



ASIC

Australian Securities & Investments Commission

REPORT 192

Audit inspection program public report for 2008–09

March 2010

About this report

This report sets out key themes and issues identified by ASIC's audit inspection program for 2008–09.

We expect this report to be beneficial to the audit firms we inspected, other audit firms, the investing public, companies, audit committees and other interested stakeholders.

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/Disclaimer

Sections of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices or conduct of some of the 19 audit firms inspected (Firms). The absence of a reference in this report to any other aspect of a Firm's systems, policies, procedures, practices or conduct should not be construed as approval by ASIC of those aspects, or any indication that in ASIC's view those aspects comply with relevant laws and professional standards.

In the course of reviewing aspects of a limited sample of selected audit and review engagements, an inspection may identify ways in which a particular audit or review is deficient. It is not the purpose of an inspection, however, to review all of the Firm's audit or review engagements or to identify every aspect in which a reviewed audit or review may be deficient. Accordingly, this report does not provide assurance that the Firms' audits or reviews, or their clients' financial statements, are free of deficiencies not specifically described in this report.

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. Our observations and findings relate only to the individual firms inspected and cannot be extrapolated across the auditing profession in Australia. Our observations and findings can differ significantly even between firms of similar size and for that reason we caution against drawing conclusions about any firms not yet inspected by ASIC.

Unlike some other jurisdictions, ASIC is also the securities regulator in Australia. This report covers inspections but does not include any matters arising from other regulatory activities such as investigations or surveillances in relation to the Firms or its clients, although these matters may inform focus areas in inspections.

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Executive summary

Overview of findings

- 1 This report covers audit firm inspections substantially completed in the period 1 January 2008 to 30 June 2009 as part of ASIC's audit inspection program. This report does not cover audits for the year ended 30 June 2009 or the results of ASIC's other activities relating to auditors (such as our financial reporting surveillance program, surveillances relating to identified concerns with individual audits, referrals to the Companies Auditors and Liquidators Disciplinary Board, and investigations in connection with corporate failures).
- 2 Australia's audit regime compares well internationally. Further, it was pleasing to see that Australian firms have taken steps since our last report to make further enhancements and refinements to their independence and audit quality systems and processes.
- 3 ASIC reviewed audit engagement files across 19 firms, focusing on the substance of the auditor's work and whether sufficient and appropriate audit evidence was documented to support the conclusions reached in relation to key audit judgements. Our audit inspection program has identified a number of cases requiring improvements in audit quality in audit areas related to the global financial crisis (GFC), such as appropriate use of experts in testing asset valuations. Our audit inspections also continue to identify a number of other matters to be addressed by firms, particularly in the areas of audit evidence and documentation for significant audit judgement areas.
- 4 We will continue to assess the overall performance of the auditing profession as we complete our inspection activities for the end of 2009 and 2010 and as the results of surveillances and investigations become known.
- 5 Different entities are affected differently in the current economic conditions. Auditors should continue to focus on areas such as going concern, impairment of assets, and determination of fair values of assets, as appropriate.

The inspection process

- 6 Unlike many other regulators internationally, ASIC is both an audit oversight regulator and a securities regulator. In addition to our audit inspection program, the results from which are the subject of this

report, we conduct a range of other activities that cover the work of auditors. These other activities include our financial reporting surveillance program, surveillances of individual audits, and investigations into corporate failures. While the focus areas in our inspection program are informed by these other activities, the inspection program does not duplicate these other activities. For example, we do not review audit files in our inspections relating to entities for which we are also investigating a corporate failure. Where serious concerns are identified with individual audits in an inspection, these matters are transferred to separate surveillance activities.

- 7 The results of our investigation and surveillance activities also reflect on firm audit quality. However, investigations and surveillances can take time to be resolved, including the results of court action and other appropriate actions. We will be in a better position to assess the performance of the audit profession during the GFC once the outcomes of those activities are known.
- 8 During 2009, we conducted more timely reviews of individual audit engagement files by performing those reviews closer to the completion of audit work. Previously reviews were conducted 12 months or more after audit completion. While our inspections have continued to focus on audit process matters, we have also placed emphasis on assessing the quality of audit risk assessments and judgements. Our file reviews focused on entities and areas most likely to be affected by the GFC.
- 9 Much of this report is split between national partnerships that are members of global networks with multiple offices (National Firms), individual offices of firms that are members of international associations (Network Firms) and firms with small number of audit partners that audit a limited number of listed entities (Smaller Firms).

Key findings—audit quality

- 10 Our audit inspections continue to identify a number of significant matters that need to be addressed by the firms, particularly in the areas of audit evidence and documentation for significant judgement areas. While there may be cases where the necessary audit evidence was obtained and proper consideration was given to significant judgement areas but not documented, there will also be cases where the necessary audit evidence and analysis to support the audit opinion was not obtained or performed. There may be no material misstatement in the audited financial report, but if evidence and analysis are not obtained or performed the auditor does not have a basis for their opinion. This

extends to evidence and judgements in areas most impacted by the GFC.

- 11 While the full implications and outcomes of the GFC, including the public outcomes of our investigations and surveillances, are still unknown, improvements are required by all firms in specific areas most affected by the current economic conditions such as going concern assessments, impairment of assets and fair value determinations. Further details of the implications of the GFC on the audit profession are provided in Section B.
- 12 There are instances where audit risk assessments have failed to identify key risks and where fundamental audit procedures have not been conducted. Even where there are no identified audit risks for particular transactions or balances, a basic level of testing is still required.
- 13 Even in focusing on risk areas identified by the Firms, our individual audit and review engagement reviews for Firms continue to reveal significant numbers of cases where there was a lack of sufficient appropriate audit evidence for judgements in key audit areas, documentation failed to provide enough evidence to support the conclusions reached or audit procedures were not adequately undertaken.
- 14 There continues to be a need for improvement by all Firms, particularly in the areas of audit evidence and documentation, reliance on another auditors' or experts' work, risk assessments (including risk of fraud), impairment testing, fair value measurements, related party transactions, going concern assessments and engagement quality control reviews.

Key findings—quality control

- 15 While the Firms previously inspected have made enhancements and refinements to audit quality systems and processes since our last public report, a key area of focus for National Firms continues to be the ongoing review and testing of quality control systems and ensuring that these systems remain relevant and robust, particularly in the context of risks associated with the GFC.
- 16 Some Network Firms have made good progress towards adopting common policies, systems and processes in respect of independence and audit quality within their practice. However, a number of Network Firms were in a transitional phase in modifying their systems,

- policies and processes to ensure uniformity in approach across member firms.
- 17 For Network Firms, it is critical that once common quality control policies and processes are fully embedded, an effective testing and monitoring regime is established to assess the effectiveness of quality control systems. Network Firms also need to establish clear linkages between partner remuneration and the results of quality monitoring reviews of both independence and audit engagements.
- 18 Our observations and findings for Smaller Firms related primarily to a failure to record on the audit engagement files all the work which the auditor performed and relied on in forming conclusions and, in some cases, failing to perform certain audit procedures.
- 19 Quality control areas that the Smaller Firms also need to focus on include formalising independence and monitoring processes to ensure compliance with the requirements of the *Corporations Act 2001* (Corporations Act) and professional and ethical standards.

Future focus

- 20 As the full effect of the GFC is still uncertain, our inspection approach continues to focus on relevant audit risk areas and how firms are addressing those areas.
- 21 Inspections will continue to focus on quality control systems and processes with a greater emphasis on engagement performance for those firms previously inspected. We will continue to focus on those firms that audit entities likely to be of greater public interest. We will also continue to focus on how firms are complying with the Auditing Standards and professional and ethical standards, paying particular attention to those Auditing Standards impacted more by the effects of the GFC and those that were poorly applied in previous years.

A The audit inspection program

Key points

There remains a need for improvement by the firms in relation to audit evidence and documentation, including in areas most affected by the GFC. The full implications of the GFC are still unknown.

We have observed that significant improvements in quality control systems and processes are made after our first inspection of a firm.

Objective

- 22 ASIC’s audit inspection program aims to promote high-quality external audits of financial reports under Ch 2M of the Corporations Act of listed and other entities of greater public interest so that users can have greater confidence in financial reports. A strong audit profession helps maintain and promote confidence and integrity in Australia’s capital markets.
- 23 The purpose of the inspection program is not to benchmark the Firms and firms are responsible for addressing any improvement areas identified.
- 24 Our audit oversight activities help maintain and raise the standard of conduct in the auditing profession. We focus on audit quality and promoting compliance with the requirements of the Corporations Act, Auditing Standards and Professional Ethical Standards. We do not seek to confirm the overall audit opinions.
- 25 Our inspection program has an education and compliance focus, although enforcement action will be taken where significant non-compliance is identified. Such enforcement actions are outside the scope of the audit inspection program and are referred to ASIC’s Deterrence teams for further consideration and action.

GFC focus

- 26 The financial performance of many entities has been adversely affected by the global economic downturn. Our financial reporting surveillance media releases identify key financial reporting areas that have been significantly affected by the economic downturn. These media releases geared towards the accounting and audit profession,

- are published on a regular basis and available on our website (www.asic.gov.au).
- 27 Inevitably, the GFC has placed increased focus on accountants and auditors who are part of the financial reporting chain, together with management, directors, audit committees, internal audit, and external experts.
- 28 The GFC has heightened the need for auditors to focus on assessing the appropriateness of the going concern assumption, particularly given reduced liquidity and ability of clients to refinance debt or raise new funds, and comply with lending covenants. Firms need to ensure that audit team members have sufficient skills to audit fair values and impairments, or the means to engage their own expert if necessary. In addition, the scope of an expert's work, whether internal or external, must be adequate for audit purposes. Auditors need to adopt an even higher degree of professional scepticism in challenging clients, particularly for significant audit judgement areas.
- 29 As part of our inspection program activities, during 2008–09, we also met with the senior leadership of the eight largest firms in Australia to discuss and assess each firm's preparedness for auditing in the GFC. The purpose of these meetings was to understand the range of measures and specific actions undertaken by these firms to manage the implications of the GFC for their audit activities.
- 30 Generally, the firms that we met had taken proactive steps to manage the risks associated with the GFC on their audit clients. Some of these steps included identifying and reassessing audit client risk ratings, appointing specialist panels for quality assurance purposes, adopting an increased focus on specialist consultations, providing additional specific technical training on areas of focus, and reassessing the allocation of partners and staff for higher-risk engagements.
- 31 As the majority of the 101 individual audit and review engagement files we selected for review at National Firms, Network Firms and Smaller Firms were for financial reporting periods between 30 June 2007 and 31 December 2008, we will continue to focus on the effectiveness of the above initiatives in our 2009–10 audit inspection program.

Improvements since previous inspections

- 32 The firms inspected continue to respond positively to the legislative and professional requirements by implementing robust systems and processes that are designed to ensure compliance with the audit

quality and auditor independence requirements of the Corporations Act, Australian Auditing Standards (ASAs) and Accounting Professional and Ethical Standards (APESs).

- 33 Most firms improve their quality control systems after the first inspection. In most instances, the results of the first inspection indicate that some quality control elements either have not been addressed by these firms, or many systems and processes have not been fully developed.
- 34 Subsequent inspections almost always show a marked improvement in most, if not all, areas identified in the first inspection receiving attention by the Firms' leadership. Many Firms have committed, and continue to commit, dedicated technical resources and, where required, have developed or further enhanced existing policies and systems to assist them in complying with legislative requirements. This trend was also observed in this cycle of inspections.

Changes to the inspection approach

- 35 A number of Firms meet the revised definition of a network firm contained in Accounting Professional and Ethical Standard APES 110 *Code of Ethics for Professional Accountants* (APES 110), applicable from 1 July 2008. We therefore changed our approach from individual Firm inspections to inspections of a number of member firms of a network. Five Firms were inspected under a network basis for the first time in this inspection cycle.
- 36 In 2008–09, we inspected four National Firms and nine Network Firms where we undertook full-scope inspections comprising the review of firm-wide procedures and review of individual audit and review engagements. We also extended our coverage, using a limited inspection scope, to include six Smaller Firms. We maintained the number of audit and review engagements selected for review compared to the previous inspection cycle, with particular focus on those entities with a heightened risk as a result of the GFC and those Auditing Standards that our previous inspections showed required continued attention.
- 37 Appendix 1 contains further details about how we conducted our work.

Scope of our audit inspections

- 38 This is the fourth public report on our audit inspection program since the enactment of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9) on 1 July 2004.
- 39 This report summarises the results of audit inspections of 19 audit firms (Firms) conducted over an 18-month period from 1 January 2008 to 30 June 2009. The Firms inspected range in size as follows:
- (a) national partnerships that are members of global networks with multiple offices (National Firms);
 - (b) individual offices of Firms that are members of international associations (Network Firms); and
 - (c) firms with small number of audit partners that audit a limited number of listed entities (Smaller Firms).
- 40 A summary of our inspections of the Firms and whether they were inspected for the first time or more than once is provided in Table 1.

Table 1: Summary of firms visited in 2008–09

Firms	Inspected for the first time	Inspected more than once	Total
National Firms	—	4	4
Network Firms	8	1	9
Smaller Firms	6	—	6
Total	14	5	19

Note 1: For the eight Network Firms visited once, under the revised APES definition of a network firm applicable from 1 July 2008, five firms were inspected on a network basis with a number of member firms of the network being inspected. One of these networks had previously been inspected in 2007. Three individual member firms of other network firms were also inspected.

Note 2: The Network Firm visited more than once relates to a follow-up inspection of an individual member firm of a network.

- 41 This report is structured as follows:
- (a) Section B sets out our observations and findings from the review of 95 audit and review engagements for National and Network Firms;
 - (b) Section C sets out our observations and findings on quality control systems from the reviews of National Firms and Network Firms;

- (c) Section D details our observations and findings from the review of quality control systems and six audit engagement files from the Smaller Firm inspections;
- (d) Section E outlines the future focus of the audit inspection program; and
- (e) Appendix 1 provides information on how we conduct our work.

Previous inspection reports

- 42 In September 2005, we published our first public audit inspection report covering the 2004–05 financial year. This report assessed whether firms had documented and implemented a quality control system that provided reasonable assurance of compliance with the auditor independence requirements of the Corporations Act.
- 43 In 2005–06, we broadened our scope to assess whether firms’ audit methodologies facilitated the conduct of audits in compliance with the audit quality requirements of the Corporations Act. Our second public report covering this extended scope was published in August 2006.
- 44 Our third public inspection report, published in June 2008, covered an 18-month period from 1 July 2006 to 31 December 2007. During this period, we continued to focus on the firms’ independence policies, systems and processes, to assess compliance with the auditor independence requirements in Div 3, 4 and 5 of Pt 2M.4 of the Corporations Act and relevant professional and ethical standards.
- 45 This inspection report and previous reports are available on our website (www.asic.gov.au).

Diversity of Firms

- 46 As at June 2009, the National Firms audited approximately 900 (S&P 300–260) listed entities which accounted for 95% (S&P 300–97%) in terms of total market capitalisation.
- 47 Firms differ in areas such as size, nature, type of audit clients and risk management strategies. How each firm complies with its legal and professional obligations is affected by these factors.
- 48 Even among National and Network Firms there are differences in their size, structures, strategies, target markets, extent of centralised resources, international reach and risk management strategies. There are even greater differences when Smaller Firms are compared with

National and Network Firms. As a result, observations and findings varied between the National Firms, Network Firms and Smaller Firms.

- 49 Our inspection program for National Firms, Network Firms and Smaller Firms is appropriately tailored to recognise this diversity.

International collaboration

- 50 As noted in our last public report, ASIC entered into an arrangement with the US-based Public Company Accounting Oversight Board (PCAOB) on 17 July 2007 to assist the PCAOB ascertain compliance by Australian auditors with the *Sarbanes-Oxley Act of 2002* (US). Three inspections were conducted jointly with the PCAOB during the period covered by this report.

B Audit quality—National and Network Firms

Key points

There continues to be room for improvement by all firms with regard to:

- sufficiency and appropriateness of audit evidence and documentation;
- reliance on another auditor's or expert's work;
- risk assessments;
- impairment testing and fair value measurements;
- going concern assessment; and
- engagement quality control reviews.

Introduction

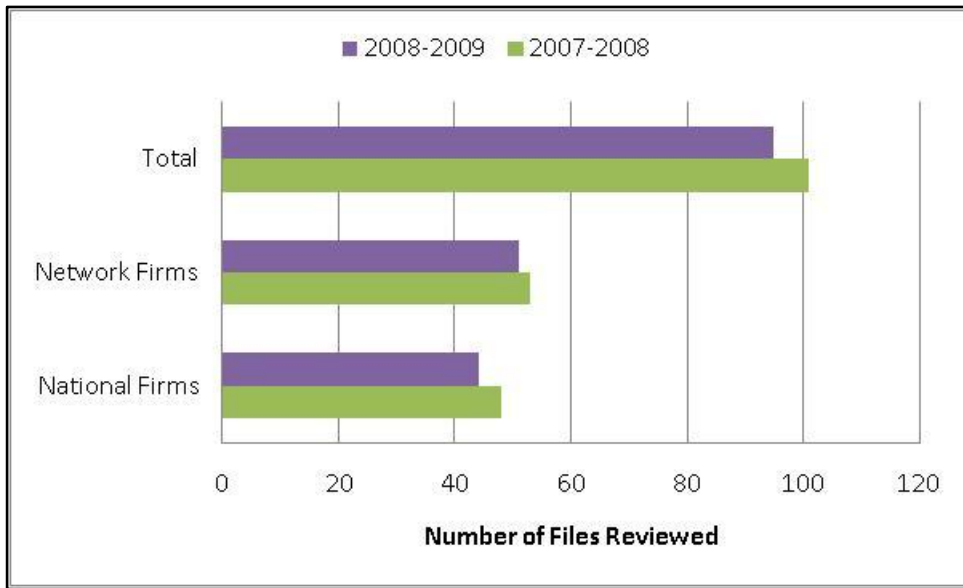
51 Our inspection program focused on the practical application of the Firms' audit methodologies. During the 18-month period covered by this report, we inspected 19 Firms and reviewed 88 audit and 7 review engagements across the National Firms and Network Firms. In comparison, during the period covered by the previous public inspection report, we undertook 82 audit and 19 review engagements.

Note: The 88 audit and 7 review engagements exclude 6 audit engagements that were reviewed as part of the Small Firm inspection program (see Section C).

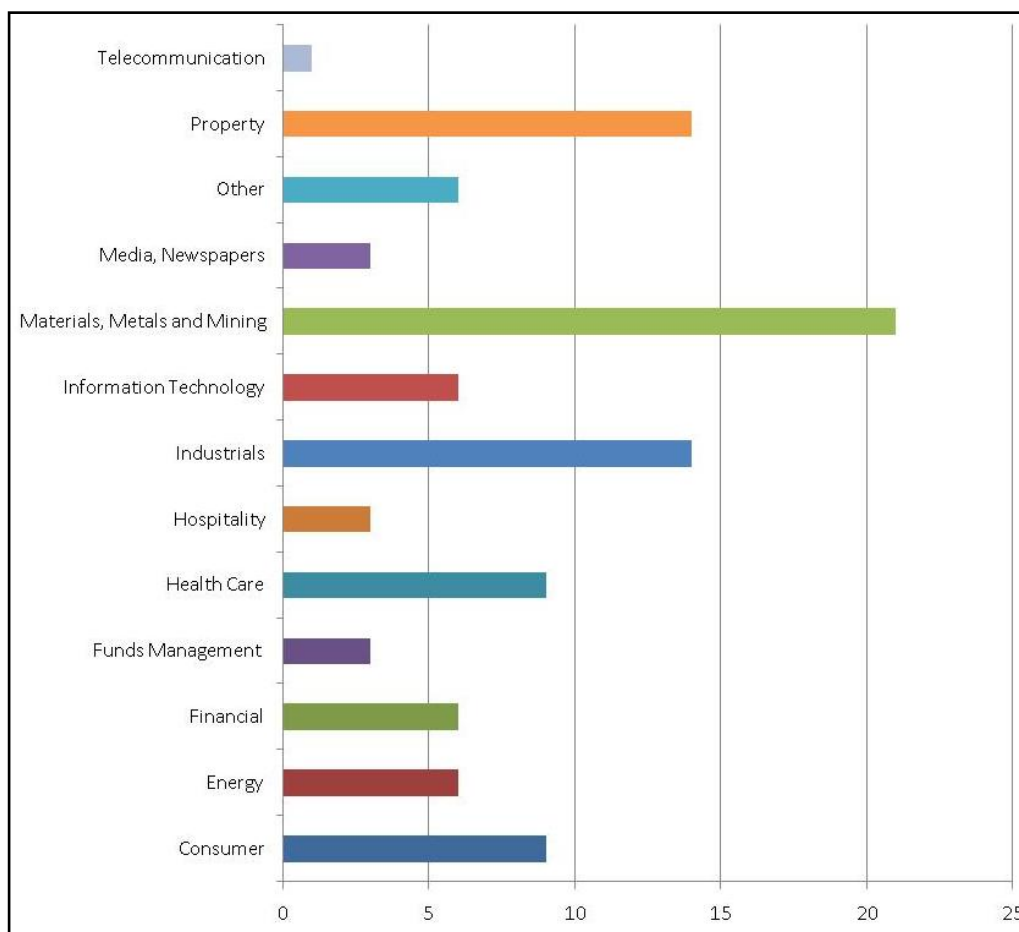
52 Similar matters were noted in relation to National Firms and Network Firms from the engagement file reviews. For this reason we have not made a distinction between observations and findings that relate to National Firms or Network Firms in this section.

53 We only reviewed those engagements where the final assembly of the audit and the review engagement file has been completed by the firm. Auditing Standard ASA 230 *Audit Documentation* (ASA 230) ordinarily allows 60 days after the audit report date for the final assembly of the file to be completed. As such, the majority of the individual engagement files selected for review in Figure 1 were for financial reporting periods ending between 30 June 2007 and 31 December 2008.

Figure 1: Number of engagement files reviewed by ASIC during public reporting years



- 54 The engagement file reviews focused on specific areas affected by current economic conditions. Each review focused on the substance of the auditor’s work and on whether sufficient appropriate audit evidence was on file to support the conclusions reached in relation to key audit decisions and significant judgements.
- 55 Our file selections were spread across a number of sectors and based on entities perceived to be at heightened risk as a result of the economic downturn. A summary of the basis for selecting engagement files reviewed is provided in Figure 2.

Figure 2: Engagement files reviewed by sector 2008–09

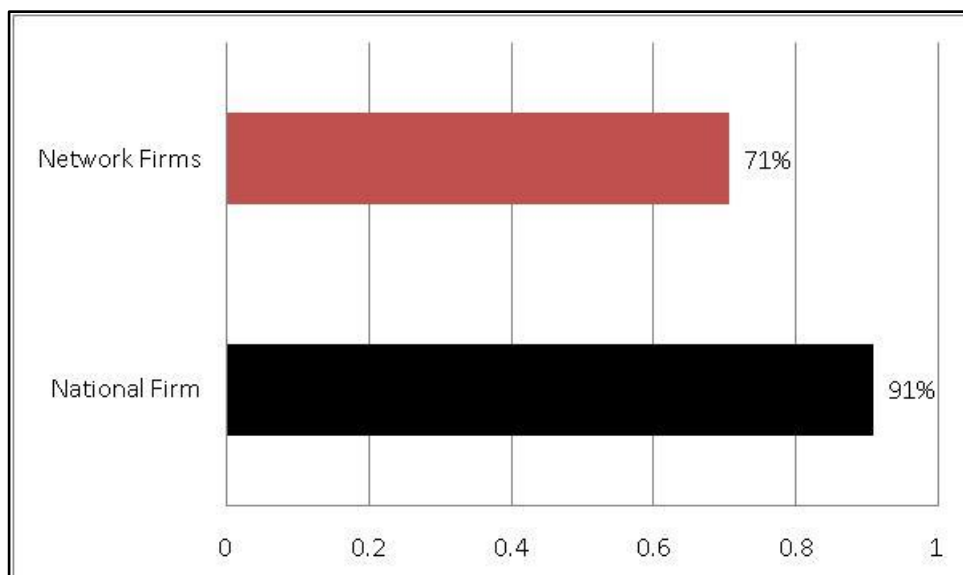
Audit quality

- 56 Our review of aspects of the 95 selected engagement files at National Firms and Network Firms was designed to focus on audit quality to assess whether the key matters that contribute to an audit opinion or review conclusion had been adequately considered by the engagement team. It was not designed to detect all instances of non-compliance or to confirm all aspects of the audit opinion or the review conclusion.
- 57 Our reviews revealed a number of instances where documentation on the engagement file failed to provide sufficient appropriate audit evidence to support certain audit assertions. A lack of audit documentation meant there was a lack of sufficient appropriate audit evidence on the engagement file to support certain audit assertions, even allowing for oral explanations.
- 58 In some cases, the auditor failed to perform or to document certain mandatory audit procedures necessary to support the audit opinion or the review conclusion. In these cases, we challenged audit partners

regarding the basis on which significant judgements were made prior to their signing of the audit or the review report.

- 59 As a result of our discussions with the audit partners, in a few instances, further audit work was performed by engagement teams to confirm that the original judgements and conclusions were appropriate and that the financial report was not materially misstated.
- 60 Network Firms and National Firms continue to communicate our and their own internal monitoring findings regarding engagement files to individual engagement teams as well as the broader audit practice through technical training sessions, regular staff alerts and bulletins.
- 61 We have reported separately to each Firm in relation to these deficiencies and in some cases have accelerated our follow-up inspections of firms to ensure that corrective actions taken by the Firms are adequate.
- 62 The proportion of reviewed engagement files that contained sufficient appropriate audit evidence to support all key conclusions appears in Figure 3.

Figure 3: Percentage of engagement files which contained sufficient appropriate audit evidence to support key conclusions reached

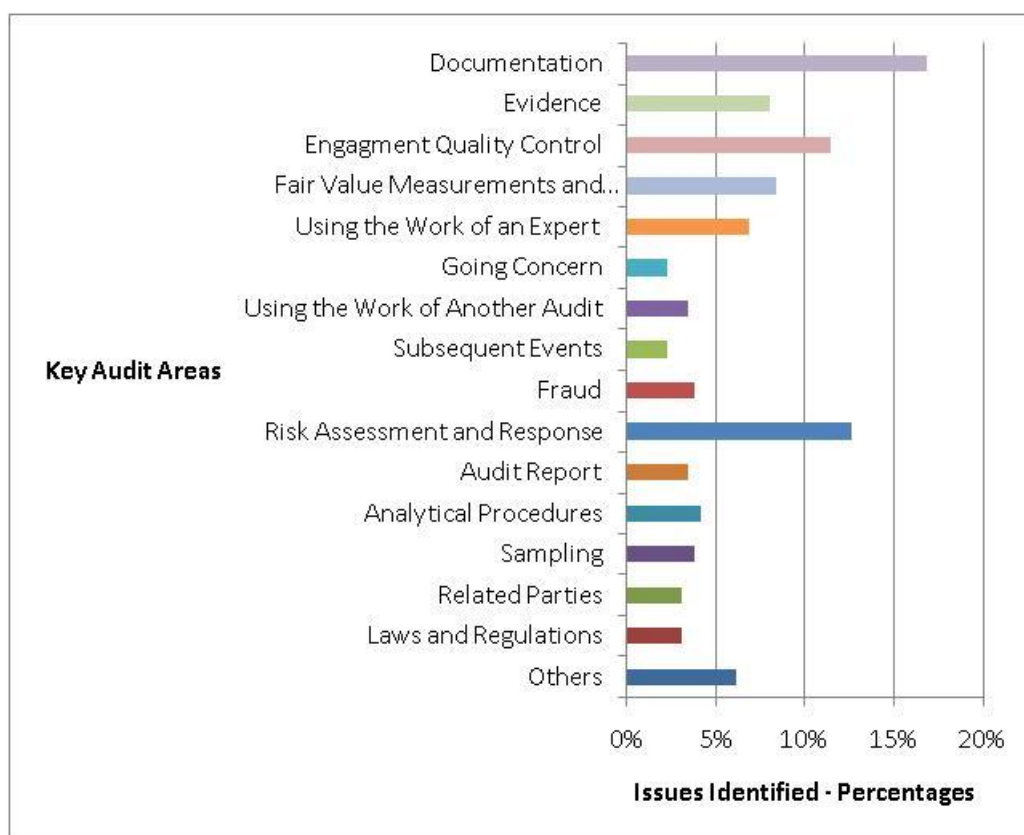


Common observations and findings

- 63 A summary of our observations and findings from the 95 engagements inspected at National Firms and Network Firms is provided in Figure 4.

- 64 This chart represents observations and findings in the key audit areas requiring improvement as a percentage of the total observations and findings from the 95 engagement files reviewed. These observations and findings are presented in two parts to reflect:
- (a) matters that were frequently identified across the Firms and most significant in the context of the risks associated with the economic downturn; and
 - (b) other matters requiring improvement.

Figure 4: Observations and findings from engagement file reviews



Note: Figure 4 represents observations and findings in each key audit area as a percentage of the total observations and findings from the 95 engagement files reviewed.

Audit documentation and audit evidence

- 65 The Corporations Act requires audits to be conducted in accordance with the Auditing Standards. The same Auditing Standards were applicable for all 95 engagements selected for review.
- 66 Auditing Standards ASA 230 and ASA 500 *Audit Evidence* (ASA 500) require the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base their opinion. However, insufficient documentation of audit work

undertaken and the basis on which audit judgements have been made continues to be a major area of concern. Documentation deficiencies are pervasive across a number of areas noted in this section.

Lack of documentation and audit evidence

67 Matters relating to audit evidence and documentation accounted for 25% of the total issues noted in the 95 engagement files we reviewed. A number of these related to:

- (a) inadequate documentation to support the audit procedures performed or the evidence obtained; and
- (b) incomplete or late assembly of engagement files.

68 In most of these cases, there was a failure to record on the engagement file audit work which the auditor performed and relied on in forming their conclusions about key audit assertions. In these cases, there is a risk that the audit work was not adequately performed and that the conclusions reached were not appropriate.

69 In some instances, the auditor may have failed to perform certain procedures.

70 In the majority of cases, the auditor made verbal representations that the audit work had been performed but not documented.

71 Paragraph 13 of ASA 230 states that ‘ordinarily, oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation’.

72 In addition a fundamental requirement of paragraph 11 of ASA 230 is that ‘the auditor shall prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:

- (a) the nature, timing, and extent of the audit procedures performed to comply with Auditing Standards and applicable legal and regulatory requirements;
- (b) the results of the audit procedures and the audit evidence obtained; and
- (c) significant matters arising during the audit and the conclusions reached thereon.’

Documentation must be timely

73 ASA 230 also requires timely preparation of audit documentation that provides a sufficient and appropriate record of the basis for the auditor’s report and evidence that the audit was performed in

accordance with the Auditing Standards and applicable legal and regulatory requirements.

- 74 Timely documentation of audit procedures performed helps ensure the quality of the audit, and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the audit report is finalised.
- 75 In many cases, the engagement files were not assembled and completed within 60 days of signing of the audit report. Auditing Standard ASA 230 ordinarily allows 60 days after the audit report date for the final assembly of the engagement file to be completed.

Engagement quality control

- 76 In a number of engagement files there was a lack of evidence of reviews by the engagement partner and the EQCR partner and/or a lack of timely reviews. In particular:
- (a) engagement partners or EQCR partners didn't identify a lack of sufficient appropriate audit evidence and documentation to support key conclusions reached;
 - (b) there were recurring or similar findings of deficiencies from the Firms' own internal quality monitoring processes;
 - (c) there was minimal documentation of high-risk areas and complex matters considered by the engagement partner and/or the EQCR partner at the planning and/or the completion phases of the audit; and
 - (d) time records for a number of engagements indicated that the EQCR partner spent or recorded less than 1% of the total time charged by the engagement team to the individual engagement, including instances where no time was charged by the EQCR partner.
- 77 ASA 220 requires that before the auditors' report is issued, through review of the audit documentation and discussion with the engagement team, the engagement partner shall be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.
- 78 ASA 220 also requires an engagement quality control review for audits of financial reports of listed entities that includes an objective evaluation of the significant judgements made by the engagement team, and conclusions reached in formulating the auditor's report.
- 79 The involvement of a suitably-qualified EQCR partner at critical stages of the audit (including the review of audit planning and review of the engagement teams' key judgements and conclusions) is a vital element of quality control.

Fair value measurements and impairment

- 80 Auditing Standard ASA 545 *Auditing Fair Value Measurements and Disclosure* (ASA 545) requires the auditor to obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework. ASA 545 applies to fair value measurement for the purpose of impairment testing under the accounting standards and similar impairment calculations, such as 'value in use' calculations.
- 81 Values of many assets were affected by the economic downturn. Accounting standards have required enhanced disclosures of key valuation assumptions and sources of estimation uncertainty.
- 82 In a number of engagements reviewed, auditors failed to adequately document their consideration of whether client staff had the relevant expertise and experience to perform 'value in use' calculations in accordance with Accounting Standard AASB 136 *Impairment of Assets* as required by ASA 545 and whether there was a need to use the work of an expert. Similar issues were noted when financial models were utilised to determine fair values.
- 83 In some instances where there was a significant risk relating to the fair value of an asset, the auditors did not adequately document or challenge whether the key assumptions used by management provided a reasonable basis for measuring fair value and disclosures in the financial report.
- 84 Other common flaws observed included:
- (a) lack of clarity in the audit working papers, which suggested the auditor did not understand the nature of the discount rate being used or the nature of the cash flows being discounted;
 - (b) the discount rate utilised not reflecting the risks specific to the asset;
 - (c) the use of high growth rate assumptions, both within and beyond explicit forecast periods, which were not adequately supported and in some cases very optimistic;
 - (d) poor documentation of sensitivity analyses performed by the engagement team to test management assumptions;
 - (e) failing to evaluate whether the disclosures about fair values made by the entity were in accordance with the relevant accounting standards;
 - (f) the client omitting an estimate of some key future cash flows which the company expected to derive from the asset; and

- (g) failing to ensure that the ‘value in use’ calculation was consistent with other audit evidence obtained during the audit, including valuation cross checks.

Using the work of experts

External experts

- 85 Auditing Standard ASA 620 *Using the Work of an Expert* (ASA 620) requires an auditor to obtain sufficient appropriate audit evidence that the scope of the expert’s work is adequate for the purpose of the audit. The auditor is also required to evaluate the expert’s objectivity. The risk that an expert’s objectivity may be impaired increases where the expert is employed by the client.
- 86 A number of engagement files we reviewed did not adequately document how the auditors met the requirements of ASA 620. Common deficiencies were:
- (a) the lack of sufficient evidence on the engagement files that the auditor considered the professional competence and objectivity of the expert, the appropriateness of the expert’s work as audit evidence, and the reasonableness of the source data used by the expert to confirm the integrity and consistency of the data used;
 - (b) some experts’ work did not include independently assessing the reasonableness of key assumptions which underpinned the valuation and the audit documentation did not adequately address this key limitation of scope in the expert’s work; and
 - (c) it was not always clear that an expert engaged to determine the discount rate had determined the rate having regard to the risks attached to cash flows, as required by the relevant accounting standard.

Internal experts

- 87 Due to the recent economic downturn, it is increasingly common for engagement teams to rely on internal specialists for key areas of work such as fair value measurement and asset impairment.
- 88 Although appropriate use of specialists should enhance audit quality, in some instances engagement teams accepted the work undertaken by specialists without an adequate review of the sufficiency and appropriateness of audit evidence obtained, including in some instances where specific restrictions on the scope of the specialists’ work were not addressed.

- 89 Engagement teams need to ensure that work performed by specialists is fully-integrated into the audit process, and ensure there are no gaps in work by clearly agreeing on the scope of the work to be performed, clarifying respective responsibilities, and ensuring that the scope and conclusions are appropriately documented.

Going concern

- 90 Auditing Standard ASA 570 *Going Concern* (ASA 570) requires the auditor to consider the appropriateness of management's assessment of the entity's ability to continue as a going concern in the preparation of the financial report.
- 91 ASA 570 requires the auditor to undertake specific procedures when events or conditions have been identified, which may cast significant doubt on the entity's ability to continue as a going concern. This includes gathering sufficient appropriate audit evidence to confirm or dispel whether or not material uncertainty exists by performing audit procedures and considering the effects of management plans and other mitigating factors.
- 92 In a small number of engagement files, there appeared to be a lack of sufficient appropriate audit evidence supporting the auditor's consideration and evaluation of management's assessment of the entity's ability to continue as a going concern. We noted instances where key indicators such as cash flows for the next 12 months from the date of the audit report, were not considered by the auditor. In two instances, events or conditions casting doubt on the entity's ability to continue as a going concern had been identified but a modified opinion was not issued.

Using the work of another auditor

- 93 Auditing Standard ASA 600 *Using the Work of Another Auditor* (ASA 600) requires the principal auditor to consider the professional competence of the other auditor when planning to use the work of that auditor.
- 94 In a small number of the 95 engagement files reviewed, the work of another auditor was relied upon by the principal auditor. In many of these cases there was insufficient evidence on the engagement files that the auditor considered the professional competence of the other auditor.
- 95 Although most of the other auditors were part of the network firm, it is still necessary for the auditor to give appropriate consideration to their competency. While some firms had enquired about the results of the

internal quality reviews of the other audit firm, this was not part of the formal quality control process.

- 96 Other common deficiencies noted were a lack of sufficient appropriate audit evidence and/or documentation to evidence that:
- (a) the work of the other auditor was adequate in a context of the subsidiary audit and complied with the Auditing Standards;
 - (b) the principal auditor had considered the impact of any substantial differences between the auditing and accounting standards where the entity audited by the other auditor is overseas; and
 - (c) all the work requested by the principal auditor in the interoffice or group instructions were actually received and/or reviewed by the principal auditor.

Subsequent events

- 97 Auditing Standard ASA 560 *Subsequent Events* (ASA 560) requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment or disclosure in the financial report are identified.
- 98 In a few engagement files reviewed, there was no evidence that adequate audit procedures had been performed to ensure that events up to the date of the auditor's report had been considered. In a number of instances, subsequent events work was performed, however, this was performed well before the date of the audit report.
- 99 In some instances, there was a lack of sufficient appropriate audit evidence on the engagement file to support that audit work had been performed prior to signing the audit opinion or review conclusion to fully determine the materiality of the subsequent event, and therefore to support conclusions relating to the non-disclosure of post-balance date events in the financial report. In other instances, although the directors' report contained disclosure on subsequent events, the audited financial reports did not contain similar disclosures.

Fraud

- 100 Auditing Standard ASA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report* (ASA 240) requires consideration of the risks of material misstatement in the financial report due to fraud in planning and performing the audit, and perform procedures to reduce audit risk to an acceptably low level.

- 101 Common issues noted in this area included a lack of robust documentation of fraud risk discussions within the engagement team during audit planning with those charged with governance.
- 102 In a number of instances, firms have implemented checklists or questionnaires to assist in ensuring compliance with the requirements of the standard. Although the checklists were generally completed by engagement teams, there was limited or no documentation on the engagement file supporting the risk factors identified and how audit procedures were designed to address those risks.
- 103 Contrary to the requirements of the standard, we also noted some instances where limited or no audit procedures were performed to identify and assess the risks of material misstatement due to fraud relating to revenue recognition.

Risk assessment and response

- 104 Auditing Standards ASA 315 *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* (ASA 315) and ASA 330 *The Auditor's Procedures in Response to Assessed Risks* (ASA 330) require understanding the entity and its environment, including its internal controls, and assessing the risks of material misstatement of the financial report (whether due to fraud or error), and designing and performing further audit procedures at the financial report and assertion levels in a financial report audit.
- 105 In a number of engagements reviewed, there was a lack of sufficient appropriate audit evidence on file to indicate that the requirements of the standards had been met. In some cases, there was no documented assessment and understanding of the entity and its environment, including its internal controls to identify and assess the risks of material misstatement of the financial report.
- 106 The requirements to assess the significance of identified risks during the planning process and reassessing those risks throughout and at the end of the audit were not complied with in some instances. Also, the identified risks were not linked to audit procedures designed to mitigate those risks in some instances.
- 107 Other non-compliances related to a lack of audit documentation to evidence that a review of accounting policies and an evaluation of the overall presentation of the financial report had been performed, and that material journal entries and other adjustments made during the course of preparing the financial report had been examined.

Form and content of audit reports

- 108 A number of audit reports for the engagements selected for review were not in compliance with the requirements of Auditing Standard ASA 700 *The Auditor's Report on a General Purpose Financial Report* (ASA 700) or the Corporations Act. For example, at one Network Firm we noted that several auditor's reports did not include an opinion on whether the remuneration report contained in the directors' report complied with the Corporations Act. At another Network Firm, we noted that some audit opinions were not signed under the correct name of the firm.

Other observations and findings

- 109 Our other observations and findings from the review of the audit and review engagement files are detailed below.

Analytical procedures

- 110 In a number of cases, analytical procedures used in the planning of the audit were not performed well, with limited or no predictive analysis undertaken and management data was utilised without adequate work to ascertain the reliability of the data.
- 111 Similarly, for substantive analytical procedures, it was common for engagement teams to document explanations provided by management without further independent corroboration of the explanations or reference to the auditors' own understanding of the entities' operations.

Sampling

- 112 In a small number of engagement files reviewed, we found instances of inappropriate sampling methods, inadequate sample sizes and poorly-documented rationales for selecting particular items for audit testing.
- 113 Further, the auditor's consideration of the sample results, the nature and cause of any errors identified and their possible effect on the particular audit objective on some engagements were not documented in the engagement file.

Related parties

- 114 Several engagement files had insufficient audit work in relation to the identification and assessment of related parties, related party

transactions and completeness of related party disclosures in the financial statements in accordance with the requirements of Accounting Standard AASB 124 *Related Party Disclosures*.

Laws and regulations

- 115 Several engagement files failed to demonstrate either an assessment of the client's compliance with laws and regulations or obtain specific representation from management regarding compliance with applicable laws and regulations.
- 116 In addition, at one Network Firm, we noted that the director's report (accompanying the audited financial report in the annual report) did not contain certain disclosures required by the Corporations Act.

C Quality control systems—National and Network Firms

Key points

Some National Firms need to improve the review and testing of their quality control systems, particularly in the context of auditor rotation.

Many Network Firms need to fully implement common quality control policies and processes.

Network Firms need to adopt an effective testing and monitoring regime to assess the effectiveness of their quality control systems.

Introduction

- 118 All firms need to have quality control systems in place that meets the requirements of Accounting Professional and Ethical Standard APES 320 *Quality Control for Firms* (APES 320) and Auditing Standard ASA 220 *Quality Control for Audits of Historical Financial Information* (ASA 220).
- 119 In assessing the firms' quality control framework we follow the elements set out in APES 320, being: leadership responsibilities for quality within the Firm, ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources, engagement performance and monitoring.
- 120 The following sections summarise ASIC's observations and findings for each of these elements with respect to National Firms and Network Firms inspected during 2008–09.

National Firms

Leadership responsibilities for quality within the firm

- 121 National Firms have policies and procedures designed to ensure audit quality and that audits are performed in accordance with legal and professional requirements.
- 122 Although the frequency of independence and audit quality messages appear to be adequate at all National Firms, the observations and findings from some National Firm's own monitoring processes and

our engagement file reviews were, in some cases, at odds with these messages.

- 123 National Firms should continue to ensure that appropriate leaders within their respective firms regularly reinforce the ‘tone at the top’ messages about audit quality and the consequences of non-compliance to partners and staff.

Ethical requirements and independence issues

Policies, systems and processes

- 124 All National Firms have implemented systems and processes to facilitate compliance with their independence policies, and many Firms continue to improve their policies and systems. National Firms’ policies and procedures require partners and senior staff to disclose their investments on an interactive database which is automatically matched with a prohibited securities list.
- 125 Although the extent of testing performed by the National Firms on independence quality control systems varies between each Firm, the sample sizes for testing partner independence declarations on a periodic basis increased for all Firms in 2008–09.
- 126 Irrespective of the sophistication of the systems in place or the sample sizes tested by each National Firm, all National Firms’ internal testing of compliance continued to reveal non-compliances with their independence policies and systems. It is important to note, however, that in some areas the National Firms’ policies include requirements that go further than those of the Corporations Act.
- 127 The most common non-compliance with policy at some of the National Firms continued to be the failure of partners and staff to record all reportable investments and financial interests in the Firms’ independence monitoring systems. This is despite the level of resources invested by the National Firms in their quality control infrastructure, and continuous reinforcement of independence requirements through training and communications to partners and staff from the Firms’ leadership.

Auditor rotation

- 128 Four contraventions of the auditor rotation requirements of the Corporations Act were noted at two of the National Firms—three at one firm and one at another firm. These contraventions of the Corporations Act were identified by the firm’s internal monitoring systems and disclosed to ASIC on a voluntary basis. In all cases, an

ineligible partner played a significant role either as an engagement partner or engagement quality control review partner in the audit of a listed client for more than five out of seven successive financial years.

- 129 The Firms' investigations into the root cause of these contraventions indicated that improvements were required to either the auditor rotation databases that captured the partner rotation information or other related internal monitoring processes. The leadership of each Firm took strong and timely action, including financial sanctions, against the partners involved. These National Firms also enhanced their rotation monitoring processes to reduce the possibility of further breaches.

Consultations

- 130 Some National Firms need to ensure that independence consultations are better documented so that potential independence threats are identified, escalated, and action is taken to reduce the threats to an acceptable level. National Firms increased the importance of compliance with independence requirements when evaluating partner performance, by imposing financial penalties for significant identified non-compliances.

Acceptance and continuance of client relationships and specific engagements

- 131 All National Firms have robust policies and processes for client and engagement acceptance and continuance, including allocating risk ratings to all audit clients. In response to the GFC, National Firms have increased their attention to managing the risks associated with accepting and retaining clients and have reassessed the ratings of individual clients and engagements.

Human resources

- 132 We reviewed the partner and staff evaluation and remuneration processes at all National and Network Firms to assess auditor independence and audit quality aspects.
- 133 National Firms have extensive human resource policies and procedures that give due recognition to audit quality, ethical principles, competence in staff and partner evaluation, remuneration and promotion procedures. However, the practical application of these policies and procedures can be further improved.
- 134 Some common observations from a limited sample of partner and staff performance evaluation documents reviewed at each National Firm

included the need to improve the sufficiency and uniformity of documentation regarding partner and staff performance reviews. There was a lack of transparent indicators linking compliance with independence policies and the results of internal monitoring reviews to partner remuneration and bonus allocations.

- 135 We also noted that some National Firms were not recording industry-specific training for staff. These National Firms need to implement processes to record industry-specific training to help identify staff with relevant industry knowledge for specialised and complex audit engagements.

Engagement performance

- 136 All National Firms continue to enhance their systems and processes to better integrate audit technology with their audit methodology. A number of Firms implemented, or are in the process of implementing, new audit technology systems.

Monitoring

Policies and procedures

- 137 All National Firms have comprehensive policies and procedures to govern the monitoring of independence and audit quality in accordance with legal and professional requirements. The Firms make regular and rigorous periodic inspections of a selection of completed audit engagements and the results are reported to their leadership team. Further, National Firms have clear accountable action plans for ongoing consideration and evaluation of their quality control systems and staff training.

Monitoring review findings

- 138 Overall, the processes developed and adopted by National Firms appear to be robust. However, in some instances, we noted that the types of issues identified through the internal quality review processes were very similar when compared with the previous year's monitoring results. This raises the question as to whether the Firms' program is an effective mechanism in changing partner and staff behaviour and whether the means of addressing recurring non-compliance were effective.

Timing or monitoring reviews

- 139 At some National Firms, there was a significant time delay between conducting audit work and the timing of internal quality reviews due

to the Firms' global quality monitoring timeframes. This may impact on audit quality due to a lack of timely remedial action in relation to individual engagements.

- 140 To prevent deficiencies similar to those detected in past reviews from being repeated in future engagements, prompt disciplinary action is required against partners and staff who fail to comply with the Firms' policies and procedures as well as other appropriate actions such as timely and effective staff training. Given that the timing of these reviews is governed by global policies, the affected Firms have put in place other initiatives and communication strategies to ensure that key messages from the quality reviews are provided efficiently to staff.

Reporting to ASIC

- 141 Some National Firms need to ensure they comply with their obligations under s311 of the Corporations Act to report contraventions and suspected contraventions of the Corporations Act to ASIC. These include contraventions in relation to the auditor independence requirements of the Corporations Act and significant non-compliances with Accounting and Auditing Standards.

Network Firms

Leadership responsibilities for quality within the firm

- 142 While all Network Firms have indicated their commitment to audit quality during our inspections, there is a clear need to further strengthen their policies and procedures that promote the recognition of audit quality in performing engagements and the consequences of non-compliance with these policies and procedures.
- 143 The Network Firms' leadership need to clearly communicate and demonstrate an internal culture and tone that emphasises the overriding importance of audit quality, including in strategic plans or other similar documents.
- 144 Network Firms can further demonstrate 'tone at the top' by ensuring that transparent linkages exist between their monitoring processes for audit quality, auditor independence, partner and staff evaluation and remuneration processes.

Ethical requirements and independence issues

Policies, systems and processes

- 145 The completeness and adequacy of independence policies varied among Network Firms. In particular, a number of Firms were still in a transitional phase in modifying their systems, policies and processes to ensure uniformity between member firms. Therefore we were unable to assess the operating effectiveness of policies and procedures over an extended period of time at these firms. In some instances, we noted inconsistencies in policies and the practical application of systems and processes at Network member firms.

Testing of independence systems

- 146 With the exception of two Network Firms, testing the independence systems and processes used to ensure compliance with their legal and professional independence requirements had not commenced at Network Firms. For one of the two Network Firms that is testing its independence systems, the program is not comprehensive and the Network Firm did not deal with identified breaches arising from its testing process in a timely manner.
- 147 Without a robust testing program, only limited reliance can be placed by Network Firms on the effectiveness of their independence systems and processes.

Auditor rotation

- 148 Based on the size and nature of their listed audit client portfolios, Network Firms do not have sophisticated systems to monitor compliance with the auditor rotation requirements of the Corporations Act. However, some of the more common findings for some of the Network Firms included:
- (a) no documented auditor rotation plan;
 - (b) rotation plan not updated to reflect recent partner movements; and
 - (c) the engagement quality control reviewer (EQCR) not included in rotation plans.

Consultation

- 149 In addition, some Network Firms lacked formal processes to record and monitor independence consultations and ensure that any potential independence threats were identified, documented and action taken to reduce the threats to an acceptable level.

Acceptance and continuance of client relationships and specific engagements

- 150 While no significant systemic issues were noted, many Network Firms need to make their client acceptance and engagement continuance systems and processes more comprehensive and rigorous. Appropriate consideration needs to be given to the risk assessment process, including implications of significant changes in the risk profile of existing clients. This should take into account the integrity of key management personnel, including their attitudes toward aggressive interpretation of accounting standards and the importance of an internal control environment, business reputation, its operations and practices and inappropriate limitation in the scope of audit work.
- 151 The primary focus should continue to be on independence considerations, possible conflicts of interests and whether the firm continues to have the requisite skills to conduct an engagement.
- 152 In some instances, we noted that detailed consideration of whether to continue with an existing audit engagement occurs after a firm has been appointed as the auditor at the client's annual general meeting and in some instances after the audit planning has commenced or been completed.
- 153 Network Firms need to ensure that continuance assessments are made immediately after completing an audit so that the decision to discontinue with the engagement can be communicated in a timely manner to the client prior to reappointment at the annual general meeting and consent to resign from ASIC is obtained in accordance with the Corporations Act and the timing outlined in ASIC policies.

Human resources

- 154 Most Network Firms do not have appropriate policies and procedures to adequately consider audit quality and independence attributes in partner performance evaluations, and many Network Firms do not document partner evaluations. Policies and procedures should be documented to ensure that partners and staff are aware of the Firm's expectations regarding audit quality and ethical principles.
- 155 Clear understanding of audit quality and adherence to ethical principles should be key criteria for advancement and remuneration decisions. Failure to comply with these criteria should result in disciplinary and other appropriate action, such as training.
- 156 An adequate system of performance appraisals needs to be in place in order for partners and staff to receive meaningful feedback on their

performance, including advice on areas of improvement and additional training needs.

- 157 Completion and approval of appraisal documentation for both partners and staff should be on a timely basis to promote audit quality. In addition, the results of internal and external quality monitoring processes and outcomes of the Firms' independence testing should be incorporated into individual performance evaluation and remuneration.

Engagement performance

- 158 Some Network Firms are yet to develop or implement comprehensive audit manuals that provide practical guidance on Auditing Standards and application of the audit firm's software to ensure clarity and consistency in the conduct of audit work. Gaps were noted between some Firms' audit technology software and audit manuals, which resulted in inconsistent application of electronic work paper methodology across members of Network Firms. Examples of shortcomings in engagement performance policies and their application at some Network Firms include:
- (a) lack of an up-to-date audit manual to provide staff with practical guidance on the Firm's interpretation of the Auditing Standards and the use of audit technology to ensure clarity and consistency in conducting audit work;
 - (b) no clear guidance in the existing audit manual on the roles and responsibilities of the EQCR, including the extent, timing and documentation requirements of the EQCR in accordance with ASA 220;
 - (c) no policy in audit manual regarding final assembly and archiving of audit engagement files, audit documentation requirements and inadvertent loss of engagement files;
 - (d) inconsistency in the use of audit methodology and technology between member firms of the same network; and
 - (e) non-utilisation of standard security features of the audit technology systems to enhance integrity of the engagement file (e.g. passwords and lockdown features not utilised, log of changes made to working papers and the function to back date and post date sign-offs not active).

Monitoring

- 159 Most Network Firms need to strengthen policies and procedures that facilitate monitoring of independence and audit quality requirements

to ensure they are relevant, adequate, operating effectively and are complied with in practice. Many Network Firms need to formalise internal monitoring policies and procedures by having clear guidance on the frequency of reviews, selection of audit files, and communication of the results of the reviews and consequences for partners and staff if the Firms' policies on audit conduct are not complied with.

- 160 While some Network Firms had commenced their periodic review of engagement files as required by their policy, others had not commenced these reviews. APES 320 requires periodic inspection of a selection of completed audit engagements.
- 161 A number of Network Firms need to adopt formal policies and procedures to deal appropriately with internal complaints and allegations of non-compliance with professional standards, regulatory and legal requirements.
- 162 All Network Firms need to improve their processes to ensure a clear and transparent link exists between the results of internal quality monitoring of engagement files and partner performance evaluations and remuneration.

D Smaller Firms

Key points

Smaller Firms need to focus on formalising their independence and quality monitoring processes.

Sufficient appropriate audit evidence, documentation of audit work undertaken and the basis on which audit judgements were made should continue to be major areas of focus for the Smaller Firms.

Introduction

- 163 There are approximately 90 small audit firms that audit entities listed on the Australian Securities Exchange (ASX). In 2008–09, we expanded our inspection program to include a selection of six Smaller Firms auditing entities listed on ASX.
- 164 Due to the size, client profile and nature of these firms, we used a limited inspection scope. Our inspections were limited to reviewing one listed entity audit engagement file for each firm selected and enquiring about aspects of the firm’s systems of quality control as they related to that engagement.

Audit quality

- 165 The observations and findings from our review of aspects of six selected engagement files indicated a general need to improve the level of documentation to evidence compliance with the Auditing Standards.
- 166 Smaller Firms also need to ensure that an adequate engagement quality control review is conducted for audits of financial reports of listed entities, while also managing the auditor rotation requirements of the Corporations Act. Such reviews should be conducted on a timely basis at appropriate stages during the audit, not only at the concluding stages, so that significant matters can be appropriately addressed.
- 167 In at least half of the six engagements reviewed, we noted the following concerns.

Evidence and documentation

- 168 We noted instances where the selected engagement file failed to provide enough audit evidence to support key audit assertions.
- 169 The deficiencies noted primarily related to a failure to record on the engagement file all of the audit work that the auditor asserted to have performed and relied on when forming conclusions about key audit assertions. These deficiencies increased the risk that the audit work was not adequately performed and that the conclusions reached were not appropriate.
- 170 Sufficient documentation of audit work undertaken and the basis on which audit judgements have been made should continue to be a major area of focus for Smaller Firms.

Use of experts

- 171 Some of the Smaller Firms inspected did not fully adhere to the requirements of the Auditing Standards concerning the use of experts when placing significant reliance on the work performed by a client-appointed expert. In some instances:
- (a) no evaluation of the professional competence and objectivity of the expert was performed; and
 - (b) there was insufficient evidence on the engagement file that the auditor had considered whether the scope of the expert's work provided adequate audit evidence and could be relied upon for the purpose of the audit.

Risk and fraud assessment

- 172 The risk assessments performed for the selected engagements were often not in compliance with the requirements of the Auditing Standards. The auditors did not link the identified risks to audit procedures designed to mitigate these risks, including fraud risk assessment procedures. Smaller Firms should ensure that:
- (a) proper identification and assessment of the significance of identified risks is undertaken during the planning process and a reassessment of those risks occurs during and at the end of the audit; and
 - (b) audit procedures are designed to adequately address significant risk areas identified.

Analytical procedures

173 Analytical procedures were either poorly or not completed by all of the firms. The Auditing Standards require analytical procedures to be applied as risk assessment procedures at the planning stage and in the overall review at the end of the audit. Smaller Firms should ensure that where management data is utilised, adequate work is performed on the reliability of the data, and management explanations for significant variances in financial statements are in accordance with the auditor's own understanding of an entity's operations.

Quality control systems

174 In conducting our inspections and in making our observations and findings, we are conscious of the size and nature of the Smaller Firms.

175 Our Smaller Firm inspections did not include a full review of firm-wide quality control systems. Rather, it was designed to ascertain the quality of audit conduct at Smaller Firms.

176 Our consideration of compliance by Smaller Firms' with the independence requirements of the Corporations Act and relevant professional and ethical standards was limited to high-level discussions with the Firms' leadership and considering independence matters relating to the individual audit engagement file selected for review.

177 Although our inspection of the Smaller Firms did not identify any independence breaches, Smaller Firms need to review their professional, ethical and statutory requirements in relation to independence and quality control to ensure they comply with their obligations, including the auditor rotation obligations under s324DA of the Corporations Act. For the Smaller Firms inspected we noted that:

- (a) Half of the firms did not have an annual independence confirmation process for assurance personnel to confirm their compliance with independence policies and procedures, as required by paragraph 23 of APES 320.
- (b) Two firms did not have established policies and processes for the approval of non-audit services to audit clients prior to the service being provided as required by paragraph 290.158 of APES 110.
- (c) Two firms were at a greater risk of breaching the auditor rotation requirements under the Corporations Act due to the limited number of audit partners within their respective audit practices. These firms should consider partner succession planning to

ensure they are able to continue to comply with the auditor rotation requirements of the Corporations Act.

- (d) Most of the firms did not have established policies and processes relating to the monitoring of system of quality control, including performing periodic inspection of their selected completed engagements as required by paragraph 74 of APES 320.

E Future focus

Key points

Our future focus will include:

- conducting inspections of those firms that audit significant public interest entities, focusing on risks arising due to the GFC;
- follow-up the extent to which matters noted in our previous inspections have been addressed, with an emphasis on performing engagement file reviews, particularly in relation to significant audit judgement areas;
- monitoring the impact of regulatory developments in auditing;
- ongoing engagement with firms on the future inspection reporting process and audit quality initiatives; and
- continued collaboration with foreign regulators to minimise the regulatory burden on Australian firms.

Overall scope

- 178 The focus of our audit inspection program will continue to be those firms who audit entities likely to be of greater public interest.
- 179 As in prior years, we will conduct follow-up inspections of firms visited for the first time during 2008–09 to ensure that prompt and appropriate action is being taken to address our observations and findings. We will also conduct follow up inspections of some other firms previously inspected and will continue to extend our inspections to Network Firms and Smaller Firms that have not previously been subject to an audit inspection.

Audit quality and evidence

- 180 Auditor independence and audit quality are important contributors to confidence in financial reports. Particularly given the concerns noted in this report, we will also continue to focus on specific areas most affected by the current economic conditions such as going concern assessments, impairment of assets, fair value determination, off-balance sheet arrangements, and financial instrument disclosures.
- 181 We will continue to focus our attention on engagement file reviews, paying particular attention to basic audit procedures and those Auditing Standards that have been poorly applied in previous years. Reinforcing the need for robust documentation to support the conclusions reached in relation to key decisions and significant

judgements regarding an audit will continue to be an area of focus for our inspections. If there is no documentation on file, the presumption must be that the auditor did not obtain the necessary audit evidence.

- 182 Other specific areas that we intend to focus on include:
- (a) internal quality control processes and risk assessments undertaken to identify clients with heightened risk;
 - (b) understanding the business model and risk assessment for individual engagements;
 - (c) monitoring and examining the causes of recent corporate collapses, especially where they relate to auditor matters and focusing on these areas in our future audit inspections;
 - (d) monitoring the involvement of the EQCR at different stages of the audit, including consultations held with the engagement team and review of the key judgements and conclusions reached;
 - (e) sufficient appropriate audit evidence and documentation recorded on engagement files to support the significant judgements made by auditors in reaching their conclusions and framing their audit opinions;
 - (f) monitoring of the adequacy and timeliness of s311 statutory reporting obligations of the Corporations Act when auditors have reasonable grounds to suspect a significant contravention; and
 - (g) compliance with the auditor rotation requirements of the Corporations Act, given the contraventions noted for some of the firms inspected.
- 183 Our audit file reviews will include a focus on entities most likely to be impacted by current market conditions. We will also focus on audit quality for new or existing audits where audit fees appear low or appear to have been reduced for reasons other than changes in the underlying business of the entity being audited.

Compliance with new requirements

Clarity standards

- 184 In Australia, audits conducted under the Corporations Act must comply with Auditing Standards issued by the Auditing and Assurance Standards Board (AUASB), which are based on International Standards of Auditing (ISAs).
- 185 A comprehensive program was initiated in 2004 by the International Auditing and Assurance Standards Board (IAASB) to enhance the quality

and consistency of global audit practice through applying a new ‘clarity’ format to all ISAs. This project was completed in December 2008. The ISAs have also been substantively revised.

- 186 The revised and redrafted Australian Auditing Standards based on the international clarity standards will be operative for audits of financial reports with reporting periods commencing on or after 1 January 2010. Firms need to invest time and resources in understanding the new requirements of these new standards and ensure their audit methodology meets the new requirements. We will continue to monitor compliance with legally-enforceable Auditing Standards.

Australian Standards on Quality Control (ASQC 1)

- 187 The AUASB has issued Auditing Standard ASQC 1 Quality Control for Firms that Perform Audits and Reviews, of Financial Reports, Other Financial Information, and Other Assurance Engagements (ASQC 1). Systems of quality control in compliance with this Auditing Standard are required to be established by 1 January 2010.
- 188 ASQC 1 is a new pronouncement of the AUASB and is based on the international equivalent, International Standard on Quality Control (ISQC 1 Quality Controls for Firms that Perform Audits and Reviews of Financial Reports, and Other Assurance and Related Services Engagements) issued by the International Ethics Standards Board (IESBA) for Accountants, which is in itself the basis for APES 320 issued by the Accounting Professional and Ethical Standards Board (APESB).
- 189 Firms should not need to implement new quality control processes, as they should already comply with the requirements of APES 320, but should be mindful of any changes resulting from changes to ISQC 1. Our inspections and inspection reports already cover compliance with the requirements of APES 320.

Revised international ethical standards

- 190 The IESBA has released a new *Code of Ethics for Professional Accountants*. The effective date for the revised code is 1 January 2011 subject to some transitional provisions. The revised code is being considered by the APESB.
- 191 The revised international code extends the current rotation provisions to all key audit partners in addition to engagement and review partners and extends partner rotation requirements from listed entities to include all other public interest entities. The revised international code also further strengthens some of the requirements relating to the provision of non-assurance services to audit clients.

- 192 We will monitor the effect of any changes to the existing Australian professional code (APES 110).

Our audit inspection process

- 193 We continually review our audit inspection process to ensure that it is effective and focuses on current risk areas. From 30 June 2009 file reviews we are placing emphasis on assessing the quality of the auditor's understanding of the auditee's business, risk assessments and audit judgements. We are also performing more timely file reviews. We are considering further changes in the nature and extent of our file reviews and other inspection processes, including a focus on the performance of basic audit procedures as well as risk areas.
- 194 We also monitor developments in inspection processes in other international jurisdictions that have independent programs to ensure that our inspection reporting process remains effective.

Other work

Drivers of audit quality

- 195 While we acknowledge that assessment of audit quality is subjective, we intend to continue to engage with firms to discuss factors that impact on audit quality. We understand that these factors will vary between firms. We will continue to obtain statistical data from firms on existing financial and non-financial performance measures to assess factors that could impact on audit quality.

International collaboration

- 196 We will continue to work with our international audit regulation counterparts in order to reduce any regulatory overlap. Where possible, we will concentrate on maximising cross-border recognition opportunities and establishing regulatory cooperation arrangements.
- 197 Our contribution and participation at the International Forum of Independent Audit Regulators (IFIAR) and the International Organisation of Securities Commissions (IOSCO) will continue to ensure that our inspection techniques and process remains current and relevant with the changing global financial economy.
- 198 We will continue to actively monitor future developments in auditing and will respond to trends and issues through our inspection process and other targeted project work.

Appendix 1: How we conducted our work

199 This report covers inspections of Firms substantially completed between 1 January 2008 and 30 June 2009. 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 monitoring approach

National Firms and Network Firms

- 200 We focused on assessing whether each Firm had documented and implemented a quality control system that provides reasonable assurance that:
- (a) the Firms comply with the auditor independence requirements in Div 3, 4 and 5 of Pt 2M.4 of the Corporations Act (i.e. independence); and
 - (b) the Firms' audit methodologies facilitate the conduct of their audits in accordance with the Auditing Standards as required in Div 3 of Pt 2M.3 of the Corporations Act (i.e. audit quality).
- 201 It is not the purpose of our inspection program to benchmark the Firms or to make specific recommendations on how to improve independence or audit quality policies and systems. However, during our inspection, we highlighted to each Firm some suggested areas for improvement.
- 202 In particular, we considered the following areas in respect of each of the Firms' quality control systems:
- (a) executive leadership;
 - (b) independence;
 - (c) acceptance and continuance;
 - (d) human resources;
 - (e) engagement performance; and
 - (f) monitoring.
- 203 Our inspections concentrated firstly on reviewing each Firm's independence systems and processes, including examining each Firm's testing results. We conducted only limited testing of each Firm's systems.

- 204 Second, we examined each Firm’s audit methodology for compliance with Auditing Standards operative for financial reporting periods commencing prior to the date of our inspection.
- 205 Third, we reviewed the conduct of aspects of a limited number of archived individual audit and review engagements for compliance with each Firm’s stated audit methodology and applicable Auditing Standards as at the date of each audit or review. We also focused on specific areas most affected by the current economic conditions. Each review concentrated on the substance of work and on whether sufficient appropriate audit evidence was on file to support the conclusions reached in relation to key decisions and significant judgements about the audit.
- 206 Our work programs are tailored to focus on key risk areas for each audit. They are not designed to find minor instances of non-compliance. We challenged audit partners regarding the basis on which significant judgements were made.

Smaller Firms

- 207 To reflect the size and client profile of smaller audit practices, our inspection approach is limited compared with inspections of National Firms and Network Firms.
- 208 A limited inspection of a Smaller Firm comprised:
- (a) conducting a review of aspects of one archived audit engagement file of a listed entity for compliance with each Firm’s stated audit methodology and applicable Auditing Standards as at the date of each audit or review; and
 - (b) holding discussions with leaders, engagement partners and other senior members of the engagement team (for the file selected) regarding the engagement file reviewed and certain policies and procedures relating to auditor independence and audit quality employed by the Firm.
- 209 The inspection process is not designed to gain a comprehensive understanding of the Firms’ quality control systems, but rather, focus on the quality of audit conduct. Enquiries were in the context of observations specific to the engagement reviewed and therefore, may vary across firms where different risks are identified.
- 210 Smaller Firm engagement file reviews were mainly conducted at our offices, with on-site activities limited to discussions with Firms’ personnel at the commencement and the completion of the inspection.

The inspection process

- 211 The inspection process was designed to gain an understanding of:
- (a) the Firms' executive leadership direction and strategic priorities in relation to independence and audit quality;
 - (b) the Firms' policies and systems for ensuring audit quality and compliance with their independence obligations;
 - (c) the Firms' independence and audit methodology training programs;
 - (d) the links between the Firms' independence and audit quality policies and the performance management processes; and
 - (e) internal monitoring programs conducted by the Firms.
- 212 In conducting our inspections, we:
- (a) reviewed material provided by the Firms under notice pursuant to the *Australian Securities and Investments Act 2001* (ASIC Act);
 - (b) reviewed the Firms' systems and processes for managing compliance with the audit independence requirements of the Corporations Act and for ensuring audit quality;
 - (c) reviewed aspects of a selection of archived audit and review engagements at each Firm, weighted towards listed entities;
 - (d) interviewed selected partners holding leadership roles in the Firms;
 - (e) interviewed selected human resources representatives;
 - (f) interviewed a number of the Firms' other partners and staff; and
 - (g) in the case of National Firms, visited some of their capital city offices and interviewed selected partners and staff.

Key terms

Term	Meaning in this document
AAC	Authorised Audit Company
APES	Accounting Professional and Ethical Standards
ASA	Australian Auditing Standards issued by AUASB pursuant to s336 of the Corporations Act
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
ASX	Australian Securities Exchange
AUASB	Auditing and Assurance Standards Board
CLERP 9	<i>Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004</i>
Corporations Act	<i>Corporations Act 2001</i> including the Corporations Regulations 2001 made for the purposes of that Act
EQCR	Engagement Quality Control Reviewer
IAASB	International Auditing and Assurance Standards Board
IFIAR	International Forum of Independent Audit Regulators
ISA	International Standards of Auditing
National Firms	National partnerships that are members of global networks with multiple offices
Network Firms	Individual offices of Firms that are members of international associations
PCAOB	Public Company Accounting Oversight Board of the United States of America
RCA	Registered Company Auditor
Smaller Firms	Firms with small number of audit partners that audit a limited number of listed entities