



ASIC

Australian Securities & Investments Commission

REPORT 58

Report on the auditor inspection program

September 2005

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Executive summary

Under the *Corporations Act 2001* (the Corporations Act), ASIC has responsibility for the surveillance, investigation and enforcement of the financial reporting requirements of the Corporations Act, including the enforcement of auditor independence requirements.

Australia significantly enhanced its regulatory requirements for auditors on 1 July 2004 with the enactment of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosures) Act 2004* (CLERP 9).

This report summarises ASIC's first year of on-site inspections of audit firms since the enactment of CLERP 9.

This report describes our inspection process, observations and findings, suggested areas for improvement, and our future inspections.

The Financial Reporting Council (FRC) has responsibility at a policy level to oversee the effective implementation of the new independence regime in Australia. As outlined in our Memorandum of Understanding with the FRC, we will report to them periodically, particularly noting any systemic issues identified.

During 2005, we conducted on-site inspections of Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers (the Firms).

Section 3 gives more detail about how we conducted this work.

The Firms are national partnerships and together audit approximately 54% of all entities listed on the Australian Stock Exchange, and 91% by market capitalisation of the 300 largest entities.

As this was the first time ASIC had conducted such inspections, we focused on assessing whether the Firms had documented and implemented a quality control system that provides reasonable assurance that they comply with the independence requirements in Division 3 of Part 2M.4 of the Corporations Act.

It is important to note:

1. All Firms had documented policies in place and these were generally adequate.
2. While we conducted a limited review of engagement files to see whether these policies were being implemented in practice, we did not seek to comprehensively test for breaches of the audit independence requirements.
3. No breaches of the Corporations Act were identified in the course of our inspections.

The Firms have not previously had a regulator's inspection of their policies, systems and processes. Not surprisingly, in each case, we have suggested improvements in their systems and processes.

Generally our report focuses on suggested areas of improvement in the systems, policies, procedures, practices or conduct of certain audit Firms, rather than setting out all of the positive aspects. Our suggested areas of improvement do not detract from 1 to 3 above.

The absence of a reference in this report to any other aspect of the Firms' systems, policies, procedures, practices or conduct should not be construed as approval by ASIC of those aspects, or that in ASIC's view those aspects comply with relevant laws.

Section 1: Observations and findings

The introduction of CLERP 9

CLERP 9 introduced significant enhancements to the auditor regulatory regime. Our inspections reveal:

- Overall, the Firms have responded positively to the new legislative requirements for auditor independence.
- The Firms have committed resources and where needed have developed policies, systems and processes to assist them in complying with Australian legislative requirements.
- The Firms have been greatly assisted in this by being part of global Firms.

In some instances Firms have remained more focused on the requirements of Sarbanes-Oxley Act of 2002 (US) than CLERP 9. Although there are similarities between the requirements of Sarbanes-Oxley Act of 2002 and the provisions of CLERP 9, there are differences and some Firms did not update their global policies, systems and processes for Australian legislative requirements until after 1 July 2004.

Each Firm's executive leadership has sent a strong message within their Firm about the importance of independence, but in some Firms there is scope to improve oversight of independence policies and practices, and to improve formal reporting on independence to the board of partners.

Systems to monitor compliance

The Firms have systems to monitor compliance with internal policies and processes, and with the Firm's legislative obligations (including CLERP 9). The Firms' own internal testing of compliance with their policies and processes has revealed some unsatisfactory results. The Firms have generally said that these breaches of policy were often isolated or minor in nature. In every case, the Firms asserted that this non-compliance with internal policies did not amount to a breach of any Australian legal independence requirements.

As noted, we did not identify any specific breaches of legal requirements. However, in our view it is desirable that all Firms should conduct more rigorous internal testing and that compliance rates improve. A high level of non-compliance with internal policies potentially increases the risk that breaches of legal requirements may occur in the future.

Financial interests in audit clients

All the Firms have policies about holding a financial interest in audit clients. Whilst all of the policies comply with the requirements of the Corporations Act, some Firms have implemented a higher standard than others.

The differing policies range from where one Firm prohibits all professional staff from holding a financial interest in any audit client worldwide, to where only members of the engagement team are prohibited from having a financial interest in the audit client when they work on an engagement for that client.

All the Firms require their partners to be financially independent of all audit clients.

Perception of a reasonable person

We observed that some Firms do not always consider the perception of a reasonable person when deciding whether to perform work. Some Firms appeared to take a somewhat narrow and legalistic view of their obligations.

In particular, some Firms were prepared to provide services to Australian clients that they do not provide to their SEC-registered clients, on the basis that those services are strictly prohibited in the US and not in Australia.

These Firms appeared to have carefully considered the need to avoid the suggestion of self-review of work. Nonetheless, we have stressed to the Firms that an appropriate emphasis must be placed on the perception of the provision of any non-audit services, as this strongly influences public confidence in the work performed by the Firms.

Engagement level independence procedures

All the Firms' documentation of engagement level independence confirmations was inadequate. This is partly a result of some Firms not having a documented process for obtaining independence confirmations from individual audit team members on each engagement.

Engagement level independence procedures are an important mechanism for establishing the independence of all members of the audit team.

Only one Firm has a process requiring the members of the engagement team to document their independence before starting any work on the audit client. However, that Firm's own testing has shown an unsatisfactory level of compliance with this process.

Other Firms do not appear to have a consistent process for every engagement, with one Firm only instigating formal engagement level procedures for particular clients or industry groups. There is potential for independence policies to be breached without this engagement level sign-off.

Documenting approval of non-audit services

The extent of documentation for approving non-audit services varied amongst the Firms. We believe most Firms need to establish more formal documentation requirements to evidence compliance with their independence policies.

Each Firm has a policy requiring that non-audit engagements for existing audit clients be pre-approved by the lead client service partner. However, most policies do not specify whether or how the approval should be documented. As a result, the existence and quality of documentation of the approval of non-audit services varied greatly amongst the Firms.

CLERP 9 training

Varying commitments have been made to CLERP 9 training by the Firms. Despite the Firms' leadership all reiterating the importance of the independence requirements of the Corporations Act, at several Firms this support has not translated into attendance and completion of mandatory training by all professional staff.

Consequences of non-compliance

We believe the Firms need to better communicate the consequences of non-compliance with Firm's policies and processes to staff. In some of the Firms the link between breaching policies and processes and the impact on performance and/or remuneration was not clear to staff.

Data on independence queries

Most Firms do not have a formal collection of data on independence queries and issues. Some Firms did not have a register of all independence breaches. We consider that formalising how knowledge is retained and shared will reduce reliance on key independence personnel.

Section 2: Future inspections

Our next phase of work will include selected mid-tier accounting firms and further inspections of the Firms. The mid-tier inspections will examine independence with a similar approach to the Firms which we will tailor for the mid-tier accounting firms. We will also review a selection of recently completed audits. This review will focus on audit methodology and the application of Australian Auditing Standards.

Further inspections of the Firms will include considering updates and improvements to independence systems and processes. We will also look at the Firms' preparations for auditor rotation, which becomes effective for financial years beginning on 1 July 2006. We will also review a selection of recently completed audits to gain an understanding of the Firms' audit methodologies. The timing of these visits will differ for each Firm.

We will also continue to liaise with the Public Company Accounting Oversight Board (PCAOB) with the intention that we will conduct work jointly with them in respect of the Australian audit Firms that are registered with them. The PCAOB has indicated its wish to develop cooperative arrangements which rely on ASIC's regulation to the maximum extent possible.

Section 3: How we conducted our work

During 2005, we conducted on-site inspections of each of the Firms. As noted above, the Firms are national partnerships and together audit approximately 54% of all entities listed on the Australian Stock Exchange, and 91% by market capitalisation of the 300 largest entities.

We focused on assessing whether the Firms had documented and implemented a quality control system that provides reasonable assurance that they comply with the independence requirements in Division 3 of Part 2M.4 of the Corporations Act.

Our monitoring approach

We conducted our on-site inspection work between February and May 2005. The nature of our monitoring approach means that inspections were spread throughout the period, with on-site work concluding at some Firms earlier than at others. Our observations and findings (Section 2) relate to the period of our inspection work at each Firm.

It was not the purpose of the inspection program to benchmark the Firms or to make specific recommendations on how to improve their independence systems and processes. However, during our inspections we have highlighted some areas where improvements are required.

In particular, we considered the following areas in respect of auditor independence:

- culture at the top;
- systems and processes;
- interests in clients;
- non-audit services; and
- client management.

Our inspections concentrated on reviewing the Firms' independence systems and processes, including examining the Firms' testing results. We did not conduct our own testing of the systems and processes. We did not review the Firms' audit methodology or the conduct of individual audit engagements for general non-compliance with auditing standards. We did not consider whether the Firms have complied with any international requirements.

The inspection process

In conducting our inspection, we:

- reviewed extensive material provided by the Firms under notice pursuant to the Australian Securities and Investments Commission Act 2001;
- reviewed the Firms' policies and procedures for managing compliance with the auditor independence requirements of the Corporations Act;
- interviewed selected partners holding leadership roles at each Firm;
- interviewed representatives from the Firms' external oversight function where applicable;
- interviewed a sample of partners and staff in at least two offices of each Firm. We visited offices in Sydney, Melbourne, Brisbane, Adelaide, Perth and Canberra; and
- reported our findings and observations to each Firm and obtained a formal response from them.

The process was designed to gain an understanding of:

- the Firms' executive leadership direction and strategic priorities in relation to independence and the role of each Firms' board of partners (culture at the top);
- the structure and responsibilities of the Firms' independence teams (culture at the top);
- the Firms' independence policies, systems and processes (systems and processes);
- the Firms' independence training programs (systems and processes);
- the links between the Firms' independence policies and their performance management processes (systems and processes);
- arrangements the Firms have in place for handling conflicts of interest (e.g. interests in clients);
- policies and procedures for the acceptance and provision of non-audit services (non-audit services);
- engagement acceptance and continuance (client management); and
- internal independence testing programs conducted by the Firms locally and globally (all areas).

We also considered information we received from and about the Firms; and information from external sources, including media commentary and reports published by the Firms.

As part of our inspection procedures, we interviewed staff from all levels and across all service lines, and not just the leadership of the Firms. This reinforced the importance of Australian legislative requirements to all professional staff regardless of service line or position within the Firms.