REPORT 461

Audit inspection program report for 2014–15

December 2015

About this report

This report summarises the observations and findings identified by ASIC’s audit inspection program in the 18 months to 30 June 2015.

We expect this report to be of significant interest both to the inspected firms and those firms we have not inspected, as well as companies, audit committees, investors and other stakeholders interested in financial reporting.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Scope

Sections of this report describe deficiencies or potential deficiencies in the systems, policies, procedures, practices or conduct of some of the 21 audit firms inspected. The absence of a reference in this report to any other aspect of a firm's systems, policies, procedures, practices or conduct is not an approval by ASIC of those aspects.

In the course of reviewing specific areas in a limited sample of a risk-based selection of audit engagements, an inspection may identify ways in which a particular audit is, in our view, deficient. It is not the purpose of an inspection, however, to review all of the firm's audit engagements or to identify every aspect in which a reviewed audit may be deficient.

We adopt a risk-based approach to selecting audit files and areas for review, and a random approach could result in a different level of findings.

This report covers findings from audit firm inspections only and does not count matters arising from other ASIC regulatory activities, such as our financial reporting surveillance program, and separate investigations or surveillances of the firms or the entities that they audit. However, these other activities may inform the general areas of focus in inspections.

Unless stated otherwise, not all matters in this report apply to every firm and, where they do apply to more than one firm, there will often be differences in degree of application. Our observations and findings relate only to the individual firms inspected. Our observations and findings can differ significantly, even between firms of similar size, and for that reason we caution against drawing conclusions about any individual firms.

Contents

Executive summary

Overall findings

1 This report outlines the findings from our inspections of 21 Australian audit firms undertaken in the 18 months to 30 June 2015, covering financial reports for years ended 30 June 2013 to 31 December 2014. Our inspections focus on audits of financial reports of public interest entities prepared under the *Corporations Act 2001* (Corporations Act).

2 The objective of our audit firm inspections is to promote the improvement and maintenance of audit quality. We work cooperatively with firms to achieve this objective.

3 In our view, in 19% of the total 463 key audit areas that we reviewed across 111 audit files at firms of different sizes, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 20% of 454 key audit areas in the previous 18-month period ended 31 December 2013: see Section A.

4 The level and nature of our findings are consistent with those of audit regulators in other jurisdictions, as reflected in the inspection findings survey results published by the International Forum of Independent Audit Regulators (IFIAR) earlier this year.[1]

5 Any audit findings do not necessarily mean that the financial reports audited were materially misstated. Rather, in our view the auditor did not have a sufficient basis to support their opinion on the financial report. We do not report on areas where auditors perform beyond the relevant standards and so, to that extent, the report does not represent a balanced scorecard. Our surveillance also focuses on higher risk audit areas and so caution is needed in generalising the results across the entire market. The results should be viewed as an indication of how some firms address more challenging audit situations.

6 Our audit inspection work complements our separate risk-based surveillance of the financial reports of public interest entities. This financial reporting surveillance has led to material changes to 4% of the financial reports of public interest entities reviewed by ASIC.

7 In 15 cases where we reviewed audit files as a part of our inspections, ASIC or the auditor followed up financial reporting matters identified by ASIC with the companies concerned. In 12 of these cases, the companies made

[1] IFIAR, *Report on 2014 survey of inspection findings*, March 2015.

material adjustments to the amounts of both the net assets and profits in the relevant or subsequent period, which in our view related to our concerns. One further company made additional disclosures.

8 Directors are primarily responsible for the quality of the financial report. Audit quality supports financial reporting quality, and it is in the interests of directors and audit committees to support the audit process. This includes ensuring that management produces quality financial information and that the audit is appropriately resourced. We strongly caution against selecting auditors on the basis of cost rather than to ensure a quality audit.

9 There is a need for audit firms to continue to work on improving audit quality and the consistency of audit execution. While firms continue to make good efforts to improve audit quality, these are yet to be reflected in our risk-based inspection findings.

10 Firms should undertake, or continue to undertake, comprehensive analysis to identify the underlying root causes of findings from their own quality reviews of audit files and our audit inspections. They should identify effective solutions to address these root causes, and have regard to both past initiatives of the firm that have been effective in improving audit quality and the initiatives outlined in Appendix 3.

11 While the largest six audit firms have made efforts to improve audit quality, they need to continue to focus on their action plans and other initiatives. Some action plan initiatives, including a focus on the use of the auditor's own experts and coaching on impairment of non-financial assets, have already led to improvements in audit quality at some firms; others will take more time to have full effect. Firms should also consider the need for new and changed initiatives.

12 Our inspections suggest that the following three broad areas continue to require improvement by audit firms:

(a) the sufficiency and appropriateness of audit evidence obtained by the auditor;

(b) the level of professional scepticism exercised by auditors; and

(c) appropriate use of the work of experts and other auditors.

13 Many of our findings related to accounting estimates (including impairment of assets) and accounting policy choices: see Section B.

14 Some, mostly smaller, audit firms inspected also need to further improve their quality control systems: see Section C. For larger firms, findings generally relate to adherence to existing quality control processes.

Our methodology

15 Matters relevant to understanding the percentage measure in paragraph 3 are discussed in Appendix 1 to this report. ASIC was assisted with feedback from an external consultative panel on our method of measuring findings.

16 We select audit engagements and key audit areas for review in our audit inspections using a risk-based approach. We generally select some of the more complex, demanding and challenging audits, and some more significant or higher risk areas of the financial reports. Our inspections generally exclude cases where known or suspected reporting or audit issues have already been identified in our financial reporting surveillance program, in our investigations or by other means. Hence, purely random reviews could result in a different level of findings than indicated in paragraph 3.

17 Our inspections exclude cases where we have specific prior concerns about the quality of an audit based on complaints or other intelligence. These matters are addressed through separate surveillance activities, as explained at paragraphs 226–231 in Appendix 1.

18 We also exclude a number of inspection findings from the percentages in paragraph 3. Deficiencies in many audit areas that have been excluded from the percentages are summarised in Table 1.

19 Audits necessarily involve the application of professional judgement, and there are some instances where different individuals will reach different judgements on whether the audit work performed is sufficient. Even though there may be some instances where firms disagree, the percentages in paragraph 3 do not include instances where we consider that individuals could reasonably reach different judgements.

20 Our inspections do not attempt to measure cases where auditors have performed their role and challenged an entity's draft financial report, resulting in material changes to those reports. We recognise that very often auditors will cause material change to draft financial reports in performing their role.

Initiatives to improve audit quality

21 During 2013, the largest six audit firms responded to ASIC's requests to prepare action plans to improve audit quality and the consistency of audit execution. We welcomed the firms' response to our request to develop and implement these comprehensive plans. During the 18 months to 30 June 2015, we discussed with the largest six firms their progress in implementing these plans and assessed their impact on audit quality.

22 We encourage the largest six firms to critically evaluate their action plans regularly, identifying root causes of audit quality findings and to develop actions to address those root causes. This includes continuing to develop and promote a culture and an accountability framework that identifies better and sustainable ways of improving audit quality. We also encourage other firms to develop or review action plans and initiatives to improve audit quality.

23 Improving audit quality also includes ensuring that the right experience and expertise is applied to audits and that there is appropriate supervision and review. Firms should review staffing structures to ensure that sufficient and appropriate experience and expertise is available for increasingly complex entities and audits that require significant judgements.

24 We outline areas that auditors might consider to improve audit quality and the consistency of audit execution, including initiatives that appear to have been effective in improving audit quality: see Section D.

25 We discuss actions that directors and audit committees, standard setters, accounting bodies and others can take to support audit quality: see Section E.

26 We outline our future areas of focus for our inspections in Section F.

A Overall findings

Key points

In our view, in 19% of the total 463 key audit areas reviewed across 111 audit files, at firms of different sizes, auditors did not obtain reasonable assurance that the overall financial report was free of material misstatement.

While financial reports may not have been materially misstated, in our view the auditor did not have a sufficient basis to form an opinion on the financial report.

In 2013, we welcomed the six largest firms' response to our requests to develop action plans to improve audit quality. These action plans are being monitored and require ongoing review and enhancement by the firms to have full effect.

This section includes information on our approach to audit quality.

The importance of audit quality

27 The quality of financial reports is key to confident and informed markets and investors. The objective of the statutory requirement for the independent audit is to provide confidence in the quality of financial reports. Auditors are important 'gatekeepers' in our financial system, and improving audit quality and the consistency of audit execution is essential to continuing confidence in the independent assurance provided by auditors.

28 If a company fails and the financial report did not properly show the declining financial position and results or going concern issues of the company, it is reasonable that questions would be raised about the role of the company directors and the auditor. Questions may also be raised if investment decisions are made on financial reports that do not otherwise reflect a company's true financial position and performance. If the auditor did not obtain reasonable assurance that the financial report was free of material misstatement, apply sufficient scepticism to accounting estimates and treatments, or address any deficiencies detected, investors and other users of financial reports would be concerned.

29 Directors are responsible for the quality of the financial report. Audit quality supports financial reporting quality, and it is in the interests of directors and audit committees to support the audit process. This includes ensuring that management produces quality financial information and that the audit is appropriately resourced. We strongly caution against selecting auditors on the basis of cost rather than to ensure a quality audit.

Our approach to audit quality

30 For our regulatory purposes, audit quality is about matters that contribute to the likelihood that the auditor:

(a) achieves the fundamental objective of obtaining reasonable assurance that the financial report as a whole is free of material misstatement; and

(b) ensures material deficiencies detected are addressed or communicated through the audit report.

31 This includes appropriately challenging key accounting estimates and treatments that can materially affect the reported financial position and results.

32 Our view is consistent with the objective of the audit, as outlined in the auditing standards[2], and has been adopted by Australia's Financial Reporting Council and most major foreign audit regulators.

33 While firms have made good efforts to maintain and improve audit quality, these are yet to be fully reflected in our risk-based inspection findings. Some action plan initiatives have been more effective than others. Plans should be regularly reviewed to ensure that they are effective and new initiatives are adopted to improve audit quality. This is discussed further in Section D.

34 The objective of our audit firm inspections is to promote the improvement and maintenance of audit quality. We work cooperatively with firms to achieve this objective.

35 Audit committees should take an interest in our findings and have a dialogue with their auditors about whether the findings are relevant to their auditors and their firm, and how the auditors and firms are addressing those findings.

Our findings

36 Our recent risk-based inspections show examples where, in our view, auditors did not obtain reasonable assurance that audited financial reports were not materially misstated.

37 Audit regulators in other major countries have indicated similar types and levels of findings in relation to audit quality.

38 We inspected 21 audit firms of different sizes in the 18 months to 30 June 2015, covering financial reports for years ended 30 June 2013 to

[2] See paragraph 11 of Auditing Standard ASA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with Australian auditing standards.*

31 December 2014. We reviewed a total of 463 key audit areas across 111 audit files. Appendix 1 to this report contains further information about our inspection approach and the 21 audit firms inspected.

39 In our view, in 19% of the 463 key audit areas reviewed, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. The corresponding figure for the 18 months to 31 December 2013 was 20% across 450 key audit areas.

40 The occurrence of the above findings at the larger firms was:

(a) the Largest Four National firms—18% (16% in the previous 18-month period); and

(b) Other National and Network firms[3]—15% (21% in the previous 18-month period).

41 Our findings do not necessarily mean that the financial reports audited were materially misstated. Rather, in our view, the auditor did not have a sufficient basis to support their opinion on the financial report.

42 An audit does not provide absolute assurance. Our findings are based on the requirement for the auditor to obtain reasonable assurance.

43 Our inspections do not attempt to measure cases where auditors have performed their role and challenged an entity's draft financial report, resulting in material changes to those reports. We recognise that very often auditors will cause changes to draft financial reports in performing their role.

44 We use a risk-based approach to selecting audit files and key audit areas for review during our firm inspections.

45 Our findings were not affected by any significant change in our areas of focus. The audit areas covered in our reviews in the 18 months to 30 June 2015 and the 18 months to 31 December 2013 were similar, as shown in Table 5 in Appendix 1. While the Largest Four National firms were inspected in both periods, different firms were inspected in the Other National and Network firms, which resulted in a lower level of findings for that group.

46 The level and nature of our findings are consistent with those of audit regulators in other jurisdictions, as reflected in the inspection findings survey results published by IFIAR earlier this year.[4]

[3] The percentage for the Other National and Network firms are not directly comparable between periods, as we inspected different firms in the 18 months to 30 June 2015 (seven firms) and in the 18 months to 31 December 2013 (four firms). See paragraph 222 in Appendix 1 for an explanation of the firm size categories.

[4] IFIAR, *Report on 2014 survey of inspection findings*, March 2015.

47 Other matters relevant to understanding our findings and the percentages reported above are outlined in Table 6 in Appendix 1, particularly findings excluded from these percentages. The percentages reflect findings in the areas discussed in Section B, other than those in Table 1.

48 In 15 cases, ASIC or the auditor followed up financial reporting matters identified by ASIC with the companies concerned. In 12 of these cases, the companies made material adjustments to the amounts of both the net assets and profits in the relevant or subsequent period. One further company made additional disclosures.

49 Our audit inspection work complements our separate risk-based surveillance of the financial reports of public interest entities. This financial reporting surveillance work has led to material changes to 4% of the financial reports of public interest entities reviewed by ASIC.

50 Many of our findings related to accounting estimates (including impairment of assets) and accounting policy choices. Further information appears in Section B of this report, other than the findings in Table 1.

51 We consider that there is still a need for audit firms to improve audit quality and the consistency of audit execution.

Additional indicators of audit quality

52 We review the adequacy of certain audit procedures on most engagement files selected during our audit firm inspections. Table 1 in Section B shows the deficiencies that we identified in these areas. These findings are excluded from the findings percentages in paragraph 40.

Consultative panel

53 We used a panel to consult on the method of measuring and reporting aggregate findings from our inspections. In relation to our method of measuring findings, the panel considered a sample of the anonymised individual findings from specific audit engagement files selected by ASIC, and our assessment of those individual findings. The sample included six of the 87 cases where we considered the auditor did not obtain reasonable assurance that the financial report was free of material misstatement, and four findings that were not included in the 87 cases.

54 The panel consisted of Messrs Peter Day, Brian Long and Des Pearson AO, who have extensive qualifications and experience in business, accounting and audit, and are considered independent of the audit firms and professional bodies. Overall, the panel concurred with our approach and the reporting of our findings.

B Key findings: Audit file reviews

Key points

Our inspections suggest that the following three broad areas continue to require improvement by audit firms:

- the sufficiency and appropriateness of audit evidence obtained by the auditor, especially in relation to estimates;
- the level of professional scepticism exercised by auditors; and
- appropriate use of the work of experts and other auditors.

This section provides further examples of our inspection findings in each of these areas.

Audit evidence and professional scepticism

55 Across all of the firms inspected, our review of audit files identified many cases where we had concerns about the sufficiency and appropriateness of evidence obtained by auditors to support their conclusions on significant areas of the audit.

56 Our reviews of audit files showed cases where, in our view, insufficient professional scepticism was applied, particularly for fair value measurement, impairment testing, revenue recognition, outcomes of internal control testing, tax balances, completeness of related party transactions and financial report disclosures. Exercising professional scepticism is a critical part of conducting quality audits. Professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of the audit evidence obtained and management's judgements on accounting estimates and treatments.

57 In particular, we found examples where auditors appeared to have:

(a) been over-reliant on, or readily accepted, the explanations and representations of the management of audited entities without challenging matters such as key underlying assumptions; or

(b) sought out evidence to corroborate estimates or treatments rather than appropriately challenging them.[5]

[5] Our view that professional scepticism involves challenging rather than merely seeking to corroborate is consistent with auditing standards and is supported by guidance from the Auditing and Assurance Standards Board (AUASB) in its bulletin, *Professional scepticism in an audit of a financial report*, issued in August 2012. It is also consistent with literature from standard setters in other countries that use auditing standards based on the International Standards on Auditing (ISAs), such as the UK Financial Reporting Council.

58 These examples are summarised below.

Impairment testing and fair value measurement

59 During the 18 months to 30 June 2015, we continued to focus on impairment of assets and the measurement of assets at fair value, which are important areas of estimation and judgement. In many audit files that we reviewed, we considered that auditors did not obtain sufficient appropriate audit evidence to support the values of assets in the financial report or applied an adequate level of professional scepticism. This included, but was not limited to:

(a) financial instruments;

(b) goodwill;

(c) other intangible assets;

(d) property, plant and equipment;

(e) mine development assets; and

(f) exploration and evaluation assets.

60 In the audits reviewed, we continued to find instances where the auditor:

(a) did not adequately consider the appropriateness and reasonableness of forecast cash flows and key assumptions used in discounted cash flow models, taking into account matters such as historical cash flows, and economic and market conditions—for example:

  (i) relying on out-of-date commodity pricing information;

  (ii) using resource assumptions that were not consistent with the audited entity’s own market disclosures; and

  (iii) accepting very high growth rates in net cash flows over forecasts for the first five years;

(b) failed to challenge the inclusion in the value in use calculations of cash flows that related to a future restructuring, despite the company not being committed to the restructure;

(c) did not question whether other cash flow forecasts were reasonable and supportable—for example, increasing cash flows in perpetuity after the fifth forecast year despite the fact that:

  (i) the forecasts in year five may represent a cyclical peak and not likely cash flows through the cycle; and

  (ii) perpetuity growth rates exceeded long-term average growth rates;

(d) accepted the use of similar discount rates for different cash generating units (CGUs), even though the risks were different and the CGUs were located in different countries;

(e) did not give sufficient consideration to the reasons why forecasts were appropriate, despite a history of management forecasts not being met;

(f) did not give consideration to other information in the audit file or annual report that was inconsistent with the assumptions applied in impairment calculations;

(g) did not consider whether all CGUs had been appropriately identified at the lowest level of independent cash flows;

(h) did not consider whether there was a mismatch between the cash flows used and the assets being tested—for example:

  (i) there may be a need to include the inventories, receivables and deferred tax assets in the carrying amount of the assets being tested; and

  (ii) the assets may not have been allocated to the correct CGU;

(i) failed to assess the impact and the application of the Accounting Standard AASB 13 *Fair value measurement* as it relates to impairment testing;

(j) did not obtain appropriate external evidence (such as comparable transaction prices or bid offers) or undertake valuation cross-checks with alternative valuation methods to support or corroborate a particular valuation methodology adopted;

(k) did not consider the impairment requirements of the relevant accounting standards as they apply to particular asset categories within the extractive industries (see our industry-specific findings in Appendix 2);

(l) did not test the source data used by the audited entity in its impairment models; and

(m) failed to assess whether there was a reasonable and consistent basis for allocating corporate assets and indirect cash outflows to individual CGUs.

61 In a number of cases, we found the auditor did not give adequate consideration to the fair value of financial assets and whether pricing information provided by a third party was appropriate evidence to support the valuation. There was also insufficient testing of the classification of assets into the fair value hierarchy.

62 We also found insufficient evidence in a number of cases that the auditor exercised professional scepticism when considering whether disclosures in the financial report about fair value and impairment were in accordance with the relevant accounting standards and accurately reflected key assumptions and information that the auditor had reviewed. Where disclosure deficiencies were identified, our perception was that the auditor did not take a sceptical approach that challenged the audited entity’s disclosures.

63 In a number of instances we also noted that inadequate work was performed on complex impairment calculations and the auditor did not consider whether an expert might be required to assist with these calculations. In some cases, insufficient work was carried out by the firm's expert valuation or corporate finance teams. See our findings in relation to the work of other auditors and experts at paragraphs 80–87.

64 We recently released Information Sheet 203 *Impairment of non-financial assets: Materials for directors* (INFO 203). Although the main objective of this information sheet is to help directors and audit committees consider whether the value of non-financial assets shown in financial reports continues to be supportable or whether there is a need for impairment, it can equally be of assistance to auditors. INFO 203 discusses the need for impairment testing, the process for assessing impairment, common issues with impairment calculations and questions that may be asked of external auditors.

Accounting policy choices

65 We found examples where auditors did not, in our view, consider or adequately question the accounting policy choices adopted by entities on matters such as revenue recognition including income arising from research and development activities, demerger accounting, expense deferral, hedge accounting and non-consolidation of off balance-sheet arrangements. We also noted instances where the auditor did not identify a lack of relevant disclosure in the financial reports for changes in accounting policy.

66 We noted some instances where the auditor did not sufficiently consider the application of particular accounting standards and subsequent impact on accounting treatments for entities in extractive industries: see Appendix 2.

67 In our view, auditors did not always apply an adequate level of scepticism, consider alternative treatments or involve technical accounting experts. In other cases where technical consultations were made, the auditor did not adequately consider the expert's recommendations and appeared to accept the audited entity's treatment without setting out their rationale for doing so.

Revenue

68 In many audits we reviewed, we consider the auditor did not perform adequate procedures to gain sufficient appropriate evidence about the accuracy and completeness of revenue. We found examples where auditors:

(a) did not appropriately understand the control environment (design and implementation) nor test controls in revenue processes that were relied on (see paragraphs 69–73);

(b) applied flawed substantive-testing procedures given that the auditor did not place reliance on or test internal controls, particularly in the samples selected for testing and the analytical procedures used;

(c) relied primarily on substantive analytical procedures that did not provide reasonable assurance over the revenue balance—the assumed relationship between the population tested and the population used to predict the population tested did not take into account the nature of the business or underlying contractual arrangements;

(d) did not have appropriate regard to the terms of the relevant contracts that supported the recognition of revenue; and

(e) did not fully consider the nature of the entity's business, its revenue streams and underlying risks, and whether the revenue recognition policies were appropriate.

Internal controls testing

69 During the 18 months to 30 June 2015, we noted a number of audit files where a controls reliance was not adopted. Rather, auditors adopted substantive testing to address the risk of material misstatements in the financial report. While this may be an acceptable approach, it can result in a less effective audit and may not be practical for audits of certain entities with large volumes of transactions.

70 In those instances where a controls-based approach was adopted, we identified concerns in a number of cases about the sufficiency of audit evidence gathered over controls testing undertaken, including evaluation, identification and testing their operating effectiveness. This included the areas of revenue, financial instruments and credit provisioning.

71 Examples of concerns included auditors:

(a) not clearly identifying and documenting the key control procedures;

(b) having a lack of understanding of the difference between processes (e.g. preparation and distribution of reports, calculation tools) and the control procedures over such processes;

(c) not sufficiently understanding the client's control environment;

(d) not identifying key controls and testing their operating effectiveness;

(e) not understanding the role of internal audit work as part of the system of internal control when reducing substantive testing;

(f) not assessing whether uncorrected misstatements identified through substantive testing were indicative of one or more deficiencies in internal control;

(g) placing reliance on work undertaken by internal management groups as a direct substitute for external audit work; and

(h) relying on controls for the last three or four months of the year, but not testing the controls or performing any substantive testing.

72 We are of the view that more extensive evidence should have been obtained and included in the engagement files where key management controls were being relied on by auditors, including the identification of the key controls, their design and implementation, and details of the audit work performed to test their operating effectiveness throughout the year.

73 It may not be possible to conduct an effective audit where substantive audit evidence alone is obtained to mitigate risks at the assertion level without fully understanding, assessing and, where appropriate, relying on controls—particularly for companies with large number of systematically processed transactions.

Tax balances

74 In some cases we noted the auditor did not obtain sufficient or appropriate evidence, nor apply appropriate professional scepticism, for tax provision calculations and associated balances.

75 Auditors should use their own tax experts in auditing tax calculations, where appropriate. The auditor should work closely with any tax specialist to ensure that the level and scope of the specialist's work is suitable for audit purposes. The auditor should ensure that the tax expert has a good understanding of the business and nature of the financial reporting balances, and that the auditor understands differences between tax and accounting treatments that give rise to deferred tax balances.

76 In many cases where tax experts were used, we identified concerns with the scope of work agreed and evaluation of the adequacy of the work performed for audit purposes: see our findings on using the work of experts and other auditors at paragraphs 80–87.

77 Specific examples of concerns noted for tax balances included:

(a) insufficient audit evidence gathered by auditors to support recoverability of deferred tax asset balances, including probability of future taxable profits occurring to allow for the utilisation of past tax losses recognised as deferred tax assets;

(b) insufficient audit evidence to support the eligibility of material tax deductions in the tax provision calculation, which underpin the relevant tax balances;

(c) insufficient audit evidence of testing performed by internal tax specialists who were used as a member of the engagement team to audit material tax balances. In addition, there was no evidence of how material tax-related questions raised by the tax specialist were considered and resolved by the auditor; and

(d) inadequate audit procedures performed to ensure appropriate disclosures related to tax effect accounting in the financial reports.

Assessment of going concern assumption

78 In some cases, auditors did not obtain sufficient audit evidence to demonstrate their consideration of the appropriateness of the going concern assumption.

79 In these cases, we had concerns about the adequacy of the audit procedures undertaken and the level of professional scepticism applied by the auditor in assessing whether the entity's:

(a) going concern assumption was appropriate, particularly where the entity operated in an environment of significant risk; and

(b) budgets and cash flow forecasts (including key assumptions) were reasonable and appropriate.

Using the work of experts and other auditors

80 Where financial reports involve complex or subjective matters requiring specialist skills or knowledge (e.g. valuation of assets), audited entities may obtain advice from their own external or internal experts.

81 Auditors may need to use their own specialists to obtain sufficient appropriate audit evidence for significant account balances in the financial report where the auditor does not have adequate knowledge or expertise.

82 In these cases, auditors should not rely on management's own expert, as this would result in one expert supporting both the information in the financial report and the audit. Doing so would be contrary to the fundamental objective of an independent audit. Unless the auditor has sufficient expertise to audit the work of management's expert and to challenge the expert, the auditor should engage their own expert.

83 Auditors need to consider the auditing standards requirements for the use of experts, especially underpinning material balances, to ensure the basis and underlying information evaluated by experts are fully understood by the auditor who has ultimate responsibility for the financial report.

84 In the audit of a financial report consolidating many business components, the auditor often relies on the audit work performed by other component auditors that may be affiliated or separate firms, potentially located in a foreign jurisdiction.

85 The auditor needs to assess the competence and objectivity of experts and other auditors that they use, and evaluate the appropriateness of the work performed by them.

86 We continued to find instances where, in our view, auditors did not:

(a) use their own experts where members of the audit team did not have sufficient knowledge, skill and experience in specialist areas to test and evaluate the information and opinions generated by the expert;

(b) appropriately scope and review the work and reports of experts engaged by the auditor;

(c) review, or adequately review, the work of other auditors that they relied on where such reviews should have been performed;

(d) adequately review and evaluate reports from their experts or component auditors, including resolving matters raised by those experts or component auditors;

(e) evaluate the adequacy and reliability of the work of experts engaged by the audited entity, including in the case of financial institutions where experts are used to measure complex and material liabilities and provisions or to provide pricing information. In many instances the scope of work agreed was too narrow;

(f) evaluate the competence and independence of experts or component auditors;

(g) assess the work of the auditor of service organisations used to process material transaction streams and whether that work could be relied on; and

(h) assess the completeness and accuracy of the data used by experts engaged by the audited entity or by the auditor.

87 Some, generally smaller, firms' policies and manuals did not provide clear guidance to auditors on the application of the relevant auditing standards, especially when an auditors' expert was sourced from within the firm, or on what constituted 'accounting and auditing expertise'. The work of experts was used as a substitute for audit procedures where the work was not to the level required by the auditing standards, including in relation to the scope and extent of testing and the nature of the testing performed.

Industry-specific findings

88 We reviewed audit files for selected financial institutions (including banks and insurance companies) and extractive industry companies. Our findings are set out in detail in Appendix 2.

89 While we review a similar number of financial institution audits in each 18-month inspection period across all firms inspected, we do not review this type of audit at every individual inspected firm in each 18-month period.

90 Our findings for audits of banks included concerns about auditors:

(a) obtaining insufficient and inappropriate audit evidence to support the valuation of significant financial assets;

(b) carrying out insufficient testing to assess the adequacy of provisions for loan losses;

(c) obtaining insufficient audit evidence in testing the completeness of securitisation arrangements or off balance-sheet entities;

(d) obtaining insufficient audit evidence in assessing the disclosure of interests in other entities;

(e) placing inappropriate reliance on the work of the clients' specialist internal finance teams, without evaluating their objectivity and independence; and

(f) carrying out inadequate testing of the net interest income as a result of using incorrectly designed substantive analytical procedures.

91 Our findings for audits of insurance companies included concerns about:

(a) the auditor carrying out inadequate testing of valuation of investments;

(b) the auditor and their internal actuarial expert making an insufficient assessment of life insurance policy liabilities;

(c) the firm having inadequate audit procedures over life investment contract liabilities for a life insurance company; and

(d) the auditor carrying out inadequate testing on revenue comprising premium, investment and fee revenue.

92 Our findings for audits of extractive industry companies included concerns about the existence and valuation of assets—in particular, impairment testing of non-financial assets.

Areas reviewed on most audit files

93 In addition to our review of key audit areas on selected files, we reviewed the adequacy of certain audit procedures on most engagement files selected during our audit firm inspections. Table 1 shows the deficiencies that we listed in private reports to the firms inspected in these areas as a percentage of the total files reviewed in our inspections over the relevant period.

Table 1: Deficiencies reported in other audit areas as a percentage of total files reviewed (2012–13 and 2014–15)

Audit area	18 months to 30 June 2015	18 months to 31 December 2013
Related party transactions	20%	6%
Planning and risk assessment	15%	8%
Financial report disclosures	15%	3%
Consideration of risk of fraud	12%	11%
Materiality determination	9%	6%
Journal entry testing	8%	15%
Subsequent events	7%	5%
Planning analytical procedures	5%	11%
Litigation and claims	5%	8%
Laws and regulations	5%	5%
Final analytical procedures	3%	4%
Segment reporting	2%	2%

94 The absence of findings in these areas does not necessarily mean that the work was adequate because:

(a) findings are excluded where the area was regarded as a key audit area;

(b) we do not consider all aspects of the work in each of the areas listed;

(c) there may be findings in these areas that were not reported in a private report to a firm but were dealt with through discussion with the firm; and

(d) an area may not be relevant for all files reviewed (e.g. segment reporting).

95 The findings show the need for improvement in the areas listed. For example, related party disclosures can be important to users of financial reports, and auditors should perform sufficient work to identify related parties and transactions and balances with those parties. Paragraphs 96–109 provide further information on our findings in a number of these audit areas.

Related party transactions

96 In a number of engagement files reviewed, we noted the auditor did not obtain sufficient or appropriate evidence for related party transactions and

their completeness. Files lacked evidence of the auditor's inquiries about the identity of the entity's related parties, the nature of those relationships, whether the entity entered into any transactions with related parties and whether appropriate related party disclosures were included in the financial reports.

Planning and risk assessments

97 Our inspections continue to suggest that auditors did not always obtain sufficient appropriate audit evidence to support planning and risk assessments. We note that in a number of cases the auditor did not obtain an appropriate understanding of the entity and its environment, including the entity's internal control and financial information systems (IT environment).

98 Without obtaining an understanding of the entity and its environment, the auditor may not have identified and assessed appropriately the risk of material misstatement in the financial reports of entities.

99 In a number of cases auditors assessed the risk of material misstatement for significant account balances as 'less than significant' and performed audit work commensurate with that assessment. However, these assessments were at odds with the size and nature of the balances, including the estimation uncertainty and judgement involved, and there was no planned controls reliance.

100 In some cases, we had concerns about the adequacy of the audit procedures performed and the level of professional scepticism applied by the auditor in the scoping of work on material components of a group audit engagement—in these cases, planning and risk assessments and resultant audit procedures were not complied with during the execution of testing, team discussions did not include risks, and teams did not sufficiently challenge particular accounting treatments adopted by management.

Financial report disclosures

101 Our inspections continue to show that auditors need to focus on the adequacy of disclosures in financial reports. While we are concerned that financial reports do not include unnecessary clutter, we continue to see instances where information that is important to investors and other users of financial reports is omitted. This includes information on sources of estimation uncertainty, disclosure of key assumptions underlying asset valuations and information on accounting policy choices having the most impact on the financial report.

Journal entry testing

102 In a number of audits we reviewed, we continued to note that the auditor:

(a) did not test journal entries throughout the year and/or during the year-end reporting or consolidation process;

(b) did not ensure completeness of the journal listing obtained for testing;

(c) did not provide sufficient explanation as to why appropriate journal entry testing was not performed; and

(d) provided general references to other areas of the audit where journal entries were purportedly tested, but this was not evident on the engagement files.

103 Auditors should test the appropriateness of journal entries, particularly those made close to year end and during the preparation of the financial report, due to the risk of fraud.

104 The auditor should consider the need to test journal entries throughout the reporting period. There may be a greater risk of errors or irregularities with journals because they are generally not systematically processed and may not be well controlled.

Consideration of the risk of fraud

105 The auditor should consider the risks of material misstatement in the financial report due to fraud.

106 In many audits we reviewed, the auditor did not discuss with management, or those charged with the governance of the audited entity, the risks of fraud that could have a material impact on the financial report.

107 We also found instances where the auditor did not adequately consider the risk of fraud for revenue recognition.

Materiality determinations

108 In some cases, auditors did not comply with auditing standards in the setting of materiality levels. We found examples in the audits we reviewed where auditors did not:

(a) consider the size of the business (which had changed from the prior year due to changes in business operations) when determining the overall materiality levels;

(b) consider whether the measurement base in setting overall materiality was appropriate;

(c) set out an adequate rationale for revising materiality levels and consider whether the revised materiality level was calculated in accordance with the provisions of the auditing standards; and

(d) set the thresholds for component materiality at an appropriate level in comparison to the group materiality amount.

109 We also noted instances where auditors accepted the entity’s position of not making adjustments to financial statement line items as in their view the adjustments were not qualitatively or quantitatively material, even when they were above performance materiality levels.

C Key findings: Quality control systems

Key points

Many, mostly smaller, audit firms need to further improve their quality control systems to:

- comply with the auditor rotation requirements of the Corporations Act;
- ensure there is appropriate supervision and review of audit engagements, including appointing an engagement quality control reviewer (EQCR); and
- create clear links between audit quality and partner evaluation and remuneration.

For larger firms, findings generally relate to adherence to existing quality control processes.

Auditor independence

110 The Largest Four National firms and the Other National and Network firms have established policies and processes to facilitate compliance with the auditor independence requirements of the Corporations Act and professional standards. Nevertheless, we found the following instances of non-compliance with legislative and professional requirements, which could undermine the actual or apparent independence and objectivity of auditors.

Contraventions of the auditor rotation requirements

111 Our inspections in recent years have continued to identify examples of Smaller firms not managing mandatory auditor rotation effectively. Smaller firms need to put in place systems to ensure that they comply with the auditor rotation requirements of the Corporations Act.

112 At one Other National and Network firm and one Smaller firm we noted that the auditor rotation requirements were contravened by the lead audit partners or the EQCR. In both cases either the lead partners or the EQCR played a significant role in the audits of listed companies for a period of more than five consecutive years, and failed to have a two year ‘time out’ period before playing another significant role in the audits. The firms’ quality control systems did not detect these auditor rotation breaches.

113 In response to our finding, the firms’ remediation actions included:

(a) a complete review of the firms’ auditor rotation register for other potential undetected contraventions;

(b) imposing monetary penalties on the lead audit partner and the EQCR;

(c) providing audit rotation and auditor independence training to partners affected by auditor rotation requirements;

(d) disclosing the matter in the s307C independence declaration that accompanied the entity's next financial report; and

(e) enhancing their policies and internal registers so that such a situation would not arise in the future.

114 In both of these cases, the partners were subsequently rotated off the audits. In the case of one firm, a further contravention was noted as a result of the firm's full review of their rotation register.

115 At one Other National and Network Firm the register of auditor rotation did not include sufficient and complete details to be able to accurately identify the appropriate timeframes for rotation of engagement partners that were no longer eligible to continue to play a significant role on engagements. In response to our concerns the firm agreed to review its systems and processes for managing auditor rotation.

Conflict checking

116 Two Largest Four National firms did not comply with their own policies. One firm did not update its prohibited securities list in accordance with its internal policy, and another did not include all subsidiaries of the group for one engagement on the firm's global system for conflict checking. In both instances no breaches of independence requirements of the Corporations Act were found.

Other independence-related findings

117 Independence confirmations should be obtained as a matter of better practice. At one Largest Four National firm, we noted independence confirmations were not completed for three engagements for specialists who worked as members of the engagement team.

118 Examples of other independence observations and findings at Smaller firms include:

(a) one firm's policies and procedures and related templates were not up to date with the current suite of auditing and ethical standards pronouncements, including Corporations Act requirements;

(b) one firm did not maintain a prohibited securities list;

(c) one firm did not have processes in place to obtain at least annual written confirmation of compliance with its policies and procedures on independence from all personnel involved in audit work; and

(d) in one engagement file there was insufficient evidence of procedures performed to support the engagement partner's conclusion on compliance with independence requirements.

Engagement performance

119 While the Largest Four National firms and the Other National and Network firms have established quality control systems, we noted some instances where firms were not complying with legislative and professional requirements, as outlined below.

Supervision and review

120 Two Smaller firms did not appoint an EQCR to an audit engagement for a listed entity. The auditing standards require an EQCR for the audits of listed entities.

121 We noted instances across all firms inspected where there was insufficient evidence of appropriate supervision and review by either the engagement partner or the EQCR. The engagement files did not contain appropriate sign-off by the relevant reviewer, or the time charged by the partner or EQCR was low relative to the total hours charged for the audit. More in-depth reviews and partner engagement are essential to improving audit quality.

122 We also noted a number of instances where the review of key audit working papers occurred after the audit opinion was signed. There were instances where the EQCR did not adequately document their review on the engagement file, indicating that the EQCR may not have objectively evaluated the judgements made by the engagement team in significant areas of the audit.

123 Greater involvement by the engagement partner and the EQCR should help reduce the number of findings from our file reviews.

File assembly

124 We noted one engagement file where documentation was added into the paper-based file after audit completion and archival of the engagement file without following the firm's internal policies. The firm proactively undertook its own follow-up review and developed a number of initiatives, including mandating the use of fully electronic engagement files.

125 In a number of other instances, we noted that auditors provided us with further documentation to support their conclusions on significant areas of the audit during our review. This documentation was not part of the archived audit engagement file.

Monitoring audit quality

126 Effective firm quality review processes are key to maintaining and improving audit quality.

127 The Largest Four National firms have comprehensive policies and procedures for monitoring audit quality, by undertaking regular reviews of selected completed audit engagements. Other National and Network firms also have mature policies and procedures for monitoring their audit quality in accordance with legal and professional requirements. However, some Other National and Network firms could improve their monitoring processes by changing the basis for selecting files to be reviewed and applying risk criteria.

128 We found that many of the Smaller firms had not established a monitoring program to periodically review a selection of completed audit files. Through the evaluation and monitoring of their quality control systems, these firms would be able to assess whether their systems are operating effectively to facilitate compliance with professional standards and other relevant requirements. Reviews undertaken by ASIC or professional accounting bodies are not a substitute for the firm’s own internal monitoring program.

129 Some Smaller firms have not established a formal monitoring process that provides reasonable assurance that the policies and procedures for the system of quality control are relevant, adequate and operating effectively. While we acknowledge that the size of the firm may affect its ability to establish a monitoring program that includes a periodic inspection of a selection of completed files, it is a mandatory requirement of the Australian auditing standards and must be complied with.

Linking partner appraisal to audit quality

130 The Largest Four National firms have links between audit quality, compliance with independence and ethical requirements, and partner appraisal and remuneration. However, some of the Other National and Network firms and the Smaller firms can improve the accountability of partners and directors for quality and compliance through clearer linkages in their policies and internal systems.

131 Not all Other National and Network firms were consistent in evaluating partner performance and Smaller firms generally did not evaluate partner performance.

D Improving and maintaining audit quality

Key points

Audit firms should consider developing action plans to improve audit quality, or continue to develop and revise such plans. This section includes suggested areas of focus for such action plans.

In this section we also discuss:

- conducting an effective root cause analysis;
- examples of possible initiatives to improve and maintain audit quality;
- initiatives that appear to have improved audit quality in specific areas;
- the use of audit quality indicators to monitor the implementation of initiatives;
- how audit firms could consider reviewing their staffing structures so as to have the experience and expertise needed for increasingly complex audits;
- considerations for improving firm quality review processes; and
- the importance of firms taking remedial action to address audit deficiencies.

Key initiatives to improve audit quality

132 Given the continuing overall level of findings from our audit inspections, audit firms should continue to focus on:

(a) identifying root causes of findings from their own quality reviews and audit inspections;

(b) developing and implementing action plans to address those findings; and

(c) monitoring and revising those action plans to ensure that they are effective.

Implementing and revising action plans

133 Better auditors focus on maintaining audit quality and appropriately balance this imperative with risks and commercial pressures. They ensure that appropriate resources are applied to undertake and review the audit, give appropriate messages about the importance of audit quality and ensure personnel at all levels of the firm are accountable. They recognise that quality is essential to the acceptance of a firm’s audit services and its reputation in the market.

134 During 2013, the six largest audit firms responded to our requests to prepare action plans to improve audit quality, focusing on the consistency of the execution of audits.

135 We worked actively with the firms during the preparation of their action plans. The firms responded to encouragement from ASIC for the action plans to particularly focus on:

(a) the culture of the firm, including messages from the leadership of the firm focused on audit quality and consultation on complex audit issues;

(b) the experience and expertise of partners and staff, including increased and better use of experts;

(c) supervision and review, including greater partner involvement in working with audit teams in the planning and execution of audits, and new or increased real-time quality reviews of engagements; and

(d) accountability, including impact on remuneration for engagement partners and review partners for poor audit quality, often extending to firm leadership.

136 During the 18 months to 30 June 2015 we discussed with the largest six firms their progress in implementing these plans, together with assessing the impact of these plans on audit quality.

137 While the largest six audit firms have made efforts to improve audit quality, they need to continue to focus on their action plans and other initiatives. Some action plan initiatives have led to improvements in audit quality and others can take time to have full effect. Firms should also continue to consider the need for new and changed initiatives.

138 Firms that have not yet done so should consider preparing action plans to improve the quality of the audits they conduct.

139 The initiatives in action plans should vary from firm to firm, taking into account the circumstances of each firm and its assessment of the underlying causes of any deficiencies in audit quality and the inconsistent execution of audits. Considerations may include:

(a) the firm’s size and the nature and complexity of the entities it audits;

(b) existing initiatives to improve audit quality; and

(c) existing circumstances, such as the extent of a culture focused on audit quality, the experience and expertise within the firm, and the effectiveness of quality review processes and incentives focused on quality.

140 For similar reasons, action plan initiatives may also vary from office to office with a national firm or network.

Ongoing reviews of action plans

141 To improve and maintain audit quality, we encourage firms to critically review and evaluate their action plans regularly and update the plans with a focus on matters such as:

(a) timely and effective implementation;

(b) how successful the action plan is in practice—through quality review results and other measures of audit quality; and

(c) the need for new initiatives where earlier initiatives are not fully effective or become less effective over time.

142 Firms should identify, or continue to identify, the root causes of audit quality findings and develop initiatives to address those root causes. This includes promoting a culture and an accountability framework that identifies better and sustainable ways of improving audit quality. It also includes ensuring that the right experience and expertise is applied to audits and that there is appropriate supervision and review.

Conducting an effective root-cause analysis

143 Firms should undertake, or continue to undertake, comprehensive and critical analysis to identify the underlying root causes of audit quality findings from ASIC's audit inspections and the firm's own quality reviews. They should identify and implement actions to address those root causes.

144 An effective internal quality review program is essential to this process, including identifying individual engagement issues and thematic findings across engagements.

145 Firms also need to continue to develop a culture where partners and staff:

(a) recognise and accept findings;

(b) support improvements to audit quality;

(c) support and undertake genuine root cause identification; and

(d) implement effective solutions to root causes of audit deficiencies.

146 Identifying the real underlying root causes of audit deficiencies can be challenging. Consideration should be given to:

(a) developing guidance and training to assist audit teams and offices in undertaking effective root cause analysis that identifies the real underlying root causes, rather than superficial causes;

(b) undertaking root cause analysis on findings for individual engagements, and identifying and analysing thematic findings across engagements;

(c) using independent teams to interview audit team members and others in the firm to identify the causes of findings and undertake the root cause analysis;

(d) using suitably qualified and experienced reviewers with sufficient authority to perform the root cause analysis;

(e) conducting group learning sessions to discuss identified causes of findings and the solutions to be implemented;

(f) sharing the results of the root cause analysis within the firm to enable solutions to be implemented throughout the firm;

(g) using audit quality indicators to identify potential factors leading to findings;

(h) identifying factors supporting high-quality engagements; and

(i) ensuring that the process and solutions are promoted and supported by firm leaders.

147 Firms may consider possible barriers to effective root cause analysis or implementing solutions. These barriers, in our view, might include:

(a) deadline and fee pressures;

(b) the inertia of some audit partners and staff to change, and some partners potentially not fully recognising when improvement is required;

(c) defensiveness concerning findings due to potential effects on reputation and remuneration;

(d) potential challenges in understanding and auditing large and complex clients;

(e) the extent to which past decisions and judgements are challenged;

(f) the extent to which remuneration models might support short-term decisions;

(g) potential conflicts of interest of those responsible for promoting and ensuring audit quality within firms; and

(h) adopting interpretations of auditing and accounting standards that minimise audit work or possible friction with management, rather than common sense interpretations that have regard to the overall objectives, principles and intent of the standards.

148 Firms should share, or continue to share, root causes and solutions with other firms in their global networks and learn from those other firms. Firms that are not part of networks should consider sharing root causes and solutions with other similar firms locally.

Initiatives that appear to have improved audit quality

149 Initiatives undertaken by some firms that appear to have a positive impact on aspects of audit quality at those firms include:

(a) forming specialist focus groups and risk panels on impairment of non-financial assets to develop the necessary expertise, support and coaching for audit teams;

(b) increasing partner time spent on engagements and with engagement teams;

(c) developing a strong culture focused on audit quality with accountability at all levels of partners and staff; and

(d) greater education of directors and management of audited entities to improve financial reporting quality and support the audit process.

150 Plans that were too high level and general, without specific documented actions, responsibilities and timelines, were less likely to be effective.

Example initiatives to improve audit quality

151 Table 7 in Appendix 3 provides some suggested areas of focus and examples of initiatives to improve and maintain audit quality that might appear in action plans. The action plans of the largest six firms reflect many of these initiatives. The initiatives should also be considered by firms that do not implement formal action plans.

Audit quality indicators

152 Firms should consider developing, or continue to develop or apply, measures to assist in monitoring their implementation of initiatives to improve audit quality.

153 Work has been undertaken by regulators and others in the United States and other markets to develop input and output indicators of audit quality to better inform firm leadership and others.

154 There may be value in each firm developing its own approach to audit quality indicators as one possible tool to monitor and drive the firm’s own particular initiatives to improve audit quality.

155 Information Sheet 184 *Audit transparency reports* (INFO 184) discusses the use of audit quality indicators in the context of public audit firm transparency reports. The focus in the information sheet is on ensuring that any indicators are not used in a potentially misleading manner.

Firm staff structures

156 Firms might consider reviewing whether changes are needed to their staff structures over time, to ensure the firm has access to resources with appropriate experience and expertise for audits involving increasingly complex client businesses, financial reporting and other requirements, audit judgements, and audit approaches.

157 Some firms are considering whether there is a need to move away from the traditional pyramid staffing structure, where there are a small number of experienced partners and a relatively large number of junior staff. This involves considering matters such as staff retention strategies and lateral hires to deliver the experience and expertise required for complex audits.

158 Audits now require audit staff with greater experience and expertise. There is also a greater need to use, and work effectively with, experts in other fields. This may include industry experts, valuers, actuaries, geologists, financial instrument experts and IT experts.

159 Audits require a good understanding of client businesses and risks, as well as difficult judgements on accounting estimates and policies.

160 Recent decades have seen:

(a) an increase in complexity in financial reporting and financial reporting requirements;

(b) the development of more complex company business models, often operating across borders, with large and diverse businesses that use complex financial products and make greater use of technology in producing and distributing products;

(c) the development of more complex accounting standards and other requirements;

(d) an increase in more difficult judgements required on accounting estimates, including asset values; and

(e) changes to audit approaches, which require auditors to better understand the business, make risk assessments and exercise more judgement.

161 Developments in businesses, financial reporting and audit are likely to continue this trend. This includes the impact of technological change and the greater use of computer-assisted audit techniques and substantive analytical procedures (sometimes known as ‘data analytics’).

162 Investors, directors and other users of audit and assurance services are likely to become more demanding of auditors. They may seek assurance in new areas and greater value from the audit process. The operating and financial review, integrated reporting and digital financial reporting may provide potential new opportunities for assurance services. Auditors will need to

respond to these demands to remain relevant and potentially close the expectation gap about the assurance that they provide. These new areas are also likely to require greater experience and expertise.

163 Firms should consider, or continue to consider, ways to address any possible challenges to changing staff structures, including:

(a) obtaining recognition within firms and audited entities of the need for change;

(b) addressing potential delays in the supply of new auditors and experts with appropriate experience and expertise;

(c) improving training, knowledge transfer and retention of skilled and experienced partners and staff; and

(d) recovering or absorbing any additional costs to the extent that changes are not offset by more efficient and effective audits.

Firm quality reviews

164 Effective firm quality reviews are key to maintaining and improving audit quality. Firms should assess whether the effectiveness of such reviews can be enhanced by considering the following matters:

(a) the experience, seniority and authority of reviewers, including any relevant industry expertise;

(b) the independence of reviewers and whether they can be affected by matters such as the relationship with other partners and the possibility of deficiencies in their own audit work;

(c) whether full-time reviewers should be used;

(d) whether reviewers apply sufficient professional scepticism and resist pressure not to report findings;

(e) the scope and coverage of reviews;

(f) how audit files and audit areas are selected for review, having regard to risk and coverage;

(g) whether quality reviews cover the work of the auditor’s own experts and that their work is assessed against standards that apply to auditors;

(h) the depth of reviews of individual audit files and audit areas, including the amount of time allowed for such reviews;

(i) whether reviews deal with difficult judgement areas or apply a ‘tick-a-box’ approach;

(j) whether there is a presumption that work that is not documented has not been done;

(k) whether attempts by reviewers to rationalise away findings are appropriate;

(l) whether findings are reported regardless of potential legal issues or liability;

(m) whether there is a genuine assessment of the severity of findings and the probability of misstatements; and

(n) how findings are identified and addressed.

Ensuring remedial action is taken when needed

165 Where sufficient appropriate audit evidence has not been obtained, firms should voluntarily remediate deficiencies by obtaining the evidence necessary to support the audit opinion. Otherwise, the audit has not been completed in accordance with the legally enforceable auditing standards and there is a risk that a material misstatement remains undetected.

166 Given the risks associated with not remediating deficiencies, partners and firms should not hesitate to take remedial action and revisit an audited entity to undertake additional work. Undertaking the work necessary to complete their audits for the reporting period in question will ensure that the audit report was supportable and that the market can be properly informed if any material misstatements are detected.

167 We have found instances where partners resist accepting and addressing findings from internal quality reviews and audit inspections. This appears to result from concerns about loss of reputation, impact on performance evaluations and remuneration, possible liability or disciplinary actions, and additional audit costs. While it is important to have a good dialogue between partners and ASIC to ensure that our findings are appropriate, it is in the interests of the partners, firms, audited entities, directors and users of financial reports that findings are addressed.

168 Firms should have processes in place to require partners to take remedial action. In significant cases where firms do not accept findings and implement initiatives to address them, we will consider issuing an audit deficiency report to the directors or audit committee of the audited entity, or taking other appropriate action.

169 The confidentiality restrictions imposed on ASIC under the *Australian Securities and Investments Commission Act 2001* were amended in 2012 to give us the ability to report findings to audit committees, directors and management of audited entities. In coming months, we will publicly consult on criteria for communicating matters from our audit file reviews to audit committees and directors on an exception basis.

170 The Canadian Public Accountability Board (CPAB), the Canadian audit oversight regulator, reported improvements in the overall level of findings from audit inspections. CPAB focused on the larger end of the issuer population and has the ability under law to mandate changes by firms to address audit deficiencies at both engagement and firm level within specified timeframes. CPAB is able to impose restrictions and sanctions on firms that do not make mandated changes. There are no such provisions in Australia, and it is important that firms and engagement partners take appropriate steps to address audit deficiencies identified in inspections effectively and on a timely basis.

E How others can contribute to audit quality

Key points

While auditors have the primary responsibility for audit quality, there are actions that others can take to promote and support audit quality.

This section discusses the role of the following parties in improving audit quality:

- directors and audit committees;
- auditing and ethics standards setters;
- international regulators; and
- professional accounting bodies.

We also discuss factors influencing the supply of auditors.

171 A combination of matters contributes to audit quality. While auditors have the primary responsibility for audit quality, there are actions that others can take to promote and support audit quality. This includes directors and audit committees, standard setters and professional accounting bodies.

172 While we continue to monitor international law reforms in relation to auditors, our aim is to improve audit quality and the consistency of execution within the existing regulatory framework.

Directors and audit committees

173 In 2014, we released Information Sheet 196 *Audit quality: The role of directors and audit committees* (INFO 196) to assist directors and audit committees in their role in supporting the quality of the external audit of a financial report.

174 Among other matters, INFO 196 suggests that directors and audit committees consider:

(a) non-executive directors recommending audit firm appointments and setting audit fees;

(b) assessing the commitment of the auditors to audit quality;

(c) reviewing the resources devoted to the audit, including the amount of partner time;

(d) reviewing the need to use experts and the reliance on other auditors;

(e) accountability of the engagement audit partner, the EQCR, specialists and audit team members for quality;

(f) facilitating the audit process, including support by the audited entity's management for the audit process;

(g) two-way communication with the auditor on concerns and risk areas;

(h) assessing the level of professional scepticism exhibited by the auditor in challenging estimates and accounting policy choices;

(i) ensuring independence of the auditor;

(j) asking for the results of any review of the audit engagement files by ASIC; and

(k) reviewing audit firm responses to findings from ASIC audit inspections.

175 The quality of work and documentation by audited entities to support judgements on accounting policies and estimates is an essential part of the financial reporting process and can facilitate an effective audit.

176 The responsibilities of directors in relation to financial reporting are discussed in Information Sheet 183 *Directors and financial reporting* (INFO 183).

177 In June 2015 we released INFO 203, which is designed to help directors and audit committees consider whether the value of non-financial assets shown in financial reports continues to be supportable or whether there is a need for impairment.

178 We have also worked with the Australian Institute of Company Directors, Chartered Accountants Australia and New Zealand (CA ANZ), CPA Australia and the Institute of Public Accountants to develop a quiz for directors on financial reporting.

Auditing and ethics standard setters

Auditing standards

179 Audit quality is underpinned by quality auditing standards. In late 2012 and early 2013, we wrote to the International Auditing and Assurance Standards Board (IAASB) suggesting opportunities for improved guidance in the International Standards on Auditing (ISAs).

180 Our suggestions included improved guidance in auditing standards on internal control reviews, determining sample sizes, substantive analytical procedures, group audits, use of other auditors in relation to interests in joint arrangements and associates, and the use of experts and service organisations. We continue to encourage the IAASB to address these

matters, together with improved guidance in areas such as quality reviews of audit files, auditing values of financial instruments, substantive testing for significant assertions for material balances and transaction types, determining materiality, and the use of internal audit.

181 The IAASB now has active projects in relation to quality control, group audits, the use of experts and values of financial instruments.

182 The ISAs are the basis for the auditing standards that apply for audits of financial reports under Ch 2M of the Corporations Act. Our suggestions have also been provided to Australia's Auditing and Assurance Standards Board (AUASB).

183 The IAASB also issued their report, *Audit quality: An IAASB perspective*, in 2011.

Ethical standards

184 During 2013 we also prepared a submission for the International Organization of Securities Commissions (IOSCO) suggesting improvements to the international ethical code of the International Ethics Standards Board for Accountants (IESBA) that includes auditor independence requirements. This code is the basis for the professional ethical code issued by the Accounting Professional and Ethical Standards Board, which has the force of law through the auditing standards.

185 The submission included suggestions to adopt a clarity format that clearly distinguishes between requirements and guidance, and to review the appropriateness of 'safeguards' that provide exemptions to the independence requirements. These suggestions have since become the basis for active projects of the IESBA.

International regulators

186 It is important that we work with securities and audit regulators in other countries to promote improved audit quality—many corporations operate across borders and the larger audit firms are part of global networks, our auditing and ethical standards are based on international standards, and our markets are affected by international economic, regulatory and other developments.

187 The level and nature of our findings are consistent with those of audit regulators in other jurisdictions, as reflected in the inspection findings survey results published by IFIAR earlier this year.[6]

188 Through our participation in IOSCO we have worked with other securities regulators on matters such as an international guide on audit transparency reporting, which was issued in November 2015.

189 We also suggested the formation of an IOSCO Audit Quality Task Force, which is currently considering possible initiatives for international regulatory bodies directed at improving audit quality. We are members of this task force, which is undertaking three initiatives to improve audit quality:

(a) Possible enhancements to independence of the standard setting governance and arrangements for the IAASB and IESBA.

(b) A survey of securities regulators on the role of audit committees in connection with audit quality.

(c) Communication with other international regulatory groups (such as IFIAR) regarding audit quality matters and initiatives.

190 We have also been pursuing a number of initiatives to improve audit quality through IOSCO Committee 1's Auditing Subcommittee, including seeking improvements to the international auditing and ethical standards, addressing any inappropriate firm interpretations of the ISAs, and a possible summary of themes from enforcement actions involving auditors.

191 Global and national firm influence may be used to promote improvements in audit quality at the individual engagement level, and strategies at each level can complement each other.

192 Through IFIAR, we have worked with other major regulators in discussing actions to improve audit quality with the largest six firms internationally. We also led work to develop and finalise a multilateral memorandum of understanding (MMOU) on information sharing between audit regulators. Assessments for participation in the MMOU are currently underway.

Professional accounting bodies

193 Professional bodies such as CA ANZ and CPA Australia have undertaken a number of important initiatives to improve audit quality, such as their quality review programs and ongoing training opportunities.

[6] IFIAR, *Report on 2014 survey of inspection findings*, March 2015.

194 We have suggested to the professional accounting bodies ways in which their firm quality review programs could be further enhanced.

195 We have also suggested that the bodies provide additional training and workshops on core skills to assist auditors in exercising professional scepticism. CA ANZ and CPA Australia have responded to our suggestions with initiatives in this area. For example, CA ANZ has developed an online e-learning module on professional scepticism.

196 The bodies also have a key role to play in considering the supply of future auditors. During 2014–15, CA ANZ undertook a review of the extent of requirements to use registered company auditors under state-based legislation, to better understand the demand for these auditors.

Supply of accountants and experts

197 Ensuring the necessary supply of auditors and other experts involves attracting people to the profession, upskilling them, and ensuring suitable levels of staff retention by audit firms. This requires the efforts of a number of parties, including firms, tertiary institutions and accounting bodies.

198 Auditors need the ability to apply professional scepticism and to challenge accounting policies and estimates.

199 There is a need for specialisation in a range of areas supporting the audit process. There is also a need for auditors to bring together all of the pieces supporting the audit, see the whole picture, understand and challenge the work of experts, and ensure that financial report outcomes make sense.

200 Factors affecting the supply of auditors and experts may include:

(a) the overall supply of accountants, including opportunities for, and the cost and quality of, tertiary and professional education;

(b) the ability to bring in auditors and experts from other jurisdictions, which could be impacted by global supply issues;

(c) the extent to which clients understand the audit process, pay reasonable fees for audit services (including the auditor’s own experts), and have the capacity to pay reasonable fees; and

(d) the impact of economic and market conditions.

201 Auditors require a broad range of skills developed from practical experience, on-the-job training, and formal training and education at all levels. In particular, audit inspections show that more needs to be done to support professional scepticism. Some of the skills required include:

(a) effective written and verbal communication skills;

(b) technical and analytical skills; and

(c) professional scepticism, supported by firm leadership, culture, behaviours, case studies; and

(d) core negotiation, interview and other skills.

202 Factors that may affect the retention of auditors and experts include:

(a) providing interesting work opportunities, including challenging significant judgements in financial reports;

(b) being able to compete on price in the market for accountants;

(c) diversity programs; and

(d) reviewing policies for partners and staff to leave firms (e.g. retirement ages and creation of specialist non-partner roles).

203 While audit is partly a creation of statute, market forces may operate effectively over time. However, there may be time lags between the demand for auditors and experts, and the availability of those individuals. There may also be a gap between what tertiary institutions and accounting bodies can realistically provide, and the skills needed by audit firms.

204 Possible liability and regulation can be incentives to promote audit quality, but may also be seen by some to have the potential to negatively affect a firm’s ability to attract and retain staff. Although capping of auditor liability and proportionate liability apply under the Corporations Act, the cost of insurance may be seen by some as a potential issue.

205 With markets and companies becoming increasingly global, there may be benefits in firm networks being able to move auditors and experts between jurisdictions to meet demand. This would be facilitated by common global accounting, auditing and ethical standards, as well as appropriate and consistent regulation in each jurisdiction. There may also be internal barriers within firms to the mobility of auditors at partner level, such as pension arrangements and the need to rebuild a client base on returning home.

206 Firms should also consider the recruitment of staff with other languages as emerging economies become more important in global markets.

F Areas of focus

Key points

We will continue to inspect firms that audit significant public interest entities, using a risk-based approach.

Areas of focus for our upcoming inspections include:

- firms developing, implementing and revising action plans to improve audit quality;
- maintaining and improving audit quality through a strong culture, the use of appropriate experience and expertise, supervision and review, and accountability frameworks;
- audit evidence, professional scepticism, and the use of experts and other auditors;
- the focus areas identified in our six-monthly financial reporting media releases;
- balancing audit efficiency and effectiveness;
- understanding of business models and risks; and
- internal control reviews and taxation.

Areas of focus for our future inspections include enhanced audit reports.

Our continuing general approach to inspections

207 Our reviews will continue to focus on:

(a) firms that audit entities that are likely to be of significant public interest;

(b) files for audits of financial reports of listed entities and other public interest entities, such as financial institutions;

(c) files for audits of entities and industries that may be more vulnerable to risks arising from existing and emerging market conditions; and

(d) assessing the quality of judgements and decisions made by the auditor and not on matters of mere process.

208 We will continue to conduct follow-up inspections of firms. Where significant issues have been identified in previous inspections, we will perform follow-up reviews to ensure that the firms are taking prompt and appropriate action to address our observations and findings.

Our areas of focus in upcoming inspections

209 Table 2 outlines 14 areas of focus for firms and our upcoming inspections.

Table 2: ‘Top 14’ areas of focus for firms and our inspections

Focus area	Details
Action plans	Whether firms that have developed action plans to improve audit quality and the consistency of execution have continued to review and update those plans to ensure they are effective in improving and maintaining audit quality. We consider that developing, maintaining and updating action plans to address the underlying causes of audit deficiencies is a key part of improving audit quality and inconsistent execution of audits. This involves ongoing analysis of the underlying root causes of findings from quality reviews and audit inspections. Firms should consider which initiatives have been most effective in improving audit quality at their firms, at other firms or elsewhere in their international networks. Firms that do not have action plans should consider developing and implementing such plans. This would include identifying underlying causes of audit deficiencies identified by internal and peer reviews, as well as in ASIC inspections and this report, and developing solutions and actions to address those underlying causes.
Culture	Whether a culture has been developed at a firm that promotes audit quality, including strong, consistent and genuine messages from firm leaders and partners. There should be acceptance of the need to change, improve, and accept and address quality review findings.
Quality reviews	Effective quality reviews are key to maintaining and improving audit quality. We will review firm internal monitoring processes to ensure that they are robust and effective. This will include: • the quality, experience and independence of reviewers; • the scope and coverage of reviews; • how audit files and audit areas are selected for review; • the depth of reviews of individual audit files and audit areas; • whether reviews deal with difficult judgement areas or apply a ‘tick-a-box’ approach; and • how findings are identified and addressed. We will consider why there are differences between firm quality review processes and findings, compared to our independent audit inspection processes. These differences may indicate opportunities to improve processes to achieve more effective outcomes.
Partner involvement	Whether partners are involved and active at key stages of the audit, including both the planning and execution of the audit and the concluding procedures and key judgements. We will look for evidence on the partner’s involvement on the engagement file, including sign-off and the quality of the work on the file. We will also consider the time the partner has charged to the engagement.

Focus area	Details
Supervision and review	Areas of focus will include whether: • there is strong and effective supervision and review at all stages of the audit, including planning, performance and concluding procedures; • reviews by senior team members, the partner and the EQCR are timely and comments raised are properly addressed and cleared by the reviewer; • the importance of supervision and review is adequately emphasised by firm leadership, and through training and quality reviews; • firm quality reviews are frequent, timely, have depth and are undertaken by independent reviewers; and • firms have considered real-time quality reviews and coaching for key areas during execution of the audit.
Accountability	Whether partners, managers and staff are adequately held accountable through performance reviews and remuneration for findings from firm quality reviews and external inspections. Credit should be given for accepting findings and acting to address those findings.
Audit evidence	Whether auditors have obtained sufficient appropriate audit evidence to conclude whether the financial report is free of material misstatement and to support their audit opinions. Particular attention should be given to the areas of findings in this report, including impairment of non-financial assets, revenue recognition and testing the fair value of financial instruments.
Professional scepticism	The level of professional scepticism exercised by auditors, focusing on significant judgements in relation to audit evidence, accounting estimates, going concern assumptions and accounting treatments.
Use of experts and other auditors	The appropriate use of: • experts, whether employed or engaged by the audited entity or employed or engaged by the auditor; and • the work of other auditors, including in the context of group audits, interests in joint ventures and the use of service organisations. This includes focusing on the processes of a firm's internal specialist groups (e.g. technical accounting, business valuation, treasury, actuarial and taxation) in supporting audit engagement teams and the quality of their advice and judgements as audit evidence.
Financial reporting focuses	Whether audits adequately address focus areas identified in our six-monthly financial reporting surveillance program media releases, particularly accounting estimates and accounting policy choices. These focus areas include: • impairment of non-financial assets, including assets in the extractive industries, mining services and entities that may be affected by digital disruption; and • revenue recognition, including the appropriateness of accounting policy choices, consistency with the substance of commercial arrangements and cut-off.
Audit efficiency and effectiveness	Whether changes in approaches to audits have led to audit quality being compromised in individual engagements: see paragraphs 210–215.

Focus area	Details
Business models and risk assessment	The adequacy of an auditor's understanding of the business model of the entity and risk assessment for individual engagements. We will also consider whether the auditor has identified and appropriately responded to key areas of risk. Auditors need to understand the impact of technology on the businesses of their clients, such as any threats from competitors using new electronic product distribution channels.
Internal controls	Areas of focus will include whether: • consideration is given to audited entities where assessing controls can give rise to a more effective audit and add value; • internal control reviews are conducted and the impact of deficiencies identified for institutions with large numbers of systematically processed transactions, where an effective audit may be difficult without relying on controls; • auditors appropriately identify and understand the internal controls of the audited entity that they rely on; and • auditors undertake adequate tests of the controls that have been relied on to address risk or determine the level of substantive testing.
Tax	Areas of focus will include whether the auditor has independently reviewed the tax calculations of the audited entity and used their own tax expert. This includes the extent to which auditors and their tax experts have communicated effectively in reviewing and testing tax calculations, including ensuring that: • tax experts understand the business and general ledger items; • the auditor understands the potential implications of tax treatments affecting the entity on the financial report; and • differences between tax and accounting treatments are properly identified and accounted for appropriately.

Audit efficiency and effectiveness

210 Seeking greater efficiency in the audit process is a positive feature of market forces and private sector audit firms. Changes in the audit process aimed at greater efficiency should not compromise audit quality and, ideally, should also be accompanied by a more effective audit.

211 The statutory audit is imposed by legislation and market forces may not always operate perfectly to achieve the right outcome for markets, investors and other users of financial reports in terms of audit quality. While firms recognise that audit quality is important to their reputations and businesses, there may be instances where directors and audit committees could be more engaged in setting audit fees and promoting improved audit quality.

212 Good firms try to achieve the right balance between business imperatives and audit quality. While some changes could result in both a more effective and more efficient audit, there may be additional costs in achieving more effective audits.

213 Firms should have processes in place, such as quality reviews of audit files, to ensure that any efficiency measures have not led to audit quality being compromised on individual audit engagements.

214 In our upcoming inspections, we will continue to:

(a) focus on the impact of audit efficiency measures, and changes in audit approaches or techniques, on the quality of audits in individual audit file reviews;

(b) consider the effectiveness of, and outcomes from, firm quality reviews of files; and

(c) review whether there is evidence that firm leadership has given consistent and genuine strong messages to partners and staff that improvements in efficiency do not mean compromising on audit quality.

215 Table 3 outlines some of the areas that firms might consider in relation to audit efficiency measures and the effect of any audit fee reductions.

Table 3: Matters to consider in relation to audit efficiency and effectiveness

Focus area	Details
Tone at the top	Whether firm leadership gives strong and consistent messages that improvements in efficiency do not mean compromising on audit quality.
Fee reductions	Whether audit quality is being maintained for engagements where there have been large fee reductions for new or existing audits without underlying changes to business operations. Attempts to sell additional services to these clients can also raise auditor independence issues. We will review audit files where there have been fee reductions that do not reflect changes in the business of the audited entity. We will also review whether there is evidence that firm leaders have given strong, consistent and genuine messages that, where fees are reduced, audit teams must still perform quality audits.
Methodology changes	Whether audit methodologies and changes in methodologies are consistent with auditing standards, result in more effective audits and do not compromise audit quality, and whether individual audit teams have adopted methodologies in a manner that does not compromise audit quality. Interpretations of auditing standards should be genuine and common sense interpretations that have regard to the overall objectives of the standards, rather than interpretations taken to minimise audit work.
Standardisation	Whether standardising audit processes and procedures to promote greater consistency in audit quality has been appropriately balanced against the risk that auditors fail to address circumstances where standard procedures do not deal with matters such as the business models, risks and controls specific to individual audits. Standardisation can assist in ensuring a minimum level of work but can have limitations, given the need to apply judgement to the specific circumstances of any audit.

Focus area	Details
Risk ratings, materiality, and sampling	Whether audit partners and teams have sufficient regard to the risks, materiality and sample sizes for individual audits.
Internal control reviews	Whether a more effective audit that adds greater value can be achieved by evaluating and determining whether reliance can be placed on internal controls, rather than performing increased tests of detail.
Reliance on internal audit and management's experts	Whether reliance placed on internal audit or management experts is appropriate, even though it may reduce audit costs. Even where reliance on internal audit is not regarded as direct assistance at the request of the external auditor, the type of work performed by internal auditors as employees of an audited entity may be inconsistent with the fundamental requirement for an independent audit. Internal audit work may help inform audit risks and form part of the system of internal control, but should not be used as a substitute for work that should be undertaken by the external auditor. Similarly, reliance on management experts rather than engaging the auditor's own expert can result in the work of the expert forming the basis for both the financial report and the audit. This can undermine the ability of investors and other users of financial reports to rely on, and have confidence in, an independent audit.
Data analytics	Whether the use of data analytics results in a more effective audit has been properly implemented with an understanding of the business, and whether the results can be relied on. Proper use of data analytics will generally increase audit costs rather than result in greater efficiency, particularly in the first year. Audit firms are also making, or planning, greater use of computer-assisted audit techniques and substantive analytical procedures (sometimes known as 'data analytics'). This can lead to greater effectiveness of the audit process but can also require greater expertise and judgement in using the data. Data analytics can lead to a more effective audit, but there are risks. For example: • the auditor must have a good understanding of business, risks and controls; • data used must be complete and reconciled to the financial report or appropriate independent sources; • controls around the data should be reviewed and tested for effective operation; • models and techniques must be reviewed each reporting period to ensure that they remain relevant and effective, including taking into account changes in the business and controls of the audited entity; and • appropriately qualified and experienced staff should be used to design and perform the procedures. Data analytics is a tool or enabler in the existing audit process. There are limitations to the circumstances in which it can be used. For example, substantive analytical procedures rely on the ability to predict a population from independent data, and there are limited cases where this technique can be used. Significant judgement and business knowledge can also be required to use data analytics to identify exceptions or unusual patterns in populations for audit focus. Further, data analytics will not assist with the most difficult judgements on accounting policies and estimates. These judgements will continue to require experience, expertise and professional scepticism. Data analytics requires more highly qualified and experienced staff, which can place pressure on traditional firm staffing and cost structures.

Focus area	Details
Outsourcing	Whether appropriate use has been made of centres of excellence and offshoring arrangements. For example, some firms have outsourced basic audit work to offshore service centres to reduce costs and maintain the quality of this work. They have also created centres of excellence to provide specialist skills and advice to audit teams. Where work is outsourced, the quality of the work needs to be properly controlled, monitored and reviewed. Staff need to be properly experienced and have appropriate expertise. The use of outsourcing arrangements could affect the ability to develop staff that will be future audit partners.

Our areas of focus for future inspections

216 Our focus areas for the 18 months commencing 1 January 2017 will include enhanced audit reports, as outlined in paragraphs 217–219.

Enhanced audit reports

217 At its December 2015 meeting, the AUASB approved new standards that will require enhanced audit reports containing key audit matters for years ending on or after 15 December 2016. The standards are consistent with the ISAs. Some firms have also been conducting ‘dry runs’ of enhanced audit reports for larger audits and a small number have been issued publicly.

218 Investors and others have sought from auditors greater insights into the financial report, the difficult judgements made and how auditors have addressed key matters. When enhanced audit reports are introduced in Australia, it will be important to ensure that these reports contain useful and meaningful information specific to the risks and audit of each entity concerned.

219 Many matters that might be reported by the auditor, such as difficult accounting policy judgements and accounting estimates should already be highlighted in the financial report or the operating and financial review. Directors may wish to consider supporting auditors in providing useful and meaningful information in audit reports.

Appendix 1: Our inspection approach

The firms we inspected

220 Our audit inspection program is risk based and focuses primarily on the review of audits of listed entities and other public interest entities.

221 This report outlines the results of the inspections of 21 audit firms substantially completed in the 18 months to 30 June 2015. These firms, in aggregate, audit 93% of listed entities by market capitalisation. In the 18-month period to 31 December 2013 (2012–13), we inspected 17 firms.

222 The firms we inspected ranged in size as follows:

(a) Largest Four National firms—large firms that audit listed entities with the largest aggregate market capitalisation, and are national partnerships and members of a global network with multiple offices;

(b) Other National and Network firms—firms with national partnerships or individual offices that audit many listed entities and are members of a national or international network; and

(c) Smaller firms—firms that audit a limited number of listed entities and have a small number of partners.

223 The number of firms we inspected in each category is provided in Table 4.

Table 4: Number of firms inspected (2012–13 and 2014–15)

Type of firm	18 months to 30 June 2015	18 months to 31 December 2013
Largest Four National firms	4	4
Other National and Network firms	7	4
Smaller firms	10	9
Total	**21**	**17**

Key audit areas selected for review

224 The spread of key audit areas reviewed by us in the 18 months to 30 June 2015 is similar to the previous two review periods, as shown in Table 5.

Table 5: Key audit areas selected for review as a percentage of total key audit areas reviewed (2011–12, 2012–13 and 2014–15)

Key audit area	18 months to 30 June 2015	18 months to 31 December 2013	18 months to 30 June 2012
Revenue/receivables	21%	22%	20%
Impairment/asset valuation	20%	17%	13%
Tax	10%	1%	2%
Loans/borrowings	7%	6%	9%
Inventory	7%	5%	4%
Cash	4%	6%	9%
Expenses/payables	4%	4%	10%
Mining exploration and evaluation	3%	5%	5%
Investments	3%	4%	2%
Provisions	2%	5%	3%
Goodwill	2%	4%	2%
Financial instruments	2%	3%	4%
Acquisition accounting	2%	1%	1%
Group audit	1%	2%	2%
Share-based payments	1%	2%	1%
Other (including 'Experts and other auditors' and 'Joint ventures')	11%	13%	13%

Our methodology

225 Matters relevant to understanding our findings and the percentages reported in paragraphs 2, 39 and 40 are outlined in Table 6, particularly findings excluded from these percentages.

Table 6: Matters relevant to understanding our findings

Matter	Explanation
Quality of financial reports	As noted in paragraphs 39 and 40, our findings do not necessarily mean that there is a material misstatement in the overall financial report. Rather, in our view, the auditor did not have a sufficient basis to form an opinion on the financial report.

Matter	Explanation
Inspection findings	Our findings are based on the objective of an audit, as set out in the auditing standards—to obtain reasonable assurance that the financial report as a whole is free of material misstatement. There have been no significant changes in auditing standards between the 18 months to 30 June 2015 and the 18 months to 31 December 2013 that could have had an impact on the level of findings in each period. Table 5 shows that the key audit areas that we reviewed were broadly consistent between the 18 months to 30 June 2015 and the 18 months to 31 December 2013. The split of deficiencies between each category of key audit area was also broadly consistent between the periods. For that reason, we cannot attribute the level of our findings to any change in our inspection approach. All findings in inspections of individual firms are discussed with the firm to ensure that we have fully understood all of the relevant facts and we have properly taken into account all relevant audit work. During the 18 months to 30 June 2015, our private reports to the firms identified instances where we considered that the firm did not obtain reasonable assurance that the overall financial report was free of material misstatement. These private reports better enable the firms to challenge our findings and to undertake remedial action. The approaches of individual firms to our findings range from full acceptance and willingness to remediate to disagreement with most findings from individual file reviews. Firms that disagree with our individual file review findings nevertheless generally agree to either take actions recommended by us in relation to individual audits or on an overall basis for the firm.
Subjectivity	All of the matters reported in Section B are supported by findings that we reported to audit firms inspected following our reviews of selected audit files. Our findings relate to compliance with the principles-based auditing standards. Audits necessarily involve the application of professional judgement and there are some instances where different individuals will reach different judgements on whether the audit work performed is sufficient. Our percentage measure does not include instances where we consider that individuals could reasonably reach different judgements. Each of our inspection findings is subject to quality review within ASIC, and discussion with the engagement partners and firms. Our staff have considerable practical experience in auditing. Our inspection activities also expose our staff to a range of firms and audits. There are cases where auditors disagree with our findings from reviews of individual audit files. In most of these cases, the auditor asserts that the necessary work was performed but not documented, rather than disagreeing with the work that should have been performed or the judgements that should have been reached. The purpose of our inspections is to work cooperatively with the firms to improve and maintain audit quality. We are always open to the possibility that we do not have all of the facts, that there may be differing views on requirements of auditing standards, or differing judgements. We have extensive due process with the firms and within ASIC to address any such concerns and ensure that findings do not include matters where, for example, reasonable professionals could differ in their views.

Matter	Explanation
Subjectivity (cont.)	Ultimately, the value from inspections is for ASIC to express an informed and independent view on findings from reviews of audit files. The extent of agreement by individual engagement partners with our findings can be influenced by matters such as impacts on remuneration and reputation, and potential liability. These factors lead to similar levels of disagreement by engagement partners with findings by firms from their own quality reviews of audit files. We have had discussions with the largest six firms collectively and individually on audit methodology questions and interpretations of auditing standards. These discussions have confirmed common views between ASIC and the firms on most matters discussed. Some firms have a different view of the requirements of the auditing standards on two matters, which are not reflected in our inspection findings results. These matters will be formally referred to the standard setters, subject to further input from the firms. We have also had discussions with the largest six firms about the interpretation of accounting standards. Where the accounting or auditing standards are unclear, we refer these matters to the relevant international standard setter.
Documentation versus audit evidence	If audit work is not documented, our presumption is that the work has not been performed (in the absence of evidence to the contrary). This is the same approach applied by other audit regulators and by most firms in their internal quality review programs. We apply professional scepticism to assertions that work has been performed without any documentation. Significant testing, analysis and challenging of estimates and accounting policy choices are generally not possible without some documentation. In addition, auditing standards require sufficient documentation so that another professional can understand the work performed and the basis for the conclusions reached.
Remediation	During the 18 months to 30 June 2015, where we identified that a firm did not in our view obtain reasonable assurance that the overall financial report was free of material misstatement, we generally suggested that the firm should perform additional audit work for the financial period that was the subject of the audit. However, we cannot follow up all matters arising from inspections with companies. Auditors have an obligation to complete their audits to support their opinions on financial reports and to undertake the audit work that has not been performed. In a number of cases, where we identified inadequate audit work, the relevant firm performed additional audit work and did not identify material misstatements in the financial report concerned. While some firms performed additional audit work (i.e. obtaining additional evidence from the audited entity) for the financial year reviewed, most other firms generally addressed our findings for subsequent year audits. Firms cooperated by allowing us to refer to company-prepared information from their audit files when we contacted some of these companies about our concerns with the company’s financial reporting that we identified in our audit inspections.

Matter	Explanation
Remediation (cont.)	Given the risks associated with not rectifying deficiencies, partners and firms should not hesitate to take remedial action and revisit the audited entity to undertake additional work. We consider it is important that firms undertake the work necessary to complete their audits for the reporting period in question where we have findings from our inspections. This will ensure that the audit report is supportable and that the market can be properly informed if any material misstatements are detected.
Level of assurance	An audit is not intended to provide absolute assurance that there are no material misstatements in the overall financial report. That is, reasonable assurance implies a confidence level of less than 100% that a financial report is free of material misstatement. Our findings relate to instances where we consider that the auditor has not obtained reasonable assurance that the financial report as a whole is free of material misstatements.
Impact of risk-based approach	Our reviews of audit files do not cover all areas of an audit engagement or all subsidiaries and divisions in a group. Typically, four to six key audit areas are covered and, for groups, only one major operating component is covered. We select audit engagements and key audit areas for review in our audit inspections using a risk-based approach. This means that we generally select some of the more complex, demanding and challenging audits, and some more significant or higher risk areas of the financial reports. However, we also include a spread of audited entities and areas outside this group. Some have suggested that this approach could result in the percentages reported being greater than would be the case with random reviews. On the other hand, more experienced partners and staff are usually allocated to such audits, and there are generally more extensive firm reviews and consultation processes for these audits and the key audit areas. Our experience is that there can be more findings relating to smaller audit engagements for these reasons. Our inspections focus on audits of public interest entities and include a small number of large financial institutions. Our audit inspection program generally does not include cases where we have already addressed material misstatements through our financial reporting surveillance program. However, these matters may be followed up through our separate audit surveillances, the results of which are not counted in the findings in this report.
Inspection focuses	Our inspections focus on key audit evidence and judgements. We do not adopt a checklist approach. Our file reviews concentrate on the substance of work and on whether sufficient appropriate audit evidence was obtained to support the auditor’s conclusions. Our procedures are not designed to find minor instances of non-compliance. We challenge engagement partners on the basis on which significant judgements are made.

Matter	Explanation
Adjustments	There will be instances where auditors detect material misstatements during the audit process and these misstatements are corrected before a financial report is completed and released. It is a key aspect of the role of the auditor in conducting an adequate audit that material misstatements are detected and addressed. Due to the nature of the audit process, it can be difficult to distinguish adjustments resulting from a company's own processes from those resulting from the audit process. Adjustments resulting from the audit process are not measured in this report.
Key audit areas	A key audit area generally relates to a financial statement line item that we specifically select for review on an audit engagement file before commencing our review. The areas relate to: • financial statement line items that are significant and considered higher risk due to factors such as the need for judgement or estimation; and • other key audit procedures that historically have been problematic (e.g. group audits). As shown in Table 5, our approach to selecting key audit areas has been consistent over the three most recent 18-month audit inspection cycles. For that reason, we cannot attribute the level of our findings to any change in our inspection approach. In any event, audit quality should be maintained in all key audit areas. We have seen a proportionately larger number of findings on the audits of large financial institutions. Our coverage of these institutions was unchanged across all audit firms. Although we do not review every working paper on an audit file, evidence or explanations of the audit approach on other parts of the audit file are taken into account in reaching our findings. This is covered through our reviews of audit planning documents and discussion of findings with engagement partners and firms. There is also written correspondence between ASIC and the firm on our findings, which ensures that all aspects of an audit that may be relevant to our findings are taken into account. Our comments and private reports include the firm's responses to each individual file review finding.

Matter	Explanation
What is measured	The percentages provided in paragraphs 39 and 40 relate to cases where the auditors, in our view, did not obtain sufficient appropriate audit evidence, exercise sufficient judgement or otherwise comply with auditing standards in key audit areas, such that the auditor did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. The percentages do not include other findings relating to audit quality and compliance with auditing standards, such as the adequacy of planning, obtaining an understanding of business, risk assessment, reviews and reliance on internal controls, non-substantive analytical procedures, documentation, supervision and review, auditor independence, firm quality control systems, and training of partners and staff. The percentages also exclude findings concerning insufficient work for related party transactions, reviews for unusual journal entries, reviews of legal expenses and legal representation letters, and subsequent event reviews. In our view, findings in these areas could have resulted in material misstatements not being detected. Although excluded from the percentages, these remain important areas for improvement by firms. The results of our findings in some of the areas that are excluded from the percentages are shown in Table 1. Where we consider that a risk of misstatement would not be material to the overall financial report or where the risk that it is material to the overall financial report is remote, the finding is excluded from our percentage measure. However, it is possible that such matters could aggregate with matters relating to areas of an audit that we did not review to create a risk of material misstatement to the financial report as a whole.
Number of procedures and findings	There may be a number of audit procedures in a key audit area. Findings have been included in the percentages reported where there was only one instance of the auditor not performing an audit procedure in any given key audit area, if that meant the auditor did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. Where multiple separate findings in a key audit area each individually meant that separate material misstatements would not be detected, the percentages reported only include one of those occurrences. There were a number of cases where we found more than one deficiency in a key audit area, each of which could have resulted in material misstatements not being detected.
Other National and Network firms	Although the percentage of reported findings for Other National and Network firms has reduced in the 18 months to 30 June 2015 compared to the 18 months to 31 December 2013, we inspected different firms in each period. The same Largest Four National firms were inspected in the 18 months to 30 June 2015 and the 18 months to 31 December 2013.

Matter	Explanation
Surveillances and investigations	ASIC is both an audit regulator and a securities regulator. In addition to audit inspections, we conduct a range of other activities that relate to the work of audit firms. These other activities include our financial reporting surveillance program, surveillances where there is a concern about a specific audit or an individual auditor, and investigations into the quality of financial reports and audits where there have been corporate failures. Where our concerns about material misstatements in financial reports have originated from these other activities, the audits are not reviewed in our audit inspection program but are the subject of separate auditor surveillance activities. The findings in Sections A–C do not count findings from any of these other activities. The outcomes of these activities are reported in separate media releases and our regular enforcement reports. The findings are not reflected in the percentages in paragraphs 39 and 40. However, these other activities can inform our general areas of inspection focus and the timing of future audit firm inspections.
Enforcement action	The objective of our inspections is to work cooperatively with audit firms to improve and maintain audit quality. We expect audit firms to make changes and to undertake work in response to our findings. However, there are some cases where findings are so serious as to warrant enforcement or similar action. We are considering enforcement action on concerns arising from some 2014–15 inspections of firms.
Process improvements	Where firms put in place initiatives to improve audit quality, there can be a period before the benefits are realised through improved audits.

Lessons from surveillances

226 In addition to regular audit firm inspections, we review audits based on specific concerns that may lead to action against auditors. These surveillances focus on concerns with specific audits arising from complaints and other intelligence, including corporate collapses where there are questions over the adequacy of information on the financial condition and results provided in the financial report and questions over the audit.

227 While auditors are not responsible for the failure of companies, the audit is important to quality financial reporting so that markets, investors and other users are properly informed.

228 Our surveillance reviews have led to enforcement outcomes. For example, over the past three years, 10 auditors have been removed from practice for varying periods or had their registration cancelled through enforceable undertakings and decisions of the Company Auditors and Liquidators Disciplinary Board (CALDB). These cases reinforce the need to improve audit quality and the consistency of audit execution, particularly in relation to the adequacy of audit evidence, the exercise of professional scepticism, and the use of experts and other auditors.

229 The inspection findings detailed in Sections A–C do not count the results of our audit surveillance activities because:

(a) the activities are not part of our regular inspection activities;

(b) surveillance matters may take time to resolve by way of an enforceable undertaking or decision by CALDB, and so may relate to audits in periods before the inspection periods covered in this report; and

(c) including surveillance outcomes might reduce comparability with the public inspection reports of audit regulators in some other major jurisdictions.

230 Results from our surveillance activities are published in individual media releases and our six-monthly public enforcement reports.

231 Lessons that may be relevant for auditors from our audit surveillances that have resulted in enforcement outcomes include the matters summarised in Table 4 of Report 397 *Audit inspection program report for 2012–13* (REP 397).

Our inspection process

Largest Four National and Other National and Network firms

232 We reviewed selected key audit areas in the audit working papers for selected audit engagements.

233 For some of the firms we also assessed whether their quality control systems:

(a) comply with Auditing Standard ASQC 1 *Quality control for firms that perform audits and reviews of financial reports and other financial information, other assurance engagements and related services engagements*;

(b) are designed to ensure that audits are performed in accordance with auditing standards; and

(c) ensure auditors comply with the auditor independence requirements.

234 During our inspections, we highlighted to each firm areas where we consider that they did not obtain reasonable assurance that the financial report as a whole was free of material misstatement and suggested remedial actions they should take.

235 In order to ensure more timely reviews of audit files, from 1 July 2015 we spread audit file reviews for the larger firms over time. This provides the opportunity for firms to address our findings on a more timely basis.

Smaller firms

236 To reflect the size and client profile of Smaller firms, our inspection approach was limited to:

(a) conducting a review of, generally, the audit files relating to a listed entity for compliance with the auditing standards; and

(b) holding discussions with leaders, engagement partners and other senior members of the engagement team about the audit file reviewed and certain policies and procedures relating to auditor independence and audit quality in the context of that file.

Joint inspections

237 ASIC has arrangements to assist the Public Company Accounting Oversight Board (PCAOB) of the United States with their inspections of Australian auditors to ascertain compliance with the relevant audit requirements in each of those jurisdictions. During 2014–15, two inspections were conducted jointly with the PCAOB.

Appendix 2: Industry-specific findings

238 We reviewed audit files for selected financial institutions (including banks and insurance companies) and extractive industry companies.

Financial institutions

239 Our findings for audits of financial institutions included matters common to all industries, such as not obtaining sufficient appropriate evidence to support audit procedures conducted in relation to financial instrument valuations, impairment of financial instruments, the application of professional scepticism and using on the work of others: see paragraphs 55–87.

240 Findings specific to the audit of banks are set out paragraphs 242–247 and those specific to the audit of insurance companies are set out at paragraphs 248–251.

241 While we review a similar number of financial institution audits in each 18-month inspection period across all firms inspected, we do not review this type of audit at every individual inspected firm in each 18-month period.

Banks

Insufficient and inappropriate audit evidence obtained to support the valuation of significant financial assets

242 In some audits we reviewed, the auditors did not:

(a) adequately test the operating effectiveness of key controls to support the valuation assertion or consider the impact on the substantive-testing approach where the results of internal control testing identified deficiencies in key controls;

(b) seek to understand the basis for the thresholds or challenge whether the thresholds set by the internal specialist for assessing variances caused by the model and inputs used were sufficiently precise to generate an appropriate level of assurance;

(c) fully investigate variances that exceeded the threshold. In some cases, in our view, the thresholds were so large that further consideration should have been given to whether they were useful in identifying differences for investigation;

(d) adequately test the valuation of material financial products and the completeness of the population;

(e) undertake procedures to obtain sufficient assurance that third-party information used to support the valuation of financial instruments was reliable; and

(f) perform relevant procedures to ensure that the financial instruments were classified into the appropriate fair-value hierarchy categories.

Insufficient testing to assess the adequacy of provisions for loan losses

243 In relation to material loan loss provisions we noted instances where the auditor:

(a) did not obtain an appropriate understanding of the client's control environment over loan loss provisions, including overlays to collective provisions and specific loan provisions;

(b) did not perform substantive testing of material overlays to collective provisions, including seeking to understand and test management's basis for their recognition and measurement;

(c) used a deficient substantive analytical procedure for specific loan provisions by inappropriately determining an expectation without demonstrating that the basis for setting the expectation was both plausible and predictable, and that it was based on reliable and independent data; and

(d) in a group audit context, did not obtain sufficient appropriate audit evidence to address credit risk in various offshore components where credit risk was identified as a significant risk. The group auditor did not sufficiently evaluate and review whether the component auditors obtained sufficient appropriate audit evidence for these offshore components.

Insufficient audit evidence in testing the completeness of securitisation arrangements or off balance-sheet entities

244 In one engagement, the auditor did not obtain sufficient appropriate audit evidence in testing the completeness of securitisation arrangements and off balance-sheet entities. We consider securitisation and off balance-sheet arrangements to be risk areas.

Insufficient audit evidence in assessing the disclosure of interests in other entities

245 In one engagement, insufficient audit evidence was obtained in assessing whether the entity had met the disclosure requirements for the maximum exposure to loss of the audited entity's interests in unconsolidated structured entities as required by accounting standards.

Inappropriate reliance on the work of the clients' specialist internal finance teams without evaluating their objectivity and independence

246 We expressed significant concern that auditors did not undertake an objective and sceptical assessment of the level of reliance to be placed on the work performed by the audited entities' specialist internal finance teams (as a substitute for internal audit work) for the purposes of gathering sufficient, appropriate control assurance. Even if reliance was appropriate in these instances, there was insufficient assessment and evaluation of the overall control environment and the objectivity of the internal finance teams within the governance framework of the entities.

Inadequate testing of the net interest income as a result of using incorrectly designed substantive analytical procedures

247 We noted instances where auditors did not:

(a) consider presumed risk of fraud with revenue recognition in the context of material net interest income;

(b) develop appropriate expectations;

(c) compare expectations to the actual population—rather, expectations were compared to the audited entity's forecasted figures;

(d) adequately perform comparison to forecast actual balances;

(e) apply an adequate level of professional scepticism in assessing the source of the audited entity's forecast actual balance and whether it was appropriate for the purposes of the substantive analytical procedure;

(f) adjust thresholds for disaggregated parts of the population being tested;

(g) calculate the difference between the expected interest income balances and the actual balances at a product level; and

(h) investigate differences that were greater than the disaggregated threshold.

Insurance companies

Inadequate testing of valuation of investments

248 The work performed by one auditor involved:

(a) inadequate identification of classes of investment assets for testing;

(b) inadequate evaluation of the custodian's control report;

(c) insufficient evidence of the operating effectiveness of controls throughout the audit period and inadequate application of audit sampling methodology;

(d) relying on audit procedures performed by another audit team of the firm without assessing the adequacy of the extent and timing of those procedures;

(e) not gaining appropriate evidence of the effectiveness of controls; and

(f) not performing adequate substantive audit procedures over a material portion of investments at balance date.

Insufficient assessment by the auditor and their internal actuarial expert on life insurance policy liabilities

249 Inadequate audit procedures were performed by one firm's internal actuarial expert over the reasonableness and implementation of certain assumptions and changes in assumptions used in the calculation of the insurance liabilities. The expert performed a non-substantive review of the company's explanations of movements in liabilities and their impacts on profit. The auditor did not appropriately evaluate and assess the adequacy of the procedures performed by the expert.

Inadequate audit procedures over life investment contract liabilities for a life insurance company

250 One auditor did not perform sufficient testing of the unit pricing methodology and the unit prices that were used for the calculation of life investment liabilities at year end. The auditor relied on the work performed on financial assets at fair value to corroborate life investment contract liabilities, for which we also had concerns regarding the sufficiency and appropriateness of audit evidence gathered.

Inadequate testing by the auditor on revenue comprising premium, investment and fee revenue

251 We found:

(a) insufficient audit evidence was gathered by the auditor in support of the rebuttal of fraud risk associated with revenue recognition;

(b) walk through procedures did not cover all key controls and processes;

(c) the scope of controls testing was not agreed with the IT specialists;

(d) there was no work on relevant IT application and general controls; and

(e) substantive testing, including analytical procedures performed, did not respond to the assessed risks at the assertion level.

Extractive industry companies

252 Auditors often need to rely on experts in reviewing valuations of the reserves and other assets of extractive industry companies. Where these companies have operations and resources overseas, auditors may need to rely on the work of other auditors.

253 Common findings in the audit of extractive industry companies included examples of auditors not:

(a) confirming the existence and valuation of significant and material asset balances, such as capitalised exploration, evaluation or development expenditure;

(b) confirming the existence and validity of tenements;

(c) engaging their own expert or, where they had sufficient expertise, not auditing the work of the audited entity's expert; and

(d) obtaining sufficient audit evidence to support the impairment assessments and carrying value of mining-related assets. In particular, we had concerns about:

(i) whether the forecast assumptions, including mine plans and management-prepared resource estimates underpinning the impairment models, were reasonable and supportable;

(ii) insufficient demonstration of an understanding of the various accounting requirements, as outlined in Accounting Standard AASB 136 *Impairment of assets*, when presented with client-prepared impairment models;

(iii) a lack of understanding, in our view, of the application of Accounting Standard AASB 6 *Exploration for and evaluation of mineral resources* and AASB 136 to the carrying value of exploration and evaluation assets. In particular, we noted that auditors did not identify the appropriate provisions that apply to impairment assessments for exploration and evaluation assets versus development assets, and accepted the capitalisation of exploration expenditure after expiry of the relevant exploration licence; and

(iv) a lack of consideration of the application of AASB 136, together with AASB 13, to support a fair value less cost of disposal methodology (using information that market participants would use), instead of the value-in-use methodology.

Appendix 3: Example initiatives to improve audit quality

254 Table 7 provides some suggested areas of focus and examples of initiatives to improve and maintain audit quality that might appear in action plans. The action plans of the largest six firms reflect many of these initiatives. The initiatives should also be considered by firms that do not implement formal action plans.

Table 7: Examples of possible initiatives to improve audit quality

Focus areas	Example actions
Firm culture	Ensuring clear and frequent communications about the importance of audit quality. Fostering a strong firm culture of promoting and supporting professional scepticism, including strong and consistent messages from firm leaders, and supporting professional scepticism in individual cases. Ensuring clear, consistent and genuine messages from firm leadership and partners that professional scepticism and audit quality must not be compromised to meet deadlines and budgets, support a particular outcome desired by management or protect fees. Firm leadership emphasising the importance of accepting and addressing findings from quality reviews and external reviews. Creating a culture of accepting the need for change and that approaches taken in the past do not necessarily continue to be appropriate. Communicating a culture of audit quality in training and guidance materials. Promoting a culture of consultation with colleagues and specialists. Conducting staff surveys to assess the culture of the firm and areas for improvement. Feedback from audit team members at all levels to assess culture and quality on individual engagements may also be effective.
Experience and expertise	Ensuring that partners and staff assigned to particular audit engagements have a strong understanding of the audited entity's business, appropriate industry knowledge, appropriate experience and a sound understanding of financial reporting requirements. Ensuring assignments of partners and staff take into account the nature of the audited entity, risk areas and any complexities (e.g. the use of complex financial instruments), the level of professional judgement required, and the likely planned audit approach. Ensuring that experts are assigned to audits requiring specialist expertise in areas such as valuation of complex financial instruments. Forming separate panels of experts for each high-risk engagement to advise on the audit approach and focuses. Setting up specialist focus groups to develop the necessary expertise, support and coaching for audit teams in areas such as impairment of non-financial assets, tax, extractive industries, financial institutions and insurance. Implementing processes to ensure that the firm does not undertake work that is not adequately resourced or for which there is insufficient expertise.

Focus areas	Example actions
Experience and expertise (cont.)	Resources to enhance audit quality are funded and promoted, including dedicated partners to promote and support audit quality, industry specialists and technical specialists. Increasing partner involvement on engagements, and working with the audit team in the planning and execution of the audit engagement. This may necessitate reducing the time spent on administration and selling services. Engagement partners bring their knowledge and experience to the process of assessing the audited entity's business model, its internal and external environment and risks, and how these factors affect the nature and extent of audit procedures. Implementing flatter staffing structures with a greater number of skilled staff. Mandating the use of specialists in defined circumstances, including where the auditor does not have the necessary skills, knowledge and experience. Reviewing the reasons for not retaining skilled and experienced staff. Inwards and outwards secondments to enhance experience and expertise available for audit engagements, including bringing in experience in complex industry or other matters. Providing training, firm guidance and procedures, consultation processes and technical support. Reviewing training methods to ensure training is engaging and interactive, and includes real-life case studies. Consider different methods of training, using new technologies and formats that are engaging for younger generations. Providing additional training and guidance on audit evidence, professional scepticism, professional judgement and reliance on other auditors and the use of experts. This includes developing core skills, such as interview and negotiation skills. Ensuring active participation by partners in training and knowledge-sharing sessions with staff to communicate experiences and drive audit quality messages. Developing skills to deal with large and complex audits, such as audits of large financial institutions. As well as industry knowledge, this requires an ability to understand the business and the elements of the audit to assess the effectiveness of the whole audit process. Training audit staff to better understand the work undertaken by specialist staff. Training specialist staff who undertake audit work to understand the audit process and how their work will be used. Using real-life case studies for training on areas of focus, including professional scepticism and impairment testing. Providing additional training, guidance and quality reviews covering the materiality of disclosures. This is important to ensure that financial reports contain disclosures important to users, but also that these disclosures are not lost in excessive detail that adds unnecessary complexity to financial reports. Ensuring partners and staff have a sound knowledge of the accounting standards and framework to conduct an effective audit. When considering accounting treatments, partners and staff should consider the substance of transactions and arrangements, alternative views, and the principles and intent of accounting standards in making their judgements.

Focus areas	Example actions
Supervision and review	Appointing specialists or champions for particular areas (e.g. substantive analytical procedures and impairment testing) to advise teams and review planned procedures. Ensuring earlier EQCR involvement to focus on whether partners and staff have obtained a good understanding of the client's business and associated risks. Enhancing the role descriptions of EQCRs and specialists and assessment of their effectiveness. More in-depth reviews by engagement partners and EQCRs. Introducing coaching during the audit to challenge the audit team's decisions in particular areas (e.g. impairment, substantive analytical procedures). Ensuring firm quality reviewers: • have sufficient authority, knowledge and experience, as well as a commitment to audit quality; • are independent, preferably having strong practical experience but no current audit entity portfolio. Consider more cross-border reviews; and • report directly to the chair of the firm rather than the head of assurance. Ensuring quality review findings are communicated throughout the firm to promote improvements in audit quality for engagements that are not reviewed. Introducing or increasing real-time reviews by an expert external to the engagement team for key areas of the audit before the audit is finalised. Implementing real-time and post-completion quality reviews to ensure that any reliance on substantive analytical procedures is appropriate. Introducing reviews to ensure that any reliance on internal audit is not excessive. Increasing the number and depth of quality reviews. Ensuring quality reviews include the work of internal firm specialists. Ensuring quality reviews focus on documentation of key judgements, as well as audit evidence. Using quality reviews to ensure that any efficiency measures do not compromise audit quality. Ensuring quality reviews consider adequacy of engagement partner and EQCR involvement at all stages of the audit.
Accountability	Linking the remuneration of partners and managers to audit quality, as assessed through firm quality reviews and audit inspection findings. Linking a meaningful proportion of partners' income to audit quality. Ensuring partner performance evaluations take into account the results of surveys of audit teams in relation to the adoption of audit quality initiatives. Ensuring staff at all levels have specific accountability for audit quality and their performance is assessed accordingly. Considering whether credit should be given to partners for accepting findings and addressing them on a timely basis.

Focus areas	Example actions
Other matters	Planning for deadlines, including reviews of major new transactions, contentious accounting treatments, key accounting estimates and financial report formats before year end. Ensuring adequate resourcing for audit completion. Ensuring that management of audited entities understands the need to provide support for the audit process. Increasing the use of, and reliance on, internal control reviews. Re-evaluating decisions made in previous audits and regularly bringing fresh minds to bear. Ensuring appropriate use and reliance on other auditors in the context of group audits (particularly in connection with business components in emerging markets), interests in joint ventures, and the use of service organisations. This work can include assessing the other auditors and reviewing their audit work. Ensuring appropriate systems and monitoring processes relating to audit independence, as well as training, guidance and support in considering possible threats to independence. Reviewing the processes in place to ensure that advice given to non-audit clients on accounting treatments is appropriate. Inappropriate accounting advice may place pressure on the external auditor to accept an inappropriate treatment. Ensuring that where audited entities grow, there is not a mismatch between the audited entity and the size or professional capacity of the auditor and the breadth of audit team experience. Involving the whole engagement team in sessions with management of audited entities to obtain a better understanding of the business of the audited entity.

Key terms

Term	Meaning in this document
AASB 136 (for example)	An accounting standard (in this example numbered 136)
accounting standards	Standards issued by the Australian Accounting Standards Board under s334 of the Corporations Act
ASA 200 (for example)	An auditing standard (in this example numbered 200)
ASIC	Australian Securities and Investments Commission
ASQC 1	Auditing Standard ASQC 1 *Quality control for firms that perform audits and reviews of financial reports and other financial information, other assurance engagements and related services engagements*
AUASB	Auditing and Assurance Standards Board
auditing standards	Standards issued by the AUASB under s336 of the Corporations Act
CA ANZ	Chartered Accountants Australia and New Zealand
CALDB	Company Auditors and Liquidators Disciplinary Board
CGU	Cash generating unit
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
CPAB	Canadian Public Accountability Board
engagement quality control review	A process designed to provide an objective evaluation, before the auditor's report is issued, of the significant judgements the engagement team made and the conclusions they reached in formulating the auditor's report
EQCR	Engagement quality control reviewer
firm	An audit firm inspected by ASIC as part of the audit inspection program
IAASB	International Auditing and Assurance Standards Board
IESBA	International Ethics Standards Board for Accountants
IFIAR	International Forum of Independent Audit Regulators
INFO 203 (for example)	An ASIC information sheet (in this example numbered 203)
IOSCO	International Organization of Securities Commissions

Term	Meaning in this document
ISAs	International Standards on Auditing
Largest Four National firms	Large firms that audit listed entities with the largest aggregate market capitalisation, and are national partnerships and members of a global network with multiple offices
Other National and Network firms	Firms with national partnerships or individual offices that audit many listed entities and are members of a national or international network
public interest entities	Listed entities and other entities of public interest with a large number and wide range of stakeholders considering factors like the nature and size of the business and the number of employees
s307C (for example)	A section of the Corporations Act (in this example numbered 307C), unless otherwise specified
Smaller firms	Firms that audit a limited number of listed entities and have a small number of audit partners

Related information

Reports

REP 397 *Audit inspection program report for 2012–13*

Information sheets

INFO 183 *Directors and financial reporting*

INFO 184 *Audit transparency reports*

INFO 196 *Audit quality: The role of directors and audit committees*

INFO 203 *Impairment of non-financial assets: Materials for directors*

Legislation

Australian Securities and Investments Commission Act 2001

Corporations Act, Ch 2M; s307C

Standards

AASB 6 *Exploration for and evaluation of mineral resources*

AASB 13 *Fair value measurement*

AASB 136 *Impairment of assets*

ASA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with Australian auditing standards*

ASQC 1 *Quality control for firms that perform audits and reviews of financial reports and other financial information, other assurance engagements and related services engagements*

Other documents

AUASB, *Professional scepticism in an audit of a financial report*

IAASB, *Audit quality: An IAASB perspective*

IFIAR, *Report on 2014 survey of inspection findings*