in excessive related party lending (Wu and Malthus, 2012), many of them did not provide full disclosure of their related party loans in the financial statements. Examples include Bridgecorp (R V Petricevic, 2012a), Belgrave Finance Limited (Fletcher, 2014a), Capital+Merchant Finance (Grant Thornton, 2009), National Finance 2000 (Krause, 2012), Rockforte Finance (Indepth Forensic Limited, 2011) and South Canterbury Finance (Nippert, 2012). None of these companies received any audit opinion modification on their last financial statements.

This section presents evidence of financial misstatements by 11 companies. Only two of them received GCO¹⁹ and none received any audit opinion modification (e.g., “except for” opinion). One would expect financial statements containing material misstatements to be accompanied by modified audit opinions. These results suggest audit failure.

Nine of these 11 companies (i.e., 81.81%) were audited by non-Big N auditors. This is despite the fact that only 62.16% of the failed finance companies (i.e., 23 out of 37) were audited by non-Big N auditors. Table III reported positive earnings, cash flow and liquidity prior to failure for the non-modified opinion sub-sample. The evidence in this section suggests that the good financial performance and condition of the unmodified opinion sub-sample were the result of material misstatements. Yet, contrary to the requirement of professional scepticism for the auditor, the non-Big N auditors seem to have relied on the reported accounting numbers. As far as financial misstatements are

¹⁹ The companies are South Canterbury Finance and Rockforte Finance.

concerned, these results are consistent with Big N auditors providing higher quality auditing services than non-Big N auditors.

8.3 *Breach of the Code*

Table VI shows that the DT and the PCC of NZICA took actions against nine members of eight audit firms for breaching the Code during the audit of the financial statements of the failed finance companies. In assessing this number, it is important to bear in mind that normally only serious breaches of the Code were referred to the DT.

Table VI about here

Table VI reveals that members against whom disciplinary actions were taken violated Rule 2 (two members), Rule 7 (one member), Rule 9 (six members) and Rule 11 (eight members). While Rule 2 prohibits false or misleading statements by a member, Rule 7 requires a member to take a professional engagement only if (s)he is competent to carry out the assignment (NZICA, 2006). On the other hand, Rule 9 requires a member to perform all professional work with due care and Rule 11 requires a member to comply with the requirements of all professional standards (NZICA, 2006).

Broadly speaking, the paper finds that the DT and the PCC took actions against the members for four types of negligence – (a) lack of professional skepticism in assessing the reported amounts of balance sheet items such as allowance for doubtful debts and goodwill (Capital + Merchant, Hanover Finance, and South Canterbury Finance), (b) failure to obtain sufficient and appropriate audit evidence regarding the collectability of loans, advances, mortgages and receivables (Belgrave Finance, Capital +Merchant, National Finance 2000, and Nathans Finance), (c) failure to take due care in determining

the adequacy of disclosures of related party transactions and impaired/past due assets, and the classification of advances (Beneficial Finance, Capital + Merchant, and Nathans Finance), and (d) failure to assess whether aggregated uncorrected misstatements were material (South Canterbury Finance).

The disciplinary actions taken against the errant auditors include censure (nine auditors), suspension of the certificate of public practice (two auditors), review of practice by the Practice Review Board (one auditor), a ban on audit of issuers for the next five years (four auditors), undertaking not to audit issuers (one auditor) and monetary penalty (nine auditors).

It is worth noting that only one of the eight audit firms whose auditors were disciplined gave a GCO prior to the audit client's failure. The remaining seven audit firms gave unmodified audit opinions on their clients' last financial statements published immediately prior to their failures. This is consistent with the results in sub-sections 8.1 and 8.2, and the results, taken together, strongly suggest that the unmodified audit opinions were inappropriate.

It is also to be noted that only one of the nine auditors against whom disciplinary actions were taken was from a Big N audit firm (i.e., KPMG), with the remaining eight auditors came from non-Big N audit firms. This is despite the fact that Big N and non-Big N auditors audited 14 and 23 of the sample failed finance companies, respectively. Thus, the percentage of non-Big N auditors disciplined was disproportionately higher than that of Big N auditors. This result is consistent with Big N auditors providing higher quality auditing services than the non-Big N auditors in the finance company setting.

On a related note, four failed finance companies – Capital + Merchant Finance, Belgrave Finance, Nathans Finance and Strategic Finance – alleged negligence in audits and brought claims against their auditors in the court (Fitzgerald and McNeely, 2012;

Fletcher, 2014b, 2014c; Nathans Finance NZ Limited v. Doolan, 2011). Out of the four cases, Capital + Merchant Finance and Strategic Finance cases resulted in auditor payments. In case of Capital + Merchant Finance, its liquidator reached an NZ \$ 18.5 million out-of-court settlement with its auditor, BDO Spicers (Fletcher, 2014c). On the other hand, in case of Strategic Finance, its receivers and Financial Market Authority reached a settlement of NZ \$ 22 million with the company's directors and auditor (Fletcher, 2014b). While the auditors did not admit their liability in these two cases (Fletcher, 2014b, 2014c), the payments by these auditors imply their tacit admission of their failure in the audits (Palmrose, 1988).

9. Summary and discussion

This study examines audit failure in the failed private finance companies, utilizing three related but different sets of evidence – the frequency of GCOs, financial misstatements and the breach of the Code – and find that, in only 41% of the sample cases, GCOs were issued on the last financial statements issued immediately prior to failure. While the low rate of GCOs prior to failure may be construed as audit failure, one alternative explanation is provided by the auditor's belief about the self-fulfilling prophecy²⁰ (Carson et al., 2013). However, the high rate of unmodified audit opinion along with the evidence of financial misstatements by companies receiving unmodified audit opinions and the breach of the Code strongly suggest audit failure in a number of cases.

Regarding the audit quality distinctions, the paper finds that Big N auditors rendered GCOs more frequently than their non-Big N counterparts although the

²⁰ The self-fulfilling prophecy says that companies that receive GCO are more likely to fail than other companies as the issuance of a GCO may precipitate corporate failure (Carson et al., 2013). However, empirical evidence on the self-fulfilling prophecy is mixed (Carson et al., 2013).

difference is not significant. Further, more non-Big N auditors were associated with financial misstatements and were disciplined by NZICA than Big N auditors. On balance, the evidence is consistent with Big N auditors providing higher quality audits than non-Big N auditors even in the finance company setting.

The proxies for audit failure in this study are derived from accounting and auditing standards and pronouncements. Assuming that the auditor had knowledge of these standards and pronouncements, the audit failure documented in this study seems to be the result of auditor incentive problem created by the finance company setting.²¹ However, the negative impact of the setting on audit quality appears less severe for Big N auditors than for non-Big N auditors. Thus, the results are consistent with Big N auditor reputation acting as a motivator for higher quality audits even in this setting. The results are also consistent with Big N auditors partially compensating for the weaker corporate governance and weaker enforcement of securities law.

The paper has implications for regulators and the accounting profession for enhancing audit quality (IAASB, 2015). The paper directs attention to an area deserving regulatory and professional effort. Given that finance companies suffer from weaker governance that leaves their auditors open to management pressure, measures that may be considered for mitigating the pressure would include entrusting the trustee with the responsibility of appointing the auditor, and appointing them for a fixed term (say, three years). Further, since finance company financial statements, especially those audited by

²¹ An alternative explanation is that the global financial crisis (GFC) made the assessment of the client's ability to continue as a going concern difficult for the auditor. However, the explanation does not seem plausible given that there were finance companies that failed before the GFC. Further, it could be argued that since the GFC continued for a long time, it should have alerted the auditor to its potential negative consequences for the continued survival of the finance companies.

non-Big N auditors, represent greater risk of misstatements, the review of their audited financial statements by the trustee and the regulator on an on-going basis would enhance the probability of detecting misstatements and thus mitigate the incentive problem of the auditor.

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Table I.**Sample selection procedure**

Number of failed finance companies in Deep Freeze List	67
Less number of companies with no annual report on Companies Office website	<u>30</u>
Final Sample	<u>37</u>
Disciplinary action against the auditor	8
No disciplinary action	<u>29</u>
	<u>37</u>

Table II.

Audit opinions in last audit reports of failed finance companies in New Zealand

Name of Finance Company	Date of Failure	Auditor	Last financial statement reporting period ended	Last audit report sign-off date	Audit opinion given in last audit report	Failure Lag (Days)
National Finance 2000	9 May 2006	O'Halloran & Co	31 March 2005	21 July 2005	Unmodified opinion	292
Provincial Finance Ltd	30 May 2006	Ernst & Young	31 March 2005	3 June 2005	Unmodified opinion	361
Western Bay Finance	3 August 2006	Ingham Mora	31 March 2005	30 June 2005	Unmodified opinion	399
Bridgecorp Ltd	2 July 2007	PKF	30 June 2006	10 November 2006	Unmodified opinion	234
Bridgecorp Investment	6 July 2007	PKF	30 June 2006	10 November 2006	Unmodified opinion	238
Nathans Finance	20 August 2007	Staples Rodway	30 June 2006	5 September 2006	Unmodified opinion	349
Five Star Consumer Finance	29 August 2007	BDO Spicers	31 March 2006	25 September 2006	Unmodified opinion	338
Property Finance Securities	29 August 2007	Ernst & Young	31 March 2006	28 July 2006	Unmodified opinion	397
LDC Finance	4 September 2007	Sherwin Chan & Walshe	31 March 2007	27 April 2007	Unmodified opinion	130
Beneficial Finance	1 October 2007	BDO Spicers	31 March 2007	26 June 2007	Unmodified opinion	97
Capital + Merchant	29 November 2007	BDO Spicers	31 March 2007	7 November 2007	Unmodified opinion	22
Numeria Finance	17 December 2007	BDO Spicers	31 March 2007	7 November 2007	Unmodified opinion with going concern explanation	40
Lombard Finance	10 April 2008	KPMG	31 March 2007	30 May 2007	Unmodified opinion	316
Belgrave Finance	28 May 2008	Hayes Knight Audit	31 March 2007	11 July 2007	Unmodified opinion	322
IMP Diversified Fund	1 June 2008	PWC	30 June 2007	28 September 2007	Unmodified opinion with going concern explanation	247
Hanover Capital	1 July 2008	KPMG	30 June 2007	29 August 2007	Unmodified opinion	307
United Finance	1 July 2008	KPMG	30 June 2007	29 August 2007	Unmodified opinion	307
Hanover Finance	23 July 2008	KPMG	30 June 2007	29 August 2007	Unmodified opinion	329
Dominion Finance	9 September 2008	BDO Spicers	31 March 2007	13 July 2007	Unmodified opinion	424
Chancery Finance	10 November 2008	O'Halloran HMT	30 June 2007	18 February 2008	Unmodified opinion with going concern explanation	266

Name of Finance Company	Date of Failure	Auditor	Last financial statement reporting period ended	Last audit report sign-off date	Audit opinion given in last audit report	Failure Lag (Days)
Mascot Finance	2 March 2009	Martin Wakefield Timaru NZ	31 March 2008	11 June 2008	Unmodified opinion	264
OPI Pacific Finance Ltd	15 September 2009	Sherwin Chan & Walshe	31 March 2007	16 August 2007	Unmodified opinion	761
Boston Finance	19 November 2009	Auditors on London	31 March 2009	24 June 2009	Unmodified opinion with going concern explanation	148
Strategic Finance	12 March 2010	KPMG	30 June 2009	28 August 2009	Unmodified opinion with going concern explanation	196
Vision Securities	31 March 2010	Ernst & Young	31 March 2009	9 July 2009	Unmodified opinion with going concern explanation	265
St Laurence	29 April 2010	KPMG	31 March 2009	15 July 2009	Unmodified opinion with going concern explanation	288
Rural Portfolio Capital	1 May 2010	PWC	30 June 2009	3 September 2009	Unmodified opinion with going concern explanation	240
Rockforte Finance	10 May 2010	Grant Thornton	31 March 2008	27 June 2008	Unmodified opinion with going concern explanation	682
Viaduct Capital	13 May 2010	BDO Spicers	31 March 2009	31 August 2009	Unmodified opinion with going concern explanation	255
North South Finance	8 July 2010	BDO Spicers	31 March 2010	30 June 2010	Unmodified opinion with going concern explanation	8
Mutual Finance	14 July 2010	PKF	31 March 2009	15 July 2009	Unmodified opinion with going concern explanation	364
Allied Nationwide Fin	20 August 2010	PWC	30 June 2009	30 September 2009	Unmodified opinion with going concern explanation	324
South Canterbury Fin	31 August 2010	Woodnorth Myers & Co.	30 June 2009	30 September 2009	Unmodified opinion with going concern explanation	335
Equitable Mortgages	29 November 2010	PWC	31 March 2010	30 June 2010	Unmodified opinion	152
Finance & Leasing	18 January 2011	Martin Wakefield Timaru NZ	31 March 2010	6 July 2010	Unmodified opinion	196
NZF Money	22 July 2011	Grant Thornton	31 March 2010	17 June 2010	Unmodified opinion	400
Orange Finance	1 August 2012	E&Y	31 March 2012	26 June 2012	Unmodified opinion with going concern explanation	36

Name of Finance Company	Date of Failure	Auditor	Last financial statement reporting period ended	Last audit report sign-off date	Audit opinion given in last audit report	Failure Lag (Days)
Note: Failure lag indicates the number of days between the last audit report sign off date and the date of failure. Other headings are self-explanatory.						

Table III.**Descriptive statistics**

Variables	GCO=0 (n=19)		GCO=1 (n=13)		t-statistics for difference in means	Wilcoxon statistics for difference in medians
	Mean	Median	Mean	Median		
AUDLAG	0.271	0.249	0.285	0.252	-0.318	0.403
BIGN	0.263	0.000	0.538	1.000	-1.593	1.285
DISCPROV	0.020	-0.002	0.041	0.008	-0.522	0.460
Δ ROA	-0.034	-0.001	-0.023	-0.050	-0.181	0.998
Δ CFO_TL	0.005	0.007	0.073	0.046	-1.405	1.458
Δ CR	-2.165	-0.131	1.714	0.043	-1.389	0.806
Δ LEV	0.016	-0.006	0.201	0.038	-1.766*	2.110**
ROA	0.009	0.027	-0.054	-0.021	0.912	2.763***
CFO_TL	0.061	0.047	0.130	0.010	-1.001	0.038
CR	1.591	1.306	6.768	1.237	-1.450	0.652
LEV	0.898	0.875	1.148	0.926	-1.683	1.343

Note: GCO is 1 for going concern explanatory paragraph and 0 otherwise; AUDLAG is audit lag (in days) for the last audit report deflated by 365; BIGN is 1 if the auditor was a Big N auditor, 0 otherwise; DISCPROV is discretionary loan loss provision; Δ ROA is change in net income divided by total assets; Δ CFO_TL is change in cash flow from operation divided by total liabilities; Δ CR is change in current ratio; Δ LEV is change in total liabilities divided by total assets; ROA is net income divided by total assets; CFO_TL is cash flow from operation divided by total liabilities; CR is current ratio and LEV is total liabilities divided by total assets.

***, ** and * indicate statistical significance at 1%, 5% and 10%, respectively.

Table IV.

Regression analyses

Variables	Model (2)	Model (3)
Intercept	-2.934 (-1.957*)	-5.593 (-2.054*)
AUDLAG	3.756 (1.118)	5.360 (1.206)
BIGN	1.646 (1.363)	1.712 (1.551)
DISCPROV	8.462 (0.629)	-6.093 (-0.858)
Δ ROA	-0.785 (-0.190)	
Δ CFO_TL	8.782 (1.889*)	
Δ CR	0.526 (1.884*)	
Δ LEV	17.772 (1.756*)	
ROA		-1.721 (-0.369)
CFO_TL		1.718 (0.464)
CR		0.282 (0.778)
LEV		2.536 (1.362)
LR statistic	17.937**	10.224
n	32	32

Note: z-statistics are in parentheses and are based on Huber/White standard errors.
Variables are as defined in Table III.

***, **, and * indicate statistical significance at 1%, 5% and 10% level, respectively.

Table V.

Trends of receivables, advances, interest and operating revenue of Nathans (in million NZ\$)

Variables	2006	2005	2004	2003
Total assets	172.323	137.047	83.679	43.994
Intercompany advances	79.630	60.777	11.649	0.170
Finance receivables – Current	34.366	25.047	27.375	8.058
Finance receivables – Non-Current	34.077	45.160	40.479	28.596
Total finance receivables	68.443	70.207	67.854	36.654
Total receivables and advances	148.073	130.984	79.503	36.824
Total intercompany receivables and advances	135.262	122.324	63.938	32.046
Total receivables and advances as a percentage of total assets	85.928%	95.576%	95.010%	83.703%
Intercompany advances and receivables as a percentage of total finance receivables	91.348%	93.389%	80.422%	87.025%
Interest from intercompany advances	13.300	10.007	4.017	0.000
Interest from finance receivables	4.963	2.955	1.876	2.852
Total interest from intercompany advances and finance receivables	18.263	12.962	5.893	2.852
Total operating revenue	19.701	13.818	7.007	3.440
Total interest from intercompany advances and finance receivables as a percentage of total operating revenue	92.701%	93.805%	84.102%	82.907%
Interest revenue minus interest expense	6.590	4.786	1.922	0.989
Interest received minus interest paid	(4.234)	(5.455)	5.298	2.307
Net profit for the year	4.973	3.376	1.497	0.437
Net cash inflow/(outflow) from operating activities	(5.806)	(7.317)	2.535	1.630
Interest revenue from intercompany advances	13.300	10.007	4.017	0.000
Non-cash interest revenue from intercompany advances*	13.300	10.007	0.000	0.000
Receivables and advances – current	113.996	85.824	39.024	8.228
Cash inflow from loan repayments	11.848	6.975	14.303	5.563

Note: Total intercompany receivables and advances are the total of intercompany advances, vending licenses financing receivables, equipment financing receivables and related party receivables.

*This item appears as a non-cash adjustment to earnings to derive cash flow from operations in Note 12 to Nathans Finance 2006 financial statements (Nathans Finance NZ Limited, 2007).

Source: Nathans Finance NZ Limited (2003, 2004, 2005, 2007)

Table VI.

Auditor negligence and disciplinary actions

Panel A Types of auditor negligence and actions by the Disciplinary Tribunal

Name of Finance Company	Date Failed	Audit Firm	Auditor	Breach of the Code of Ethics				Punishment			
				Rule 2	Rule 7	Rule 9	Rule 11	Censured	Certificate of public practice suspended	Ban on audit of an issuer for five years	Payment of monetary penalty
National Finance 2000	May-06	O'Halloran & Co	Bruce Arnold Mincham & Michael Derek Wood	√		√	√	√			√
Nathans Finance	Aug-07	Staples Roadway	Christopher John Hughes			√	√	√		√	√
Beneficial Finance	Oct-07	BDO Spicers	Robert Scott Innes-Jones				√	√	√	√	√
Capital + Merchant	Nov-07	BDO Spicers	Peter John McNoe			√	√	√	√	√	√
Belgrave Finance	May-08	Hayes Knight Audit	Colin Bruce Henderson				√	√			√
Hanover Finance	Jul-08	KPMG	Bill Wilkinson				√	√			√
South Canterbury Fin	Aug-10	Woodnorth Myers & Co.	Byron John Watson Pearson			√	√	√		√	√

Panel B Types of auditor negligence and actions by the Professional Conduct Committee

Name of Finance Company	Date Failed	Audit Firm	Auditor	Breach of the Code of Ethics				Punishment			
				Rule 2	Rule 7	Rule 9	Rule 11	Censured /Reprim and	Review of practice by Practice Review Board	Undertaking not to audit	Payment of monetary penalty
Mascot Finance	Mar-09	Martin Wakefield	Richard John White		√	√		√	√	√	√

Note:

Rule 2 deals with false or misleading statements and reads as follows:

“A member must not make, prepare or certify, or permit or direct another person to make, prepare or certify, any statement which the member knows, believes or ought to know to be false, incorrect or misleading, or open to misconstruction, by reason of the misstatement, omission or suppression of a material fact or otherwise”. (NZICA 2006, para 21, italics omitted)

Rule 7 emphasizes the importance of competence in the following words:

“A member who accepts or undertakes professional work must have the Competence necessary to carry out the work. Accordingly, a member must refrain from undertaking or continuing any assignment which the member is not competent to carry out, unless the member obtains such advice and assistance as will enable the member to complete the assignment in an efficient, proper and timely manner.” (NZICA 2006, italics omitted)

Rule 9 requires the members to “perform all their professional work with due care and diligence” (NZICA 2006, italics omitted).

Rule 11 reads as follows:

“Members must comply with the requirements of the Professional Engagement Standards, the Professional Standards and any other Standards or pronouncements which the Council may from time to time issue and declare to be mandatory for the purposes of this provision” (NZICA 2006, para 97 italics omitted).
