



ASIC

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REPORT 78

Audit inspection program (Second report to FRC)

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Contents

Contents	2
Executive summary	3
Section 1: Scope of ASIC audit inspections	6
Section 2: Observations and findings - Big Four Firms	7
Section 3: Observations and findings - Mid-Tier Firms	13
Section 4: How we conducted our work	20
Section 5: Future inspections.....	22
Appendix 1: Structure of Firms	24

Executive summary

About this Report

This report describes our inspection process together with observations and findings in relation to independence systems and audit quality for the Big Four Firms and selected offices of six Mid-Tier Firms (together referred to as "the Firms" – refer Appendix 1 for details of each firm included in these categories).

We have reported separately to each Firm our observations and findings, and highlighted areas where improvements are required. All Firms inspected have committed in writing to consider and act on the matters that have been brought to their attention to further build on independence and quality.

This report focuses on improvements since our first inspections, where relevant, together with weaknesses identified, rather than areas of strength requiring no action. It is not the purpose of the inspection program to benchmark the Firms, nor to compare the Big Four and Mid-Tier Firms, nor to make specific recommendations on how to improve their policies and systems.

Unless stated otherwise, not all matters in this report apply to every Big Four or Mid-Tier Firm and, where they do apply to more than one Firm, there will inevitably be differences in degree.

Collectively the Big Four Firms audit 53% of the listed entities in Australia, and approximately 88% by composition and 96% by market capitalisation of the 300 largest entities listed on the Australian Stock Exchange ("S&P/ASX 300"). In contrast, the Mid-Tier Firms inspected audit approximately 2% by composition and 0.2% by market capitalisation of the S&P/ASX 300.

Overall Observations and Findings

The Firms have generally responded positively to the new Australian legislative requirements for auditor independence and audit quality. Many firms have committed resources and, where required, have developed existing policies and systems to assist them in complying with legislative requirements. Other firms, however, appear to be slow in planning and implementing a successful transition to the new regime.

Our observations and findings vary considerably between the Big Four Firms and the Mid-Tier Firms, as the challenges faced by these respective Firms and the resources available to them are significantly different. There are noticeable differences in the quality and maturity of policies and systems, and variations in the levels of compliance.

There is a need to further improve the quality of audit work being done on the financial statements of entities in Australia by both the Big Four and the Mid-Tier Firms. A significant number of our findings in relation to audit quality relate to incomplete documentation of work. Documentation of audit work performed to

support the auditor's opinion is fundamental to the overall integrity of the audit and is embedded in the Australian Auditing Standards.

Big Four Firms

All the Big Four Firms have the resources and capability to undertake audits of the largest listed entities. They also have the necessary resources to implement effective systems in response to changes to the regulatory framework on a timely basis. We are encouraged by the improvements made by the Big Four Firms since our first report in 2005 and the commitment to independence and quality demonstrated by their leadership. The observations and findings of our second year inspections indicate that significant progress had been or is being made by the Big Four Firms.

We recognise, however, that the Big Four Firms have had limited time since the completion of our first year inspections to implement all of our observations and findings. The timing of many of the individual audits we reviewed as part of our second year inspections was such that it would not be reasonable to expect actions taken by the Big Four Firms on our first inspection report to have had a significant effect on these audits.

Our second year audit inspections of the Big Four Firms demonstrate that there is a need for further improvement in the quality of the audit work being done on the financial statements of listed entities in Australia. While the necessary improvements could be characterised as further enhancements to an already fundamentally sound process, areas that require continued emphasis from the Big Four Firms' leadership include:

- Compliance with their independence policies;
- Documentation and approval of non-audit services; and
- Completeness of audit documentation.

Mid-Tier Firms

Our observations and findings vary considerably between the Mid-Tier Firms. There are significant differences in the Mid-Tier Firms' size, structural complexity, extent of centralised resources and international reach. Accordingly, general findings for the Mid-Tier Firms visited may not be indicative of this group of firms as a whole, or of other member firms of the associations to which they belong.

We are encouraged by the policies and systems developed by Mid-Tier Firms in some areas of independence and audit quality. However, we are concerned that our inspections identified that:

- Four firms need to further develop independence policies and systems to ensure they fully comply with the requirements of CLERP 9;

- Five firms do not have adequate documentation supporting decisions to provide non-audit services to audit clients. In two cases, documentation was inadequate to support the firms' views that their policies, Professional Statement F1 *Professional Independence* and the Act were complied with;
- In all firms, partner performance reviews are either not conducted or not documented, and/or the remuneration of audit partners is linked purely to financial results without explicitly considering audit independence and audit quality;
- Two firms have conducted very limited testing of compliance with audit independence policies and systems and four have not commenced any testing program;
- The application of audit methodologies ranges from two firms using audit manuals fully mapped to auditing standards and supported by tailored global proprietary software, to two firms having no audit manuals (although limited guidance is provided in audit templates); and
- Most firms need to improve compliance with Auditing Standards AUS 512 *Analytical Procedures*, AUS 210 *The Auditors responsibility to Consider Fraud in an audit of a Financial Report* and AUS 514 *Audit Sampling and Other Selective Testing Procedures*.

Most of these observations and findings are consistent with recent reviews conducted by other international regulators of Mid-Tier Firms within their jurisdiction.

Section 1: Scope of ASIC audit inspections

Under the *Corporations Act 2001* ("the Act"), ASIC has responsibility for the surveillance, investigation and enforcement of the financial reporting requirements of the Act, including the enforcement of audit independence and audit quality 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 is our second report to the Financial Reporting Council ("FRC") on our audit inspection program since the enactment of CLERP 9. Our report covers the principal observations and findings arising from the following inspections:

- a. Second year inspections of Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers (the "Big Four" Firms); and
- b. First year inspections of BDO Sydney, Horwath Sydney Partnership, PKF Sydney, Grant Thornton Western Australian Partnership, Pitcher Partners Melbourne and RSM Bird Cameron and RSM Bird Cameron Partners (the "Mid-Tier" Firms).

These Firms range in size from national partnerships with multiple offices, to individual offices of Firms that are separate legal entities. Each Firm is described in Appendix 1.

We reported in September 2005 on our first year inspections of the Big Four Firms, providing an assessment of whether these firms had documented and implemented a quality control system that provided reasonable assurance of compliance with the independence requirements in Division 3 Part 2M.4 of the Act. Section 2 reports improvements by the Big Four Firms since our last report.

We broadened our work for this year to also assess whether the Firms had documented and implemented a quality control system that provides reasonable assurance that the Firms' audit methodology facilitates the conduct of audits as required in Division 3 of Part 2M.3 of the Act. Section 4 gives more detail about how we conducted this work.

In accordance with the FRC's responsibility to oversee the effective implementation of the independence regime in Australia, and our Memorandum of Understanding, this report presents our observations relating to independence and common findings relating to audit quality.

Section 2: Observations and findings - Big Four Firms

In this section we explain the principal observations and findings arising from our second year inspections of the Big Four Firms. In Section 2.1 we also report on the extent to which the recommendations arising from our first year inspections on independence have been implemented together with any continuing areas for improvement.

2.1 Independence

2.1.1 Actions since first year inspections

In September 2005 we reported to the FRC on our first inspections of the Big Four Firms. That report included observations and findings in respect of the Big Four Firms' independence policies and systems. The findings of our second year inspections indicated that all Big Four Firms have made significant progress on the implementation of policies and systems to monitor compliance with the independence requirements of the Act. However, all Big Four Firms have made only limited progress in testing for compliance with the established independence policies and systems in one or more areas such as personal independence of partners and staff, engagement level independence confirmations and non audit services.

Tone at the top

All the Big Four Firms' executive leadership have continued to send a strong message within their firms about the importance of independence. Overall, there has also been a positive response to implementing the new legislative requirements for audit independence. The Big Four Firms have continued to commit significant resources and have further developed appropriate policies and systems to assist them in complying with the Australian legislative requirements.

Systems to monitor compliance

The Big Four Firms have continued to develop their ability to monitor compliance with both internal policies and systems, and with their legislative obligations under the Act. All the Big Four Firms have policies covering annual or quarterly independence confirmations, conflict checking and engagement acceptance and continuance, and have continued to enhance systems that facilitate the recording and monitoring of personal investments and securities.

Engagement level independence procedures

We reported in 2005 that the Big Four Firms' documentation of engagement level independence confirmations was inadequate, and that there were varying levels of documented processes within the Firms for obtaining independence confirmations from individual audit team members on each engagement. Since that time three Big Four Firms have responded positively by either implementing new systems

for documenting engagement level confirmations, enhancing policies, or reinforcing requirements to staff. This has set new standards for compliance in these firms.

Documenting approval of non-audit services

We reported in 2005 that the requisite documentation for approving non-audit services varied amongst the Big Four Firms. All firms now have a policy requiring that non-audit services for existing audit clients be pre-approved by the engagement partner and have enhanced their systems to improve the documentation and approval process for non-audit services.

Consequences of non-compliance

We reported in 2005 that the Big Four Firms needed to better communicate the consequences of non-compliance with their policies and systems to staff. All firms have since developed, or are in the process of developing, policies which include disciplinary action and the impact of breaches of the policy on performance and/or remuneration.

Data on independence queries

All Big Four Firms have now implemented systems for capturing independence consultations and enquiries by partners and staff.

Independence training

Since our last report to the FRC, three firms have enhanced their training program and introduced web based or e-learning tools to facilitate independence training whilst the other firm will be rolling out independence training in the near future.

2.1.2 Testing of compliance

All Big Four Firms have implemented systems to facilitate compliance with their independence policies. These systems range from fully integrated automated databases to standalone databases and other manual systems. Irrespective of the systems in place, all Big Four Firms' internal testing of compliance with their independence policies and systems continues to reveal unsatisfactory results in relation to overall levels of compliance. One firm is still in the process of finalising its disciplinary policy for staff below partners.

The extent of the testing performed varies significantly from one Big Four Firm to another. For example, one Big Four Firm has tested the personal independence of all partners (and plans to extend testing to staff below partners) while others have restricted testing to a very small number of partners and senior staff.

Violations of independence policies, identified during the Big Four Firms' internal testing, included the late or incomplete recording of information into the independence monitoring systems and were generally minor in nature. However, two firms' testing programs also identified breaches of the Act, which in one instance included a direct financial holding either by the partner or through a self-managed superannuation fund.

All Big Four Firms view their policies, in certain instances, to be more stringent than the requirements of the Act. Accordingly, we acknowledge that, in these instances, breaches of policies do not necessarily equate to breaches of the Act. Where the firm's internal testing programs have identified breaches of the Act, the firms concerned have asserted that they were rectified within seven days as per the requirements of the Act.

Three firms need to conduct more rigorous internal testing. In addition, we are concerned at the continued instances of non-compliance with the Act and the Firms' independence policies and systems. Failure to comply with policies and systems may increase the risk of breaches of legal and professional independence requirements.

2.1.3 Engagement level independence confirmations

Engagement level independence confirmations are an important mechanism for increasing staff awareness of the independence requirements in the Firms' policies and the Act. Completion of these confirmations assists in ensuring that the independence of all audit team members is considered at various stages of the audit process, specifically in the context of individual engagements.

Three Big Four Firms have introduced policies and systems, which mandate engagement level independence confirmations to be provided by staff at key stages of the audit. Our file reviews indicated a number of instances where the Firms' policies were not complied with.

In addition two of these firms do not currently test either the timing or completeness of engagement level confirmations to assess compliance with their policies. We consider such testing to be an important part of a system of quality control. These firms are considering testing engagement level confirmations either through their independence group or through the audit quality review processes. We will monitor the results of testing by these Firms on engagement level independence confirmations in our next inspections.

The other Big Four Firm does not currently perform engagement level independence confirmations and continues to rely upon its existing independence policies and systems, such as regular declarations from partners and staff. This firm needs to closely monitor the results of its existing independence testing to determine whether it is appropriate to place continued reliance on these policies and systems.

2.1.4 Non-audit services

All Big Four Firms have made significant progress in developing policies and systems to facilitate the engagement partner's approval for non-audit services, where appropriate. Similar to other systems, the maturity and sophistication of these systems vary significantly from one Big Four Firm to another. However, most engagement files we reviewed indicated a lack of acceptance documentation and approval for non-audit services.

Two firms do not conduct testing of the approval and documentation process for non-audit services and the firms that do perform testing vary in the nature, extent and regularity of the testing performed.

Only one Big Four Firm has implemented a regular and comprehensive testing program for non-audit services provided to audit clients. The program tests compliance with that firm's independence policy and whether the services provided are in line with the original approval from the audit partner, to detect "scope creep". The results of the testing performed, however, continue to reveal a high incidence of non-compliance with its independence policies around non-audit services. In the firm's view, these testing results revealed no breaches in relation to the conduct of services that could have potentially compromised their independence.

Regular testing by the Firms will provide the Firms with more assurance about the level of compliance with the Firms' policies and the Act concerning the provision of non-audit services to audit clients. In our next inspection we will focus on the results of testing performed by the Big Four Firms and assess compliance with their policies for approval of these services.

2.2 Audit quality

We reviewed the Big Four Firms' policies and systems to assess whether they provide the Firms with reasonable assurance that audits are performed in accordance with professional standards and applicable regulatory and legal requirements, and that reports issued by these Firms are appropriate.

During our inspections, we examined the Big Four Firms' audit methodologies for compliance with auditing standards operative for financial reporting periods ending prior to the date of our inspection. We also reviewed the conduct of a limited number of individual audit engagements for compliance with the Firms' stated audit methodologies as at the time of each audit.

All the Big Four Firms have comprehensive policies and systems that appear to conform to professional and legal requirements. With auditing standards having the "force of law" from 1 July 2006, all Big Four Firms are in the process of updating and "mapping" their policies and systems to the new requirements. This will be an area of focus in our future inspection of the Big Four Firms.

2.2.1 Application of audit methodology

Based on our limited review of the Big Four Firms' audit methodologies and associated technologies, it appears that the methodologies and technologies are comprehensive and reliable.

Our review of five engagement files of one of the Big Four Firms highlighted a number of common issues in relation to the application of its audit methodology, which could, in part, be due to the non-integration of some aspects of the firm's

audit methodology with its technology. We understand the implementation of a new documentation tool is, however, imminent in this firm.

The limited number of engagement file reviews we performed indicate that all Big Four Firms need to continue to improve the application of the audit process to ensure that compliance with their methodologies is documented.

2.2.2 Audit documentation

We reviewed the audit working papers for 20 engagements conducted by the Big Four Firms. A significant number of our findings in relation to audit quality relate to incomplete documentation of work performed or said to have been performed by the engagement teams.

We acknowledge that all the Big Four Firms have made efforts to achieve improvements in this area through the provision of additional guidance and training. These efforts have been supported by clear messages being conveyed within all the Big Four Firms regarding the need for improvement. However, engagement partners and engagement quality control reviewers need to also lead by example and continue to reinforce their messages that inadequate documentation of audit work is not acceptable.

In a number of engagement files reviewed we found inadequate documentation, especially in relation to consideration of laws and regulations, related parties, completion of mandatory fraud audit procedures and documentation of the substantive sampling approach adopted. In addition, key documents such as engagement letters, engagement level independence confirmations, acceptance and continuance documentation and management letters were not issued or obtained on a timely basis for some engagements.

2.2.3 Timing of sign-offs

Our file reviews highlighted a number of instances where the engagement partner and/or the engagement quality control reviewer either did not perform a review of the audit procedures or related working papers on a timely basis, or there was no evidence of a review being performed. The delays were mainly in relation to approval of audit planning and the resultant audit strategy or, in other instances a number of completion documents were marked as reviewed by the engagement partner and/or the engagement quality control reviewer well after the audit report was signed.

2.2.4 Monitoring

Each Big Four Firm has comprehensive policies and systems to govern the monitoring of independence and audit quality through global and local reviews.

All Big Four Firms have an effective monitoring process. This is evidenced by the Big Four Firms using the findings of their audit quality reviews to enhance their policies and systems, develop training and bring updated or new policies and

systems to the attention of staff. In all Big Four Firms there is a clear link between the results of their internal monitoring process and partner and staff performance evaluations.

Section 3: Observations and findings - Mid-Tier Firms

This section summarises significant observations and findings arising from our first year inspections of the Mid-Tier Firms. These findings should be read in the following context.

This was the first year that we conducted inspections of Mid-Tier Firms. We selected the Mid-Tier Firms for inspections principally on the basis of market capitalisation of clients audited by these firms. Collectively, the Mid-Tier Firms we inspected audit approximately 2% by composition and 0.2% by market capitalisation of the S&P/ASX 300 (compared to approximately 88% and 96% respectively for all Big Four Firms).

There are significant differences in the Mid-Tier Firms' structures, strategies, target markets, extent of centralised resources and international reach. With the exception of one of the Mid-Tier Firms visited (which has a national structure), each firm is an independent geographically based entity with formal national and/or international association arrangements. There are also differences in the size and structural complexity of each Mid-Tier Firm visited. Accordingly, general findings for the Mid-Tier Firms visited may not be indicative of this group of firms as a whole, or of other member firms of the associations to which they belong.

3.1 Independence

3.1.1 Adoption of CLERP 9 independence requirements

Major changes to the audit independence requirements came into effect on 1 July 2004. Four of the Mid-Tier Firms need to review their independence policies to ensure they fully comply with CLERP 9.

For example, at one Mid-Tier Firm, the induction process for new employees does not include awareness of independence policies and systems.

At another Mid-Tier Firm, some staff members have little awareness of the independence issues relevant to their firm, and independence training has not been widely attended by staff across all areas. In addition, there is no mechanism to ensure lateral hires and contractors are provided with independence training.

3.1.2 Non-audit services

The provision of non-audit services to audit clients constitutes one of the main threats to audit independence. However, five Mid-Tier Firms do not have adequate documentation supporting decisions to provide non-audit services to audit clients. Formal documentation requirements need to be established and

adhered to in order to clearly evidence compliance with policies, applicable codes of professional conduct, and the Act.

Mid-Tier Firms need to clarify their policies around what constitutes prohibited non-audit services. For example, one Mid-Tier Firm's policy regarding the provision of non-audit services to audit clients only precludes the provision of insolvency services.

In some instances Mid-Tier Firms are not complying with their own policies. Failure to comply with their own policies may increase the risk of the firm breaching legal independence requirements.

Our audit file reviews of one Mid-Tier Firm revealed working papers that suggested the firm prepared journal entries to record accounting transactions on behalf of some of its clients. Another Mid-Tier Firm provided payroll services to its client. The firm failed to document why it believed the provision of these non-audit services was compatible with the general standard of independence imposed by the Act, notwithstanding it acknowledged in writing to the client that the provision of the payroll services may have created a perception issue.

In both cases, documentation was inadequate to support those firms' views that their policies, Professional Statement F1 *Professional Independence* and the Act were complied with. When deciding whether to perform non-audit services work, appropriate emphasis should be placed on the perception of a reasonable person.

3.1.3 Partner evaluation and compensation

In all of the Mid-Tier Firms we found most or all of the following:

- Partner performance reviews are either not conducted or not documented;
- The remuneration of audit partners is linked purely to financial results;
- Audit independence and audit quality considerations are not taken into account in relation to partner evaluation or compensation; and
- Performance criteria either does not explicitly include audit quality and audit independence considerations, or these criteria are not emphasised.

We believe it is difficult for the Firms to demonstrate compliance with legal and professional requirements without adopting formal partner performance appraisals incorporating independence and quality performance criteria. This is fundamental to demonstrating strong and transparent leadership within the firms. Mid-Tier Firms should place greater emphasis on audit independence and quality in their appraisal, remuneration and promotion policies, including incorporating the findings (both positive and negative) from internal and external quality reviews of audit work. This will assist in promoting a culture of balance between the conflicting demands of audit independence, quality and commercial considerations.

We believe partner evaluation that takes into account audit independence and audit quality is relevant to Mid-Tier Firms regardless of size, and firms should be aware of the importance we attach to this issue.

3.1.4 Client acceptance and continuance

One Mid-Tier Firm did not have a documented process for client and engagement continuance. Miscellaneous Professional Statement APS 5.29 *Statement of Quality Control for Firms* requires firms to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements by 31 December 2005. In addition AUS 206.14 *Quality Control for Audits of Historical Financial Information*, effective for periods commencing on or after 15 June 2005, requires engagement partners to be satisfied that appropriate procedures regarding continuance have been followed and conclusions documented.

3.1.5 Testing of compliance

As systems and processes mature there will be a need for testing of independence systems. Two of the Mid-Tier Firms have conducted very limited testing but four have not commenced any testing program. All Mid-Tier Firms should conduct more rigorous internal testing. Firms can place only limited reliance on the effectiveness of independence policies and systems without an effective testing program.

3.1.6 Consequences of non-compliance

Two of the Mid-Tier Firms need to develop and communicate disciplinary policies, which outline the consequences of non-compliance to all staff. In interviews at some of the firms, staff could not be specific about what the consequences would be of non-compliance with their firm's policies. There needs to be clarity of the consequences of non-compliance for partners and staff to encourage a culture of compliance.

3.1.7 Whistleblower/complaints process

None of the Mid-Tier Firms has a whistleblower or formal complaints process, as required by Miscellaneous Professional Statement APS 5.91 *Statement of Quality Control for Firms* for dealing with internal and/or external complaints. Therefore staff and/or external parties do not have a clear process to follow if they have a complaint or an allegation relating to the firm's apparent non-compliance with professional and legal requirements.

3.1.8 Strategic plans and codes of conduct

Four of the Mid-Tier Firms have strategic plans that do not address audit independence and quality issues. Two of the Mid-Tier Firms' codes of conduct are also deficient and do not refer to legal and ethical requirements. It is important for firms to establish a tone at the top that balances commercial

considerations with compliance and ethical considerations, such as independence and quality issues. The relevant firms have agreed to revise their strategic plans and codes of conduct accordingly.

3.2 Audit Quality

3.2.1 Application of audit methodology

Based on our limited review of the Mid-Tier Firms' audit methodologies and associated technologies, the structure and adequacy of the Mid-Tier Firm's methodologies and technologies vary considerably from one Mid-Tier Firm to another.

The application of audit methodologies ranges from two firms using audit manuals fully mapped to auditing standards and supported by tailored global proprietary software, to two firms having no audit manuals although limited guidance on the conduct of an audit is provided in the audit templates. One of these firms has not updated its audit software for recent changes in auditing standards such as AUS 402 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements* and AUS 210 *The Auditor's responsibility to Consider Fraud in an audit of a Financial Report*, both operative for periods commencing on or after 15 December 2004. In the case of another firm, it has no specific audit program implementing revised AUS 210.

In addition, the engagement file reviews performed indicate that all Mid-Tier Firms need to improve the application of the audit process to ensure that compliance with their methodologies is documented.

3.2.2 Application of auditing standards

We reviewed the audit working papers for 30 engagements conducted by the Mid-Tier Firms. We found that three auditing standards were poorly applied by most of the Mid-Tier Firms:

- AUS 512 *Analytical Procedures* - We found inadequate analytical review work at the planning and overall review stages of the audit for the majority of engagements we reviewed.
- AUS 210 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report* - Staff in most Mid-Tier Firms do not appear to have a good understanding of the requirements of AUS 210, applicable for financial years starting on or after 15 December 2004. This is despite the fact that most of the firms have conducted training.
- AUS 514 *Audit Sampling and Other Selective Testing Procedures* - In the majority of engagements reviewed across all the Mid-Tier Firms, the rationale for selecting particular items and sample sizes was not adequately documented.

Most Mid-Tier Firms seem to have removed guidance on sample sizes from their audit methodology, leaving it to the auditor's judgement. The results of our inspections suggest that this lack of guidance is contributing to inconsistent approaches in the selection and documentation of sample sizes and hindering compliance with the auditing standard.

3.2.3 Audit documentation

A significant number of our findings from the review of 30 audit engagements relate to incomplete documentation of work. In all Mid-Tier Firms we found less adequate documentation in the final phases of the audit than at commencement, including inadequate evidence of procedures performed on directors' remuneration and going concern.

Other common deficiencies in documentation related to:

- Consideration of laws and regulations;
- Partner reviews of planning documentation prior to commencing field work;
- Reviews of general ledger or non-standard journal entries;
- Mandatory fraud audit steps;
- Analytical reviews; and
- Documentation of the substantive sampling approach adopted.

In addition, key documents such as engagement letters and management letters were not issued or obtained on a timely basis for some engagements.

Insufficient documentation of audit work undertaken, and the basis on which audit judgments have been made, increases the risk of not obtaining sufficient appropriate audit evidence to support the audit opinion and hindering audit quality reviewers in discharging their duties. It not only renders internal quality control reviews less effective but also affects the ability of the firm to demonstrate the basis of conclusions reached. Inadequacies in audit documentation also make external reviews more difficult.

The quality of audit documentation varied significantly both between and within Mid-Tier Firms. For example, in one Mid-Tier Firm, the methodology was applied inconsistently across different industry groups within that firm. Most of the Mid-Tier Firms need to improve in this area. The need for improvement should be supported by clear messages within those firms.

Our reviews of some engagement files revealed inadequate documentation of engagement partner or engagement quality control reviews. A cultural change appears to be needed on the part of some engagement partners and staff to improve audit documentation. Engagement partners and engagement quality control reviewers need to lead by example and make it clear to their teams that inadequate documentation of audit work is not acceptable.

3.2.4 Audit evidence

The engagement file reviews of the Mid-Tier Firms indicated a general lack of evidence for disclosures such as related party transactions, commitments and contingencies, where the amounts do not flow directly from the statements of financial performance, financial position, or cash flows. Additionally, some key documents such as engagement letters and management letters were either not filed or obtained subsequent to completion of the audits. A lack of evidence increases the risk that completeness and accuracy assertions are not substantiated.

3.2.5 Engagement quality control reviews

On some of the listed client engagement files reviewed across the Mid-Tier Firms, there was inadequate documentation to evidence the timing and extent of the engagement quality control reviews. In addition, time records do not always demonstrate that engagement quality control reviewers are spending sufficient time on the audits for which they are performing this role.

One Mid-Tier Firm currently has two types of quality reviews for its listed audit clients, with one of these types of review not being in accordance with revised AUS 206 *Quality Control for Audits of Historical Financial Information*, applicable for periods commencing on or after 15 June 2005.

In another Mid-Tier Firm it is not clear who is fulfilling the role of Engagement Quality Control Reviewer on the Firm's listed clients. For two of the listed audit engagements we reviewed, although there were two partners involved in each audit, neither partner appeared to be acting as the Engagement Quality Control Reviewer as defined by AUS 206.

3.2.6 Monitoring

The effectiveness of monitoring activity varies from one Mid-Tier Firm to another. In most of the Mid-Tier Firms the scope of their monitoring processes includes compliance with independence policies and systems. In addition, some of the Mid-Tier Firms have initiated action plans to link the results of monitoring outcomes to performance evaluation and/or ongoing audit strategies. However:

- Two of the Mid-Tier Firms do not have adequate documented policies and procedures to support their monitoring process;
- Four firms have been deficient in communicating the results of reviews beyond the engagement teams concerned;
- At one Mid-Tier Firm we were unable to sight any evidence of the extent of coverage of its monitoring process, the results of the process being communicated, any consequences for partners and staff in terms of performance evaluations, or any impact on audit policy, strategy and training;

- In three firms, the success of their educational approach to address non-compliance appears to have been limited; and
- Three Mid-Tier Firms do not have a clear link between the results of their internal monitoring process and partner and staff performance evaluations. Audit partners in particular should be held accountable when their audit files do not comply with their firm's policies and systems.

Section 4: How we conducted our work

We conducted our inspections of both the Big Four Firms and the Mid-Tier Firms between September 2005 and June 2006. The nature of our monitoring approach means that inspections were spread throughout the period, with inspections starting and concluding at some Firms earlier than at others.

Our inspections concentrated firstly on a review of the Firms' independence policies and systems, including examination of the Firms' testing results. As this was our second inspection of Big Four Firms, we updated our findings from their first year inspections. We did not conduct our own testing of the Firms' independence policies and systems.

Secondly, we examined the Firms' audit methodology for compliance with auditing standards operative for financial reporting periods ending prior to the date of our inspection. We also reviewed the conduct of 5 individual audit engagements per Firm for compliance with each of the Firms' stated audit methodologies as at the time of each audit. We did not review the conduct of individual audit engagements for specific non-compliance with auditing standards.

Our second year inspections were planned and carried out to:

1. Confirm our understanding of the design of each Firm's system of quality control, organised under the following principal elements:
 - Tone at the top;
 - Independence;
 - Client and engagement acceptance and continuance;
 - Human resources;
 - Engagement Performance; and
 - Monitoring.
2. Test the effectiveness of the implementation of each Firm's system of quality control that provides reasonable assurance that:
 - The Firm complies with the audit independence requirements in Division 3 of Part 2M.4 of the Act (independence).
 - The Firm's audit methodology facilitates the conduct of its audits in accordance with the auditing standards as required in Division 3 of Part 2M.3 of the Act (audit quality).

3. Confirm that the Big Four had implemented their responses to ASIC's observations and findings made in its 2005 audit independence inspection reports.

As part of our inspection procedures, we interviewed the leadership of the Firms together with professional staff from many levels and across all service lines. This reinforced the importance of Australian legislative requirements to all professional staff regardless of service line or position within the Firms.

The process was designed to gain an understanding of:

- The Firms' executive leadership direction and strategic priorities in relation to independence and audit quality;
- The Firms' policies and systems for ensuring compliance with their audit independence and audit quality obligations;
- The Firms' independence and audit methodology training programs;
- The links between the Firms' independence and audit quality policies and the performance management process; and
- Internal monitoring programs conducted by the Firms.

In conducting our inspections, we:

- Reviewed material provided by the Firms under notice;
- Reviewed the Firms' policies and systems for managing compliance with the audit independence requirements of the Act and for ensuring audit quality;
- Reviewed a selection of 5 audit engagements (for the financial periods ended 31 December 2005, 30 June 2005, 31 December 2004 or 30 June 2004 or) at each Firm, weighted towards listed entities;
- Interviewed selected partners in the Firms holding leadership roles;
- Interviewed selected human resources representatives;
- Interviewed a number of the Firms' other partners and staff; and
- In the case of national Firms, visited other capital city offices and interviewed selected partners and staff.

Section 5: Future inspections

We will conduct follow up inspections of all the Firms included in this report. We will conduct inspections of other partnerships of the Mid-Tier associations visited this year, and also extend our reach into other Mid-Tier Firms. Our future inspections of the Big Four Firms will include visiting offices not previously covered in our first and second-year inspections.

The inspections will continue to examine independence and audit quality. We will continue to focus on the practical application of the auditor rotation requirements, which became effective for financial years beginning on 1 July 2006. We will also significantly increase the number of audit engagement file reviews, with particular focus on those auditing standards which our inspections showed were poorly applied, in particular:

- AUS 402 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements;*
- AUS 210 *The Auditor's responsibility to Consider Fraud in an audit of a Financial Report;*
- AUS 514 *Audit Sampling and Other Selective Testing Procedures; and*
- AUS 208 *Documentation.*

In addition, given the legal enforceability of auditing standards, professional pronouncements such as APS 5 and the code of professional conduct from 1 July 2006, our next inspections will focus on how the Firms are managing this transition.

In future inspections we will also review the Firms' processes to prepare for the changes recently introduced by the International Federation of Accountants' Ethics Committee ("IFAC"), which has broadened the definition of "network firm". Effective 1 January 2008, some firms will be classified as part of the same network. This raises a number of issues for the Mid-Tier Firms in particular; for instance, all firms in the network will be required to be independent of each other's audit clients. The Mid-Tier Firms are aware of their obligations to comply with the expected future changes to the network firm definition.

We will also continue to liaise with the Public Company Accounting Oversight Board ("PCAOB") and other international audit oversight bodies 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 desire to develop cooperative arrangements which rely on ASIC's regulation to the maximum extent possible.

We have reported separately to each Firm and all Firms inspected have committed in writing to consider and act on the matters that have been brought to their attention to further build on independence and quality. Actions taken by each

firm will determine whether ASIC needs to take other regulatory action such as accelerating the next inspection of the firm or making public certain aspects of our observations and findings.

We issued a public report in November 2005 setting out the overall findings and conclusions arising from our first year of inspections and we expect to issue a public report on our second year of inspections. ASIC may consult with a range of stakeholders to determine whether any changes to the current arrangements for public reporting should be made going forward, and we will watch with interest the UK public reporting consultation process.

Appendix 1: Structure of Firms

The Big Four Firms

KPMG

KPMG describes itself as a member firm of the global network of professional services firms of KPMG International. In Australia, KPMG operates nationally across 14 offices.

Ernst & Young

Ernst & Young describes itself as part of the global Ernst & Young network, and has offices in each mainland state of Australia.

Deloitte Touche Tohmatsu

Deloitte Touche Tohmatsu describes itself as part of a worldwide network, with Deloitte's Australian practice having offices in 12 locations across Australia.

PricewaterhouseCoopers

PricewaterhouseCoopers describes itself as a truly global organisation, operating in nine cities around Australia.

The Mid-Tier Firms

BDO Sydney

BDO Sydney describes itself as a member of the BDO National Association in Australia. Our inspection was limited to the Sydney partnership of BDO and did not include any other member firms of the BDO National Association.

Grant Thornton Western Australian Partnership

The firm describes itself as a member of Grant Thornton International ("GTI"). Member firms of GTI are independently owned and operated. Grant Thornton is not a worldwide partnership. The firm is a member of Grant Thornton Association Inc in Australia (an incorporated association, the members of which comprise the individual practitioners who are the partners, directors or principals of the five separate independent Australian member firms of GTI). Our surveillance was limited to the Grant Thornton Western Australian Partnership and did not include any other member firms of GTI in Australia.

Horwath Sydney Partnership

Howarth Sydney Partnership describes itself as a separate partnership that is a member firm of Horwath Australia Limited, a network of independent partnerships. Our inspection was limited to the Sydney Partnership and did not include any other member firms either domestically or internationally.

Pitcher Partners Melbourne

Pitcher Partners Melbourne describes itself as part of an association of independent firms, who are also located in Sydney, Brisbane and Perth. Our inspection was limited to the Melbourne firm and did not include any other associated firms either domestically or internationally.

PKF Sydney

PKF Sydney describes itself as a member firm of PKF Australia Limited, which has practices in every State and Territory across Australia. Each office is a separate legal entity. Our inspection was limited to the Sydney firm and did not include any other member firms either domestically or internationally.

RSM Bird Cameron and RSM Bird Cameron Partners

The firm describes itself as is an independent national accounting practice, which is a member of the RSM International network of accounting firms. The firm operates from its head office in Perth and 28 other Australian offices located in Sydney, Melbourne, Canberra, Adelaide and smaller regional centres.