



ASIC

Australian Securities & Investments Commission

REPORT 242

Audit inspection program public report for 2009–10

June 2011

About this report

This report summarises the observations and findings identified by ASIC's audit inspection program in the 18 months to 31 December 2010.

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

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 21 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 engagements, an inspection may identify ways in which a particular audit engagement is deficient. It is not the purpose of an inspection, however, to review all of the firm's audit engagements or to identify every aspect in which a reviewed audit may be deficient. Accordingly, this report does not provide assurance that the firms' audits, 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 surveillance of the firms or their clients, although these matters may inform focus areas in inspections.

Contents

Executive summary	4
A Overview of the inspection process	6
Objectives of the audit inspection program	6
Changes to the audit inspection program	7
Scope of this report.....	8
B Major findings	11
Impact of the audit inspection program	11
Major findings: Audit quality.....	12
Major findings: Quality control	15
C Detailed observations and findings: Audit quality	17
Larger National and Other National and Network firms.....	17
Smaller firms	31
D Detailed observations and findings: Quality control	35
Larger National and Other National and Network firms.....	35
Smaller firms	42
E Future focuses	44
Inspection scope and process	44
Specific areas of focus.....	45
Regulatory developments	48
International collaboration.....	49
Appendix: How we conducted our work	51
Our monitoring approach	51
The inspection process.....	52
Key terms	54
Related information	56

Executive summary

- 1 This report covers inspections of 21 firms substantially completed in the 18 months to 31 December 2010.
- 2 Australia's audit regime is similar to the regimes in other major developed countries. However, this report identifies some important audit areas where the firms need to focus their attention and make improvements to ensure audit quality.
- 3 As a part of our ongoing review of the focuses of our program, and in response to factors such as the global financial crisis and benchmarking with other audit oversight regulators, we increased the number of audit engagement files selected for review at inspections of larger firms in 2009–10. We also reviewed additional key audit areas on each engagement file. These changes would have impacted on the number of findings on each audit file and in each area. A risk-based method was used to select firms, engagement files and audit areas for review.
- 4 Across the firms inspected, the majority of the engagement files reviewed contained sufficient appropriate audit evidence in key audit areas and audit work in those areas was conducted in accordance with the relevant Australian auditing standards. However, for the large firms 17% of engagement files reviewed did not contain sufficient appropriate audit evidence and for other firms the figure was 31%. Generally where we concluded that audit engagement files did not contain sufficient appropriate audit evidence, this was based on shortcomings identified for specific areas of the audit. Overall, we identified three broad areas where improvements need to be made by the firms. Many of the observations and findings in this report relate to shortcomings in the areas of:
 - (a) the sufficiency and appropriateness of audit evidence on engagement files. The evidence should support the audit opinion by clearly demonstrating the auditor's procedures and conclusions on key audit judgement or risk areas. Areas where improvements are required include when relying on the work of experts or other auditors, confirmation of key balances, classification of material loan balances, consideration of the risk of fraud, and financial statement disclosures;
 - (b) the level of professional scepticism exercised or evidenced on the engagement files by auditors in key areas of audit judgement, including fair value measurement of assets, impairment calculations, going concern assessments and other fundamental areas of the audit; and
 - (c) the lack of evidence on audit engagement files about the nature, timing and extent of engagement quality control reviews.

- 5 To further enhance audit quality and to ensure that the auditors' judgements are robust and well supported, leaders of firms should continue to send strong and consistent messages to partners and staff about the importance of these three areas. It is important that these messages continue to be complemented by education and training, firm guidance, effective technical support and internal monitoring.
- 6 Firms we have previously inspected continued to maintain or improve their quality control systems to facilitate compliance with the requirements of the *Corporations Act 2001* (Corporations Act), Australian auditing standards, and Australian professional and ethical standards. This demonstrates the firms' commitment to high quality audits and auditor independence, and the continued positive impact of our inspection program.
- 7 The extent of quality control systems varies between firms due to their size and structure. Aspects of some firm quality control systems can be improved to comply with legal and professional requirements: see Section D.
- 8 Future focus areas for firms are highlighted in Section E. We will continue to inspect firms that audit significant public interest entities, monitor regulatory developments in auditing and collaborate with foreign regulators to minimise the regulatory burden on Australian firms.

A Overview of the inspection process

Key points

The aim of ASIC's audit inspection program is to promote high quality external audits of financial reports of listed entities and other public interest entities so that users can have greater confidence in these financial reports and Australia's capital markets.

During this inspection cycle, we increased the number of audit engagement files reviewed at inspections of larger firms, reviewed additional key audit areas, reviewed some fundamental audit procedures and reviewed audit areas that were identified as potential risk areas in the future focus section of our last public report.

This is the fifth public report on our audit inspection program. The report outlines the results of the inspection of 21 audit firms substantially completed in the 18 month period from 1 July 2009 to 31 December 2010.

As ASIC is both an audit oversight regulator and a securities regulator, in addition to audit inspections we conduct a range of other activities that cover the work of the firms. This report covers the results of our audit inspection program only and does not include any matters arising from our other regulatory activities.

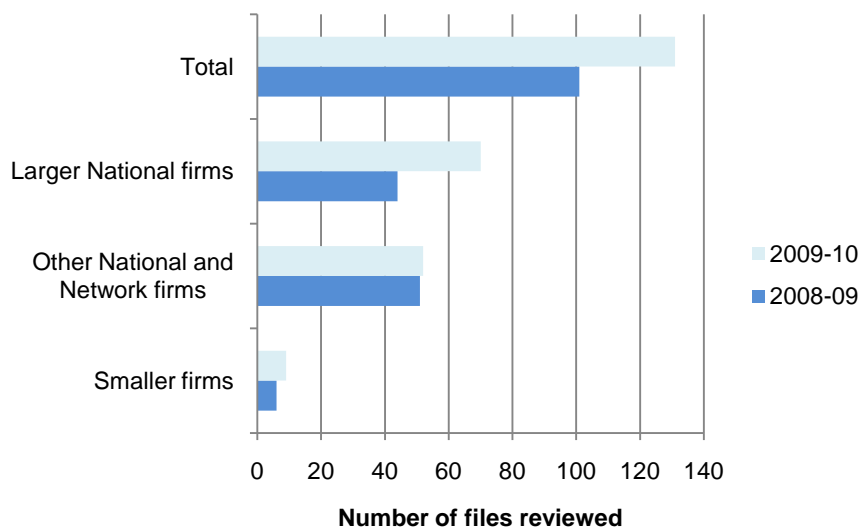
Objectives of the audit inspection program

- 9 A strong audit profession helps maintain and promote confidence and integrity in Australia's capital markets. The aim of ASIC's audit inspection program is to promote high quality external audits of financial reports of entities listed on the Australian Securities Exchange (ASX) or other Australian exchanges (listed entities) and other public interest entities in accordance with Ch 2M of the Corporations Act so that users can have greater confidence in these financial reports.
- 10 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, Australian auditing standards, and Australian accounting professional and ethical standards (issued by the Accounting Professional and Ethical Standards Board (APESB)).
- 11 Any improvement areas identified through the inspection program about compliance with Australian auditing standards or other requirements, and best practice enhancements, are included in a private individual report to each firm and they are responsible for addressing these areas. The purpose of the inspection program is not to benchmark firms.

- 12 While our inspection program has an education and compliance focus, enforcement action may 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.

Changes to the audit inspection program

- 13 Our audit inspection program focuses on reviewing the firms' quality control systems and examining aspects of a sample of the firms' individual audit and review engagement files to assess audit quality. Each year we conduct follow up inspections of firms we had previously visited and, on each occasion, we identify fewer deficiencies in the firm quality control systems or areas that require improvement.
- 14 As most of the larger firms that audit the majority of the listed entities have sound and well established quality control systems, we changed the approach of the inspection program to focus on significant changes to these systems. This enabled us to devote more time to the assessment of audit quality at the firms through engagement file reviews.
- 15 The key changes to our 2009–10 inspection program included:
- (a) significantly increasing the number of audit engagements selected for review to 131, compared to 101 in the previous 18 month period to 30 June 2009 (see Figure 1);
 - (b) reviewing a greater number of key audit areas in more depth on each engagement file;
 - (c) on each engagement file, reviewing a fundamental audit area. That area may have been identified as potential risk from our recent reviews of corporate collapses, results of other investigations or findings about Australian auditing standards that had been previously poorly applied by the firms;
 - (d) in some cases reviewing an engagement file from cover-to-cover;
 - (e) extending the period of the on-site inspection at the firms to facilitate the above changes; and
 - (f) enhancing the structure and content of our private inspection reports to firms to include best practice considerations, suggested remedial actions and the firms' responses to our observations and findings.
- 16 We also benchmarked our inspection process with those of other international jurisdictions that have independent audit inspection programs and, where appropriate, enhanced our inspection approach to ensure we continue to apply best practice.

Figure 1: Number of engagement files reviewed

17 The appendix contains further details about how we conducted our work.

Scope of this report

18 This is the fifth 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 Act) on 1 July 2004.

19 As ASIC is both an audit oversight regulator and a securities regulator, in addition to audit inspections we conduct a range of other activities that relate to the work of the firms. These other activities include our financial reporting surveillance program, surveillances of individual audits and investigations into corporate failures. While these activities inform our areas of focus and determine the frequency of future audit firm inspections, this report covers the results of our audit inspection program only and does not include any matters arising from our other regulatory activities.

20 This report outlines the results of audit inspections substantially completed in the 18 month period from 1 July 2009 to 31 December 2010. During that period we inspected 21 audit firms (firms) that, in aggregate, audit 87% of listed entities by market capitalisation. In the prior 18 month period from 1 January 2008 to 30 June 2009 (2008–09) we inspected 19 firms.

- 21 The firms inspected range in size as follows:
- (a) large firms that audit numerous listed entities (more than 5% by market capitalisation) and are national partnerships and members of a global network¹ with multiple offices (Larger National firms);
 - (b) firms with national partnerships or individual offices that audit many listed entities and are members of a national or international network (Other National and Network firms); and
 - (c) firms that audit a limited number of listed entities and have a small number of partners (Smaller firms).
- 22 A summary of our inspection of the firms is provided in Table 1.

Table 1: Summary of firms inspected

Firms	2009–10 Total inspected	2008–09 Total inspected
Larger National	4	4
Other National and Network	9	9
Smaller	8	6
Total	21	19

Note: In 2009–10, two Other National and Network firms and all of the Smaller firms were inspected for the first time. Each of the Larger National firms has been inspected more than once.

- 23 During 2008–09, our inspection approach for Other National and Network firms changed from reviewing an individual office of a network to reviewing a number of the member firms of the network at each inspection. We continued this approach during the 2009–10 inspections. Other National and Network firms visited for the first time were subject to a full-scope inspection comprising the review of network-wide quality control systems and review of a sample of individual audit engagements from various offices within that network.
- 24 Larger National firms and Other National and Network firms that we inspected previously were subject to a subsequent review inspection. The scope of a subsequent inspection consists of following up matters noted in prior inspection reports, reviewing significant changes to the firms' quality control systems, limited testing of those systems and reviewing a sample of individual audit engagement files.

¹ Network is defined in Accounting Professional and Ethical Standard APES 110 *Code of Ethics for Professional Accountants* (APES 110).

- 25 Smaller firms are subject to a limited scope inspection due to the size, client profile and nature of these firms. The inspection of a Smaller firm generally involves reviewing one listed entity audit engagement file and enquiring about the key features of the firm’s quality control systems as they relate to that engagement.
- 26 Our review of aspects of a sample of audit engagement files at the firms had regard to the Australian auditing standards that were in force at the time. The Australian auditing standards were reissued in October 2009 as part of the ‘Clarity’ project, to present them in a clearer format. However, the Clarity auditing standards are applicable for audits of financial reports for periods commencing on or after 1 January 2010 and, therefore, did not apply to audits that were within the scope of the audit inspection program for 2009–10.
- 27 ASIC has an arrangement with the Public Company Accounting Oversight Board (PCAOB) of the United States to assist the PCAOB with their audit inspections of Australian auditors to ascertain compliance with the *Sarbanes-Oxley Act 2002 (US)* (Sarbanes-Oxley Act (US)). During 2009–10, four inspections were conducted jointly with the PCAOB. Where the timing of the PCAOB and ASIC audit inspections did not coincide we were able to share our private firm inspection reports with the PCAOB to assist them in their oversight function, in accordance with the confidentiality requirements of the *Australian Securities and Investments Commission Act 2001 (ASIC Act)*.

B Major findings

Key points

In this cycle of audit inspections, the firms we had inspected previously continued to maintain or improve their quality control systems, demonstrating their commitment to high quality audits. The level of engagement and responsiveness by the firms to our observations and findings demonstrates the positive impact of our audit inspection program.

The three broad areas where the firms need to make improvements to further enhance audit quality are:

- the quality of audit evidence on engagement files to corroborate the auditor's conclusion on key judgement areas;
- the level and attitude of professional scepticism exercised or demonstrated by auditors; and
- the lack of evidence on engagement files to demonstrate the involvement of the engagement quality control reviewer (EQCR) during the engagement.

We also continue to have concerns about shortcomings in the independence systems of some of the firms and, in particular, about contraventions of the independence requirements of the Corporations Act.

Impact of the audit inspection program

- 28 In this cycle of audit inspections, the firms we had inspected previously continued to maintain or improve their quality control systems, demonstrating their commitment to independence and high quality audits. However, there are still a number of important audit areas where the firms should give continued focus and attention and make further improvements.
- 29 The firms have implemented quality control systems to ensure compliance with the independence requirements of the Corporations Act and professional quality control and ethical standards. Although the extent and complexity of these systems varies depending on the size and nature of the firm, the implementation of quality control systems demonstrates that the firms understand their obligation to comply with these requirements.
- 30 Since the commencement of our audit inspection program we have inspected all Larger National firms and Other National and Network firms once, with a large number of these firms being inspected more than once. We have also made good progress in inspecting Smaller firms over the last three years.
- 31 The results of our first inspection of a firm often indicate that some aspects of quality control have not been addressed or fully developed. Subsequent

inspections of a firm almost always show a marked improvement in most, if not all, areas identified in the first inspection. This indicates that the firms recognise the importance of our inspection program in promoting high quality external audits.

- 32 Our inspection program provides an objective assessment of the quality of audits conducted. The firms and ASIC have a common objective to enhance audit quality. The firms have generally been cooperative and receptive to our observations and findings, and suggested remedial actions, demonstrating the positive impact of our audit inspection program.

Major findings: Audit quality

- 33 As a part of our ongoing review of the focuses of our program, and in response to factors such as the global financial crisis and benchmarking with other audit oversight regulators, we increased the number of audit engagement files selected for review at inspections of larger firms in 2009–10. We also reviewed additional key audit areas on each engagement file. These changes would have impacted on the quantity of findings on each audit file and in each area.
- 34 Our review of individual audit engagements informs our assessment of audit quality at the firms. We focus our reviews on aspects of the engagement files that contribute to safeguarding and enhancing audit quality. In 2009–10 we paid particular attention to those key audit areas most affected by the global economic downturn and identified a number of audit areas that need to be improved by all the firms. The majority of the engagement files reviewed contained sufficient appropriate audit evidence in key audit areas and audit work in those areas was conducted in accordance with the relevant Australian auditing standards. Generally where we concluded that audit engagement files did not contain sufficient appropriate audit evidence, this was based on shortcomings identified for specific areas of the audit. We identified three broad areas where improvements need to be made by the firms (as outlined in paragraphs 35–48). While there may be differences in the size and structure of the firms, and variation in the conduct of an audit by the different firms, the overall themes from the review of the firms' engagement files is not markedly dissimilar.

Quality of audit evidence

- 35 We continue to have concerns about the quality (sufficiency and appropriateness) of audit evidence on the engagement files to corroborate the auditor's conclusions on key judgement and risk areas. In many instances, these areas included areas affected by the global economic downturn. Our review of approximately 32 of the 131 audit engagements resulted in

numerous concerns about the adequacy of evidence to corroborate the auditor's work or conclusions in key areas, including:

- (a) fair value measurement and impairment calculations;
- (b) classification of material loan balances;
- (c) consideration of the risk of fraud; and
- (d) assessment of the competence and the work of experts engaged by clients.

- 36 In past reports we accepted that there may be cases where the necessary audit evidence was obtained and appropriate consideration was given to significant judgement areas, but this was not documented. However, in the absence of adequate documentation on the engagement files, it can be difficult to assess whether sufficient appropriate audit evidence was gathered, and whether the requirements of the Australian auditing standards were complied with, even allowing for oral explanations provided by the auditor about the audit work performed and evidence obtained. Therefore, if there is no documentation on the engagement file, the presumption must be that the auditor did not obtain the necessary audit evidence.
- 37 Audit engagement files need to contain sufficient appropriate evidence to reduce the risk that the auditor's procedures or conclusions on key judgement areas, and ultimately the auditor's report, could be challenged. In particular, the engagement file should contain evidence of the nature, extent and timing of procedures performed over specific audit assertions about key account balances in the financial report. To ensure that engagement files and the auditor's judgements are supported, the leaders of the firms should send strong and consistent messages about the importance of sufficient and appropriate audit evidence and reinforce this through training and effective internal monitoring programs.

Professional scepticism

- 38 Our audit inspection program has identified a number of instances where we have concerns about the auditors' judgement, and the level and attitude of professional scepticism. Auditing Standard ASA 200 *Objective and General Principles Governing an Audit of a Financial Report* (ASA 200) defines professional scepticism as 'an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence'.
- 39 An auditor is required to plan and perform an audit with an attitude of professional scepticism. An attitude of professional scepticism is critical in assessing evidence in routine areas of the audit, such as classification of material loan balances and reasons for large variances in analytical review procedures.

- 40 This scepticism should be heightened particularly when assessing evidence in areas that involve significant estimation or judgement by clients (such as asset valuation and impairment calculations, and when considering the appropriateness of a client's accounting treatments or the going concern assumption).
- 41 Our review of audit engagements has found instances where auditors:
- (a) appear to have been over reliant on a client's explanations and representations (especially about fair value measurement, going concern assumptions and analytical review procedures);
 - (b) have not explored evidence available on other parts of the engagement file that appears inconsistent or contradictory; and
 - (c) have not had sufficient regard to historical outcomes in assessing the reasonableness of assumptions underlying the client's decisions (especially about optimistic cash flow projections, growth rates and discount rates for impairment testing).
- 42 In addition, we found instances where auditors have approached highly judgemental and subjective balances by seeking to obtain audit evidence that corroborates rather than challenges the client's judgments.
- 43 In some key audit areas that involve judgement it is necessary at times to rely on evidence that is persuasive rather than conclusive. Consequently, it is crucial that audit engagement files contain sufficient appropriate evidence to demonstrate the extent of professional scepticism exercised by the auditor. A lack of documentation to evidence the exercise and extent of professional scepticism by engagement partners and teams could lead to potential concerns relating to the objectivity and quality of audit work undertaken.
- 44 An attitude of professional scepticism is a critical part of conducting quality audits. Therefore, a culture of professional scepticism needs to be supported and promoted through robust messages from leaders of the firms and complemented by education and training, firm guidance and procedures, effective technical support and engagement quality control reviews.

Engagement quality control reviews

- 45 The role of an engagement quality control reviewer (EQCR) is to objectively evaluate, before an audit report is issued, the work done and conclusions reached by the audit engagement team in significant judgement and risk areas. The engagement quality control review is a critical element of quality control and contributes to achieving audit quality. To ensure this quality control function is effective, it is essential that the EQCR is involved throughout the audit process.

- 46 Most firms have policies on the EQCR's role and responsibility. Despite this, we noted deficiencies in the engagement quality control review in our previous public reports. We continue to be concerned that there are numerous findings from the 2009–10 audit inspection program about:
- (a) the lack of documented evidence on audit engagement files demonstrating the involvement of the EQCR during the engagement; and
 - (b) the relatively low levels of time recorded by the EQCR for the engagement.
- 47 To further enhance quality of an audit, the EQCR's evaluation of the work performed and conclusions reached by the engagement team on significant judgement and risk areas needs to be sufficiently and appropriately evidenced on the engagement file. The leaders of the firm need to reinforce this to engagement partners and EQCRs.
- 48 Detailed observations about our major findings relating to audit quality are set out in Section C.

Major findings: Quality control

- 49 Due to the difference in the size and structure of the firms, quality control systems will vary in sophistication and maturity. Generally, there are few, if any, findings in this area for the Larger National firms. Other National and Network firms that have been inspected more than once generally made improvements to their quality control systems, so there were fewer findings at these firms than those inspected for the first time. However, we continue to have concerns about the number of findings at many firms about independence processes and, in particular, about contraventions of the rotation and independence requirements of the Corporations Act.
- 50 Independence is fundamental to the conduct of a quality audit. Leaders of the firms need to ensure that they give strong and clear messages about the importance of independence to set an appropriate 'tone at the top'. Where relevant, the firm should take appropriate action against personnel that contravene the independence requirements of the Corporations Act and the firm's own independence policies.
- 51 Smaller firms need to continue to develop and implement many aspects of their quality control systems—in particular, systems to enable compliance with the independence requirements of the Corporations Act. In addition, Smaller firms require continued development of their systems relating to ethical and professional standards, and procedures to systematically and rigorously examine and monitor audit quality.

- 52 In June 2010, ASIC issued a report about auditor independence to the Financial Reporting Council (FRC) in accordance with our Memorandum of Understanding with them. This report, which is provided annually to the FRC, includes more detail on our findings on auditor independence and is included in the FRC's 2009–10 annual report.²
- 53 Detailed observations about our major findings relating to quality control are set out in Section D.

² *Annual report 2009–10*, Financial Reporting Council, 11 October 2010, www.frc.gov.au/reports/2009_2010/downloads/FRC_AR_2009-10.pdf.

C Detailed observations and findings: Audit quality

Key points

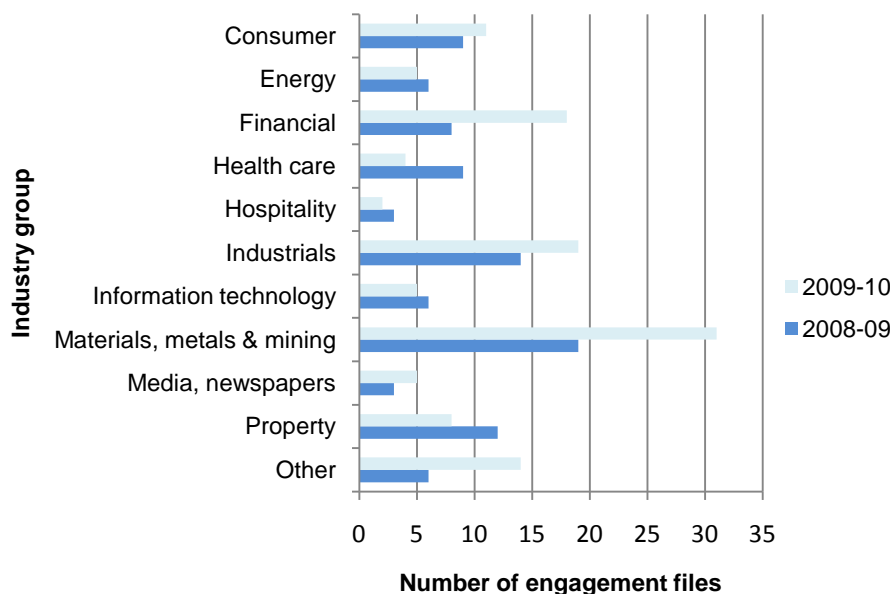
All the firms need to improve audit quality on engagements by ensuring that:

- engagement files contain sufficient appropriate audit evidence. The evidence should support the audit opinion by clearly demonstrating the auditor's procedures undertaken and conclusions on key audit judgement or risk areas. Areas where improvements are required include reliance on the work of experts or other auditors, consideration of the risk of fraud, and the audit of financial statement disclosures, including classification of material loan balances;
- auditors exercise professional scepticism in the key areas of audit judgement, including fair value measurement of assets, impairment calculations, going concern assessments and other fundamental areas of the audit; and
- that the nature, timing and extent of the engagement quality control review is adequate.

Larger National and Other National and Network firms

54 We reviewed aspects of 122 audit engagements files³ across the Larger National firms and the Other National and Network firms over the 18 month period to 31 December 2010. In a small number of these files, we conducted a cover-to-cover review considering all aspects of the audit process. Our file selections were spread across a range of sectors (see Figure 2) with financial reporting periods ended between 30 June 2008 and 30 June 2010 (10% were 30 June 2008, 57% were 30 June 2009, 29% were 30 June 2010 and 4% were other year ends). We selected the files based on a number of factors, including entities or industries perceived to be at heightened risk as a result of the global economic downturn, audit engagements where there were substantial reductions in audit fees, and entities or industries identified in other ASIC activities.

³ During the period covered by the previous inspection report, we reviewed aspects of 88 audit and seven review engagements across the Larger National and Other National and Network firms.

Figure 2: Number of engagement files reviewed by industry group

- 55 As a part of our ongoing review of the focuses of our program, and in response to factors such as the global financial crisis and benchmarking with other audit oversight regulators, we increased the number of audit engagement files selected for review at inspections of larger firms in 2009–10. We also reviewed additional key audit areas on each engagement file. These changes would have impacted on the quantity of findings on each audit file and in each area. A risk-based method was used to select firms, engagement files and audit areas for review.
- 56 The majority of the engagement files reviewed contained sufficient appropriate audit evidence to support the conclusions reached and demonstrate that the audit was conducted in accordance with the relevant Australian auditing standards. However, for the Larger National Firms, 17% of engagement files reviewed did not contain sufficient appropriate audit evidence. For Other National and Network Firms this figure was 29%. Generally where we concluded that audit engagement files did not contain sufficient appropriate audit evidence, this was based on shortcomings identified for specific areas of the audit. We identified three broad areas where improvements need to be made by the firms and these are detailed in paragraphs 61–121.
- 57 The objectives of the review of engagement files were to assess the practical application of the audit methodologies of the Larger National firms and Other National and Network firms, and consider whether the key matters that contribute to the audit opinion had been adequately addressed by the engagement team. Our reviews were not designed to detect all instances of non-compliance or to confirm all aspects of the audit opinion.

- 58 Our review of the engagement files focused on the substance of the auditors' work, to assess if there was sufficient appropriate audit evidence on the file to support the key audit considerations and the conclusions of the auditor on significant judgement areas; in particular, the areas affected by the global economic downturn.
- 59 There are differences in the size, structure and extent of centralised resources, the international reach, and the risk management strategies among the Larger National and Other National and Network firms. While there may be variations in the conduct of audits by the different firms, the overall themes from the review of the 122 audit engagements was not markedly different. Consequently, we have not reported separately the findings relating to Larger National firms and those relating to Other National and Network firms.
- 60 During 2009–10, we provided private reports separately to each of the firms on the findings from our reviews. In some cases where our findings at a firm were systemic or considered to be more serious, we accelerated our subsequent inspections to ensure that corrective actions taken by the firms were adequate.

Common observations and findings

- 61 Most of the engagement files reviewed contained sufficient appropriate audit evidence to support the conclusions reached and demonstrate that the audit was conducted in accordance with the relevant Australian auditing standards. However, we are concerned that there are several important findings common to the Larger National and Other National and Network firms that we reported on in 2008–09 and which we observed again in 2009–10. Shortcomings in the areas detailed in paragraphs 62–121 can have an adverse impact on the quality of the audit that is conducted and potentially the reliability of the auditor's report.

Audit evidence and documentation

- 62 The Corporations Act requires audits to be conducted in accordance with the Australian auditing standards. Auditing Standard ASA 500 *Audit Evidence* (ASA 500) requires the auditor to obtain sufficient appropriate audit evidence⁴ to be able to draw reasonable conclusions on which to base their opinion. Auditing Standard ASA 230 *Audit Documentation* (ASA 230) requires the auditor to prepare, on a timely basis, audit documentation that provides a sufficient and appropriate record of the basis for the auditor's

⁴ 'Sufficiency' is the measure of the quantity of audit evidence obtained, while 'appropriateness' refers to the measure of the quality of the audit evidence (i.e. its relevance and reliability in providing support for the classes of transactions, account balances, disclosures and related assertions). A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others.

report and evidence that the audit was performed in accordance with Australian auditing standards and applicable legal and regulatory requirements. If the evidence of the work done is not documented, it is difficult to ascertain what audit procedures the auditor performed to reach a conclusion and whether the auditor complied with the requirements of the Australian auditing standards.

- 63 Audit evidence and documentation deficiencies are pervasive across most of the areas noted in this section.
- 64 In a number of engagement files, the deficiencies related to sufficiency and appropriateness of evidence obtained to form conclusions about audit assertions for key areas or insufficient documentation of the audit procedures performed. In addition, we noted a small number of instances of incomplete or late assembly of engagement files. In these cases, there is a risk that the audit work was not adequately performed and that the conclusions reached were not appropriate at the time that the audit report was issued.
- 65 In the majority of cases, the auditors provided oral explanations to us that the audit work had been performed but not documented. Accordingly, the firms often concluded that many of the deficiencies we identified on the engagement files about insufficient audit evidence were simply a lack of documentation. However, we did not always concur with the firms' conclusions. 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'.
- 66 Our inspections also found instances where the auditor relied upon evidence that was not appropriate for providing the assurance required to reduce the risk of material misstatements for specific assertions to an acceptably low level. In these cases, there is a risk that the conclusions formed by the auditor are not properly supported by the evidence on the engagement file or a material misstatement is not identified or adequately addressed.
- 67 To comply with the requirements of ASA 500, auditors must have sufficient and appropriate audit evidence on the file and design procedures around specific audit assertions that reduce the risk of a material misstatement. In accordance with ASA 230, the engagement file must contain sufficient and appropriate documentation to enable an experienced auditor with no previous connection with the audit to understand audit procedures performed, the results of those procedures and the audit evidence obtained to support the audit conclusions reached.

Relying on the work of experts

- 68 Clients of the firms often rely on experts to assist with specialised areas of financial reporting, including asset valuations. The experts can be either individuals employed directly by the client or external experts engaged by the client to provide the specialised service.
- 69 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 competence and objectivity. The risk that an expert's objectivity may be impaired increases where the expert is employed by the client.
- 70 In some of the engagement files where an expert was used by the client, there was insufficient evidence to demonstrate that the auditor assessed the professional competence and objectivity of the expert and the appropriateness of the expert's work as audit evidence.
- 71 In the majority of the instances where there was insufficient evidence of the auditor's assessment of the expert's competence or objectivity, the expert was an external specialist engaged by the client. We were often advised by the auditor that, as the expert was well known in the relevant industry or provided services to other major entities in the industry, their assessment of the expert's credentials and objectivity was not documented.
- 72 The auditor must include sufficient documentation on the engagement file to enable an experienced auditor with no previous connection with the audit to understand the nature, timing and extent of the procedures performed to evaluate the competence and objectivity of an expert engaged by a client. Ordinarily, oral explanations on their own do not represent adequate support for the conclusions reached by the auditor.
- 73 In a small number of instances the expert the client relied on was an internal employee of the client. While in some cases there was evidence the auditor assessed the professional competence of the employee providing the expert advice, there was no evidence that the auditor assessed the risk that the expert's objectivity could have been impaired—for example, due to being financially reliant on the client. In addition, we did not see evidence of the auditor's consideration of whether the client should have, perhaps on a cyclical basis, engaged an external expert to corroborate the work of the internal expert.
- 74 In the cases where an external expert was engaged by the client, in a small number of instances the engagement file did not contain sufficient evidence that the auditor assessed the reasonableness of the assumptions used by the expert and whether the work performed by the expert was adequate for the

purposes of forming appropriate evidence to support the audit assertion being considered by the auditor.

- 75 Given the level of estimation and judgement involved in valuing assets, even when undertaken by specialists, we would have expected to see evidence of a heightened level of professional scepticism by the auditor, particularly where reliance is placed on the client's internal expert.

Using the work of other auditors

- 76 Auditing Standard ASA 600 *Using the Work of Another Auditor* (ASA 600) requires the principal auditor, when planning to use the work of another auditor, to consider the professional competence of the other auditor. In addition, the principal auditor should perform procedures to obtain sufficient appropriate evidence that the work of the other auditor is adequate for the purposes of the principal auditor. This might require the principal auditor to advise the other auditor of the relevant independence requirements, the use to be made of the other auditor's work and matters requiring special consideration. This is often achieved by the principal auditor issuing instructions to the other auditor.

- 77 The other auditor can be another auditor in the same network as the principal auditor or may be an unrelated auditor. The requirements of ASA 600 apply to both an auditor in the same network and an unrelated auditor.

- 78 In some of the engagement files where other auditors were utilised we found instances where, although the principal auditor placed reliance on the work of another auditor, the engagement file did not contain sufficient evidence that the principal auditor:

- (a) issued specific instructions to the other auditor;
- (b) assessed the professional competence and/or independence of the other auditor; or
- (c) considered the appropriateness of the work performed by the other auditor, including:
 - (i) assessing if materiality levels used by the other auditor were appropriate;
 - (ii) evaluating whether significant matters noted by the other auditor had been addressed; and/or
 - (iii) reviewing that the work done by the other auditor was in accordance with the instructions issued.

- 79 In some of these cases, where the auditor advised that they visited the operations of overseas subsidiaries, held meetings with the other auditors or reviewed the other auditor's working papers, evidence of this was not sufficiently documented on the audit engagement files.

80 In the majority of these cases the other auditor was part of the principal auditor's network. Nevertheless, it is still necessary for the principal auditor to appropriately consider the independence and competence of the other auditor and evaluate the work done by the other auditor. This is particularly important where the other auditor is part of a firm in a network in another country where there may be limited regulatory oversight of auditors and a different culture within that firm.

81 In a small number of these instances the other auditor was not part of the principal auditor's network. This raises concerns about how the principal auditor was able to place reliance on the work of the auditor given there was insufficient evidence on the engagement files to show that the principal auditor:

- (a) appropriately assessed the competence and independence of the other auditor;
- (b) issued specific instructions; and/or
- (c) adequately reviewed the work of the other auditor.

82 ASA 600 has been substantially revised as part of the Clarity auditing standards. While not applicable for the period under review, the new standard makes it clear that the group engagement partner is responsible for the direction, supervision and performance of the group audit and ensuring that sufficient appropriate audit evidence is obtained, regardless of who performs the work. The principal auditor needs to be adequately involved in the work of the other auditor throughout the engagement. We will focus on the application of this standard in our future inspections.

Consideration of the risk of fraud

83 Auditing Standard ASA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report* (ASA 240) requires the auditor to consider the risks of material misstatement in the financial report due to fraud.

84 A number of the engagement files reviewed did not contain sufficient evidence of the auditor's consideration of fraud. In most of these instances, there was no evidence that the engagement team discussed the susceptibility of the entity's financial report to material misstatement due to fraud. While the auditor provided an oral explanation that the possibility of fraud was discussed by the engagement team, this was not sufficiently documented in the engagement file.

85 In one instance, there was no evidence that fraud was specifically discussed by the auditor, when gaining an understanding of the entity, with either management or those charged with the governance of the entity. The lack of sufficient documentation of discussions about the risk of fraud does not comply with the documentation requirements of ASA 230 and also

ASA 240, which has specific documentation requirements for fraud assessment.

External confirmations

- 86 ASA 500 sets out how the reliability of audit evidence is influenced by its source and nature. Evidence is more reliable when it is obtained from independent sources outside the entity. It is a generally accepted audit practice that independent confirmations should be obtained for material and/or significant balances (such as cash at bank, investments, and loans with financial institutions and debtors) to support the accuracy, existence and/or completeness audit assertions.
- 87 In a small number of engagement files the auditor did not request external confirmations for significant financial statement balances. In addition, those files did not always contain an adequate explanation of why external confirmation requests were not sent by the auditor.
- 88 Where external confirmations are not obtained, the auditor is required to perform alternative procedures that will provide sufficient appropriate audit evidence about the audit assertions that the confirmation was intended to cover. In some instances, the alternative procedures performed did not, in our view, provide sufficient appropriate evidence to support the key assertions of existence and completeness of the significant balances. For example, documents faxed directly to the client by the financial institution are not a substitute for confirmations obtained directly by the auditor from a financial institution.
- 89 The failure to obtain an independent confirmation of a significant balance brings into question how the auditor gained the audit assurance required to reduce the risk of a material misstatement to an acceptably low level to conclude that the financial statements were presented correctly.

Classification of loans

- 90 The classification of loan balances has been an area of our focus in this cycle of inspections. The global economic downturn could seriously affect the ability of an entity to refinance debt. The classification of loan balances is important to understanding the financial position of an entity and we have highlighted it as a financial reporting finding in recent years.
- 91 Australian accounting standard AASB 101 *Presentation of Financial Statements* (AASB 101) requires entities, when presenting information in financial reports, to disclose liabilities as current (due and payable within 12 months) or non-current (due and payable later than 12 months). This information is useful for users of a financial report to assess the liquidity and solvency of an entity. We found that in a small number of engagement files

there was insufficient evidence of the procedures undertaken by the auditor in relation to the client's classification of loan balances.

- 92 In many instances, the auditor provided oral explanations of the work done to verify the classification of loans. However, in all of these cases the audit procedures undertaken were not adequately documented on the engagement file. Some engagement files did not contain sufficient evidence to show procedures undertaken by the auditor to verify the client's compliance with complex loan covenants, or whether internal technical or legal consultations were undertaken on complex loan covenants and agreements.
- 93 In some of these engagement files there was insufficient evidence to demonstrate the auditor exercised professional scepticism in assessing the appropriate classification of material loan balances. These engagement files did not contain evidence that the auditor critically examined the evidence provided by the client with a questioning mind, and there was no evidence that the auditor challenged the client's assertions about the repayment of the debt in light of other evidence that was available to the auditor.

Financial statement disclosures

- 94 Auditing Standard ASA 330 *The Auditor's Procedures in Response to Assessed Risks* (ASA 330) requires the auditor to perform audit procedures to evaluate whether the overall presentation of the financial report, and the disclosures therein, is in accordance with the applicable financial reporting framework.
- 95 In some cases, we found incorrect or inadequate disclosures in the financial reports of the entities audited, particularly in the notes to the financial statements. In these cases, there was no evidence on the engagement file that the auditor complied with the requirements of ASA 330. In many instances, oral explanations were provided to us by the auditors that the disclosure deficiencies were not considered to be material.
- 96 In some of these instances, there was insufficient evidence on the engagement file to demonstrate that the auditor had adequately:
- (a) reviewed the notes to the financial statements;
 - (b) assessed the information in the notes in light of the audit procedures undertaken; and
 - (c) challenged the assertions or representations of the client about the financial statement disclosures.
- 97 In such circumstances, in the absence of sufficient evidence to the contrary, it is unclear whether the auditor performed detailed audit procedures to assess the accuracy of some key disclosures and consulted with internal accounting specialists about specific disclosure requirements of Australian accounting standard. Examples of disclosure deficiencies included

disclosures related to fair value measurement, impairment testing (see paragraph 110) and segment reporting.

- 98 As set out in AASB 101, the notes to the financial statements are part of a complete financial report and the objective of financial reports is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. In light of this, we would expect auditors to assign appropriate importance to reviewing financial report disclosures.

Technical consultations

- 99 To manage the risks associated with auditing during the global economic downturn, many of the firms increased their requirements for engagement teams to consult with internal technical specialists about complex audit areas such as fair value measurements, review of impairment calculations and the appropriateness of going concern assumptions. The majority of the Larger National and Other National and Network firms have policies about such technical consultations.
- 100 In some of the engagement files there was insufficient evidence about the engagement team's consultations on complex or specialist areas with the firm's internal technical specialists.
- 101 In the majority of these instances, the evidence on the engagement file was not sufficient to demonstrate the extent and nature of discussions between the engagement team and the firm's internal technical specialists. In particular, the evidence did not clearly describe the role or the work performed by the firm's internal technical specialists. In those circumstances, it was difficult to assess whether the engagement team was able to rely on the results of the technical consultations.
- 102 In the future we will extend the focus of our inspections to the operation of the firm's internal technical specialist groups in supporting audit judgements, including a review of the relevant quality control systems within these groups.

Professional scepticism

- 103 ASA 200 requires an auditor to plan and perform an audit with an attitude of professional scepticism. Professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of the audit evidence obtained and the client's judgements on accounting treatments and estimates. In many of the engagement files there was insufficient evidence that the auditor exercised an attitude of professional scepticism and objectively assessed the evidence presented by clients and client judgements.

104 A questioning mind and objective approach to assessing evidence is critical where entities are required to make estimates and/or judgements in significant and material areas of a financial report. In many engagement files, at least one of our observations related to fair value measurements, impairment calculations and going concern assessments where, in our view, the auditor did not demonstrate adequate professional scepticism. In a number of these instances, we were concerned by the lack of evidence that the auditor clearly challenged the client; it instead appeared that the auditor sought out evidence to corroborate what they were told by the client.

Fair value measures and impairment

105 Given that the global economic downturn increased the likelihood that the value of assets could be impaired, we paid particular attention in our inspections to the key audit areas of measuring the fair value of assets and the associated audit procedures performed on asset impairment calculations.

106 It is the responsibility of an entity to determine if the value of an asset may be impaired and then to estimate the recoverable amount of the asset as set out in Australian accounting standard AASB 136 *Impairment of Assets* (AASB 136). It is the responsibility of the auditor to make a critical assessment, with a questioning mind, of the validity of the evidence provided by the client.

107 Auditing Standard ASA 545 *Auditing Fair Value Measurements and Disclosures* (ASA 545) specifically 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 Australian accounting standards and similar impairment calculations, such as 'value in use' calculations.

108 In many engagement files there was insufficient evidence that the auditor had exercised professional scepticism when assessing the key assumptions used by the clients in measuring the fair value of assets and the judgement about whether impairment charges were necessary or adequate.

109 In the majority of those instances, there was insufficient evidence that the auditor challenged:

- (a) the appropriateness of the growth rates used by the client. Often the growth rates appeared unrealistically high, but there was no evidence that this was questioned by the auditor or compared to the client's historical performance;
- (b) the correctness of the discount rates applied by the client. Frequently, the auditor did not critically evaluate whether a discount rate used by a client reflected the risks specific to the relevant industry. This may

suggest that the auditor did not have had sufficient competence to properly evaluate the client's assumptions or calculations; and

- (c) the accuracy of the source data used by the client in estimating future cash flows. Future cash flows are used when measuring the recoverable amount of an asset using the 'value in use' method and may be used in determining fair value less costs to sell. Often the engagement file did not contain evidence that the auditor had objectively evaluated whether the cash flows were complete, accurate and prepared in accordance with AASB 136 and consistent with other areas of the file (e.g. deferred tax assessments or going concern assessments).

110 In a smaller number of instances there was insufficient evidence that the auditor exercised professional scepticism in considering:

- (a) whether the disclosures about fair value in the financial report were in accordance with the relevant Australian accounting standards in particular, if sensitivities were disclosed when a reasonable possible change in assumptions could lead to impairment. Where disclosure deficiencies were identified, it often appeared that the auditor was willing to agree with the client's disclosures rather than challenge them; and
- (b) the number of cash generating units identified by the client and whether it was appropriate to apply the same discount rate to different cash generating units.

111 In some engagement files, the documentation on the file raised concerns about the competence of members of the audit engagement team to audit complex components of the client's fair value and impairment calculations. Where we have raised this concern, the firms have indicated that they will provide the relevant training and, where appropriate, ensure engagement teams consult with the internal technical specialists in the firm.

112 In some instances when the firm's internal technical specialists were consulted about fair value and impairment calculations, they raised matters of concern for the engagement team's consideration. However, the documentation on the engagement file did not always demonstrate that the engagement team conducted adequate additional procedures to address the matters raised by the technical specialists or sought the endorsement of technical specialists on the conclusions reached.

Going concern assessments

113 Auditing Standard ASA 570 *Going Concern* (ASA 570) requires an auditor to evaluate a client's assessment of an entity's ability to continue as a going concern. It also requires auditors to undertake specific procedures when events or conditions that may cast significant doubt on an entity's ability to continue as a going concern have been identified. During a global economic

downturn when there is reduced liquidity and reduced ability for companies to refinance debt or raise new funds, and/or pressure on results and asset values, an entity's ability to continue as a going concern can be at risk and accordingly this was a key audit area that we focused on.

- 114 In a small number of engagement files there was a lack of evidence that the auditor challenged evidence provided by the client to support their assumption that the entity was a going concern. It appears that the auditor often accepted the client's estimates of future cash flows without critically assessing the assumptions underlying those estimates

Analytical review procedures

- 115 In some of the engagement files the auditor did not undertake appropriate analytical procedures as required by Auditing Standard ASA 520 *Analytical Procedures* (ASA 520). In more than half of these cases, the analytical review procedures undertaken at the preliminary stage of the audit were not adequate to be considered a risk assessment procedure sufficient to obtain an understanding of the entity and its environment. In addition, in most of these cases, analytical review procedures were also not performed adequately at the final stage of the audit to gain an understanding of the whether the financial report as a whole was consistent with the auditor's understanding of the entity.

- 116 In almost half of these instances, the auditor relied on analytical review procedures as substantive tests for certain balances. However, in these cases the auditor did not sufficiently evidence:
- (a) how the analytical review procedures provided appropriate audit evidence to support audit-specific assertions relating to those balances for example, the completeness, accuracy and existence of bank balances or debtors;
 - (b) that there was an appropriate relationship between the data used and the population being audited or that the source data was sufficiently independent;
 - (c) whether the expectation established was sufficiently precise to identify a material misstatement; and/or
 - (d) that the difference of the recorded balance from the expectation established was sufficiently investigated.

- 117 Often when analytical review procedures conducted by the auditor resulted in variances, the auditor accepted explanations provided by management of the client without corroborating or challenging those explanations or comparing them with the auditors' own understanding of client's operations.

Engagement quality control reviews

- 118 In many engagement files there was a lack of sufficient appropriate evidence of the engagement quality control reviews. This deficiency can raise questions about the effectiveness of the EQCR role, particularly given the:
- (a) number of ASIC findings about engagement files that did not contain sufficient appropriate audit evidence to support the testing of and conclusions reached about key judgement or risk areas;
 - (b) lack of sufficient appropriate evidence that the EQCR actually reviewed the work done by the engagement team in key judgement or risk areas, with the file usually containing only a signature on an audit review checklist;
 - (c) many instances where time records indicated that the EQCR recorded spent less than 1% of the total time charged by the engagement team on an engagement; and
 - (d) small number of instances where the engagement quality control review was performed by a person who was not eligible to be an EQCR in accordance with the requirements of the Corporations Act. In addition, Auditing Standard ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements (ASQC 1)* sets out that an EQCR for an audit of the financial report of a listed entity is likely to be an individual with sufficient appropriate experience and the authority to act as an engagement partner on audits of financial reports of listed entities.
- 119 Auditing Standard ASA 220 *Quality Control for Audits of Historical Financial Information (ASA 220)* 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 the conclusions reached in formulating the auditor's report.
- 120 To provide assurance that a high quality audit was undertaken, an engagement file needs to contain evidence that a qualified EQCR reviewed the file in accordance with the requirements of ASA 220.
- 121 We acknowledge that the Larger National and Other National and Network firms have implemented policies and procedures for the EQCR role and review. We also recognise that the time spent by EQCRs will vary from engagement to engagement and can be affected by the composition of the audit team, the size and risk profile of the client and the EQCR's familiarity with the client. However, given the extent of findings from our 2009–10 inspection and previous inspections, we continue to have concerns about the number of deficiencies observed in this area. Leaders of the firms should remind firm personnel about the importance of the role of the EQCR.

Other observations and findings

- 122 During our review of audit engagement files, other instances were noted where the auditor failed to perform certain audit procedures or did not undertake the procedures strictly in accordance with the relevant Australian auditing standard. A smaller number of audit engagement files did not contain sufficient appropriate evidence to demonstrate that the auditor undertook procedures to:
- (a) ensure significant litigation or claims were identified. In some instances, solicitor's representation letters were not requested or obtained and there was no evidence on the engagement file of the alternative procedures the auditor performed to identify potential legal matters. In some instances where solicitor's letters were obtained, there was no evidence that the auditor considered whether matters in these letters needed to be accounted for and disclosed;
 - (b) select an appropriate sample of items for audit testing. In those circumstances, the auditor did not document sufficiently the rationale for the size or the method used for selecting the sample;
 - (c) test journal entries and other adjustments throughout the financial year. In our view, given that journal entries and other adjustments can be used to manipulate financial results, testing of unusual and material journal entries is an important audit procedure that should be performed to cover the whole financial year; and
 - (d) establish an appropriate quantitative materiality level to plan risk assessment procedures and other procedures. In those circumstances, the auditor did not meet the requirements of the firm's policy or the Australian auditing standards by either setting the materiality at an inappropriate level or using an inappropriate basis for setting materiality.
- 123 In most of these cases, the auditor provided oral explanations about the auditor's consideration of these specific matters, but this was not documented on the engagement file. If the evidence of the work done is not documented it is difficult to ascertain the nature, timing and extent of audit procedures the auditor performed to reach a conclusion and comply with the requirements of the Australian auditing standards.

Smaller firms

- 124 During 2009–10 we conducted inspections of eight Smaller firms not previously inspected. Taking into consideration the size and nature of these Smaller firms and the profile of the clients they audit, we focused on the review of nine listed entity audit engagement files selected based on risk criteria to assess audit quality.

125 Our review of the engagement files concentrated on the substance of the auditors' work, to assess if there was sufficient appropriate audit evidence on the file to support the key audit considerations and the conclusions of the auditor. Our reviews were not designed to detect all instances of non-compliance or to confirm all aspects of the audit opinion. During 2009–10, we reported separately to each of the firms on the findings from our reviews.

Common observations and findings

126 Our review of audit engagement files of Smaller firms raised concerns about the quality of audit evidence on five of the nine engagement files and the extent and timing of engagement quality control reviews.

Audit evidence and documentation

127 In our last public report we noted that in a large number of engagement files there was insufficient evidence to support key audit assertions. We noted the area of evidence and documentation as a major area of focus for Smaller firms.

128 In 2009–10 we continued to find instances where the engagement files failed to provide sufficient appropriate audit evidence to support the nature, timing and extent of audit procedures performed and the conclusions reached on key judgement and risk areas. In particular, we noted instances where some areas of the audit were performed utilising checklists with no supporting evidence or documentation of the procedures undertaken.

129 In a small number of the engagement files it was difficult to see how the auditor objectively assessed the evidence presented by clients and exercised an appropriate attitude of professional scepticism. In areas that require client management to make estimates of or judgements about significant and material areas of a financial report, a questioning mind and objective approach to assessing evidence is critical.

Consideration of the risk of fraud

130 We found in a number of the engagement files reviewed that there was insufficient audit evidence to demonstrate that the auditor had complied with ASA 240 and made enquiries of management about their:

- (a) assessment of the risk of fraud;
- (b) processes for identifying and responding to fraud risks;
- (c) communication with those charged with governance about their processes;
- (d) communications to employees about management's views on business practices and ethical behaviour; and
- (e) knowledge of any actual, suspected or alleged fraud.

131 In addition, there was no evidence that the auditor obtained an understanding of how those charged with the governance of the entity exercised oversight of management's processes for identifying and responding to the risk of fraud.

132 Smaller firms need to be diligent in their consideration of the risk of fraud so that they are able to design and perform adequate audit procedures to cover the risk of fraud.

Financial statement disclosures

133 In a number of cases we found deficiencies in the financial statements of the entities audited. It was not evident from the documentation on the file whether the auditor had complied with the requirements of ASA 330 to evaluate whether the overall presentation of the financial report, including the financial disclosures, was in accordance with the entity's applicable reporting financial reporting framework.

134 In addition, in one engagement file there was insufficient evidence that the auditor had reviewed other information in the entity's annual report to ensure it was consistent with audited financial information.

Related parties

135 In a number of engagement files there was no evidence of audit procedures performed to address the risk of the financial reports containing material misstatements that result from the existence of related parties and related party transactions. Smaller firms need to ensure they fully address the requirements for the audit of related party transactions, particularly given the nature of related party transactions and possible complexities associated with the transactions and their audit.

Laws and regulations

136 In some engagement files there was a lack of sufficient appropriate evidence that the auditor assessed the client's compliance with laws and regulations as required by Auditing Standard ASA 250 *Consideration of Laws and Regulations in an Audit of a Financial Report* (ASA 250).

Engagement quality control reviews

137 We found little or no evidence on the majority of the engagement files to support the engagement quality control review. This review should include an objective evaluation of the significant judgements made by the engagement team and the conclusions reached in formulating the auditor's report. Engagement quality control reviews provide an essential overlay of quality control, particularly for Smaller firms that have yet to develop and implement an internal monitoring program: see paragraph 185. In these instances, it may be warranted for Smaller firms to take a more rigorous

approach to engagement quality control reviews and go beyond the requirements of the Australian auditing standards in order to ensure a high quality audit is achieved.

D Detailed observations and findings: Quality control

Key points

Some Larger National firms should improve their independence systems and testing of those systems to avoid contraventions of the independence requirements of the Corporations Act.

Other National and Network firms can improve some aspects of their quality control systems, particularly by emphasising the importance of audit quality and independence in messages from leaders of the firm, and including audit quality and independence as clear criteria in partner performance evaluations.

Smaller firms need to continue to develop and implement many aspects of their quality control systems; in particular, systems to enable compliance with the independence requirements of the Corporations Act and ethical and professional requirements, and procedures to systematically and rigorously examine and monitor audit quality.

Larger National and Other National and Network firms

- 138 ASQC 1 was effective from 1 January 2010. ASQC 1 is based on the equivalent international standard on quality control that was issued by the International Ethics Standards Board for Accountants and is equivalent to Accounting Professional and Ethical Standard APES 320 *Quality Control for Firms* (APES 320).
- 139 The firm's quality control systems enable them to meet the requirements of ASQC 1 and ASA 220. Our assessment, therefore, is based on the elements set out in ASQC 1 and APES 320:
- (a) leadership responsibilities for quality within the firm;
 - (b) ethical requirements;
 - (c) acceptance and continuance of client relationships and specific engagements;
 - (d) human resources, engagement performance; and
 - (e) monitoring.
- 140 Where, in a previous inspection, we did not have any observations or findings for a particular element of a quality control system, we only reviewed and tested key changes to these elements. Our observations and findings arising from our review of the elements reviewed and tested during 2009–10 are set out in the sections below.

141 Because the extent and composition of the quality control systems can vary
 between the Larger National firms and the Other National and Network
 firms due to their structure and the resources available within the networks,
 the results for the Larger National firms and the Other National and Network
 firms are shown separately.

Larger National firms

Leadership responsibilities for quality within the firm

142 Larger National firms have policies and procedures that recognise that
 quality is essential to performing audits in accordance with legal and
 professional requirements.

143 The leadership of these firms remain committed to an appropriate ‘tone at
 the top’ and we consider this commitment continues to have a positive and
 ongoing impact on maintaining a strong culture of audit quality and
 independence.

144 However, based on the observations and findings from some Larger National
 firms’ own monitoring processes and ASIC’s observations and findings in
 this report, leaders of these firms should continue to reinforce the need to:

- (a) conduct high quality audits that can withstand internal and external
 scrutiny, and demonstrate this through obtaining appropriate audit
 evidence that is sufficiently documented on the engagement file and
 rigorous engagement quality control reviews;
- (b) exercise a heightened level of professional scepticism in significant
 judgemental areas of the audit; and
- (c) comply with independence requirements of the Corporations Act and
 the firms’ own independence policies.

Ethical requirements and independence

Auditor rotation requirement contraventions

145 During 2009–10, two contraventions of the auditor rotation requirements of
 the Corporations Act were noted at a Larger National firm. Once these
 contraventions were identified by the Larger National firm’s internal
 monitoring systems they were rectified by the firm and the matters were
 disclosed to ASIC.

146 The contraventions involved a partner playing a significant role either as an
 engagement partner or an EQCR in the audit of a listed client for more than
 five out of seven successive financial years. Consequently, a new partner and
 a new EQCR were assigned to the listed client.

Contravention of other independence requirements

- 147 A Larger National firm identified and reported to us a contravention of the independence requirements of the Corporations Act. The contravention involved a partner holding a direct financial interest in a listed audit client.
- 148 Although the partner did not provide any audit or non-audit services to the audit client, Accounting Professional and Ethical Standard APES 110 *Code of Ethics for Professional Accountants* (APES 110) notes that if any partner of a firm, in the office in which the engagement partner practices in connection with the audit, holds a direct financial interest in an audit client, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level. The partner no longer holds the position of partner at this Larger National firm.

Policies, systems and processes

- 149 The Larger National firms have independence policies and systems that reflect the requirements of the Corporations Act, and also require partners and senior staff to disclose their investments on interactive databases that are automatically matched with the firms' prohibited securities lists. During 2009–10, the Larger National firms continued to test how partners complied with these policies and systems.
- 150 Although the firms continue to identify instances of non-compliance with their own policies that include requirements that go further than the Corporations Act, the number of instances of non-compliance has not increased compared to prior years.
- 151 Our review of the Larger National firms' policies, systems and processes for ethical and independence requirements found a small number of instances where there was scope for enhancement. These findings were brought to the attention of the relevant firms in our private reports to them.

Engagement performance

- 152 All Larger National firms continue to enhance their systems and processes to better integrate audit technology with their audit methodologies, and adopt changes to policies and processes with the introduction of the Clarity auditing standards. Some firms implemented, or are in the process of implementing, new audit technology systems.
- 153 The leadership of some firms need to reinforce messages to partners and staff about the importance of following the firm's policies and the relevant Australian auditing standards when performing specific audit procedures. These relate to the nature, extent and timing of audit procedures to be performed for specific account balances in the financial report, ensuring that reasonable assurance is obtained over specific audit assertions.

154 Where there is divergence from firm policies, adequate explanations should be provided in the engagement files. These explanations should contain details of the alternative audit procedures performed to obtain the necessary assurance over specific account balances.

155 A number of firms have strategies in place to ensure audit engagements are conducted in the most efficient and effective manner. However, the firms need to focus on these aspects in the performance of audit engagements, in their audit training, partner and staff briefings, and in scoping their internal quality control review activities to ensure that audit quality is not compromised.

Monitoring

156 All of the Larger National firms have comprehensive policies and procedures for monitoring their audit quality in accordance with legal and professional requirements. The Larger National firms regularly undertake rigorous inspections of a selection of completed audit engagements. They use the results of these inspections to enhance their audit quality systems, if necessary, and direct the focus of staff training.

157 Two of the Larger National firms need to improve their processes for reporting to ASIC about contraventions and suspected contraventions of the Corporations Act, in accordance with s311. These include contraventions of the independence requirements of the Corporations Act.

Human resources

158 All of the Larger National firms have mature systems and processes in place to provide assurance that personnel are competent, capable and committed to ethical principles. We found a small number of instances where there is scope for the Larger National firms to improve aspects of these systems.

159 To provide clear messages to personnel about the importance of complying with ethical principles:

- (a) one Larger National firm should consider the sufficiency of internal disciplinary action for contraventions of the rotation requirements of the Corporations Act, to ensure they are commensurate with the nature of the breaches identified; and
- (b) another Larger National firm should formally publish its disciplinary policy for staff below the level of partner, and communicate the key messages of the policy to the relevant personnel.

160 To ensure that the sufficiency and appropriateness of training for personnel can be monitored, one Larger National firm needs to ensure it continues to properly record attendance by personnel at training courses.

Other National and Network firms

Leadership responsibilities for quality within the firm

- 161 All of the Other National and Network firms recognise the importance of audit quality. However, some of these firms need to strengthen the ‘tone at the top’ messages to partners and staff about audit quality and the consequences of non-compliance. This is essential at the Other National and Network firms that we inspected for the first time during 2009–10.
- 162 The messages from the leadership at two of the Other National and Network firms should emphasise the overriding importance of audit quality and commitment to independence and ethical principles. ‘Tone at the top’ messages can be communicated in variety of ways, including through formal and informal dialogue, at training seminars and conferences and by incorporating them into mission statements or strategic plans.
- 163 Some of the Other National and Network firms can improve the communication of their messages about audit quality and ethics and independence by making them transparent in strategic plans or an integral part of agendas for board and executive meetings.

Ethical requirements and independence issues

Auditor rotation

- 164 During 2009–10, we noted one instance where an audit partner had played a significant role in the audit of a listed client for in excess of five years, in contravention of the Corporations Act. The audit of the listed client has been assigned to another partner.
- 165 While most of the Other National and Network firms have systems in place to monitor compliance with the auditor rotation requirement of the Corporations Act, one Other National and Network firm needs to implement processes to ensure it can satisfy these legislative requirements. Another Other National and Network firm needs to improve partner rotation plans to ensure that its member firms are able to manage the rotation of partners for existing audit clients that become listed.

Policies and procedures

- 166 All of the Other National and Network firms inspected have policies and processes in place to facilitate compliance with the independence requirements of the Corporations Act and professional standards. However, the completeness and adequacy of the independence policies and processes varied, reflecting the nature or maturity of the national partnership or network structure of those firms.

167 The independence policies and processes of more than half of the Other National and Network firms need improvement to ensure that they are consistent with the requirements of the Corporations Act and Australian accounting professional and ethical standards, and are applied consistently across the member firms of the network.

Testing of independence systems

168 Approximately two thirds of the Other National and Network firms are not testing their independence systems and processes to ensure compliance with their legal and professional independence requirements. A quarter of the Other National and Network firms have commenced testing their independence systems and processes. However, in one instance the testing does not extend to assessing the completeness and accuracy of the partners' annual independence declarations and, in another instance, not all of the member firms are testing their independence systems across the network.

169 Without a rigorous testing program, firms can only place limited reliance on the effectiveness of their independence systems and processes. An effective testing program can identify potential non-compliance on an ongoing basis. Firms that have robust testing programs in place are identifying non-compliance with their policies and the Corporations Act.

170 Where firms are testing their independence systems and processes, the communication of the results of the testing process to all personnel sends a strong and clear message about the importance of independence.

Acceptance and continuance of client relationships and specific engagements

171 The majority of the Other National and Network firms have adequate policies and procedures in place for the acceptance and continuance of client relationships and specific engagements. We noted a small number of instances where the policies and procedures could be improved.

172 One of the Other National and Network firms needs to implement a formal procedure to document the process for performing conflict checks prior to accepting a new audit client. Two of the Other National and Network firms can improve their client acceptance and continuance evaluation procedures by, in one instance, including criteria for accepting clients in specific industries and, in another, by requiring a concurring partner approve acceptance and continuance decisions.

173 The primary focus of client acceptance and continuance procedures should continue to be on independence considerations, possible conflicts of interest and whether the firm continues to have the requisite skills to conduct an engagement (as required by ASQC 1).

Engagement performance

- 174 Most of the Other National and Network firms need to enhance their audit manuals so that they include complete policies and procedures for all elements of undertaking an audit, and also provide practical guidance about the application of the Australian auditing standards and the firm's audit tool.
- 175 We noted that in some instances the audit manuals did not contain formal policies on sampling, archiving and safe custody (integrity) of engagement files. The audit manuals were also deficient in guiding audit engagement teams about the role of the EQCR, the extent and timing of an engagement quality control review, and the procedures necessary to enable an auditor to rely on the work of other auditors or experts.
- 176 We also found in some of the Other National and Network firms that there was inconsistent application by member firms of the network of parts of the audit manuals, including the approach to sampling and the form and content of audit reports issued.
- 177 To achieve a high quality audit, it is critical for the firms to have comprehensive audit manuals that accurately reflect the requirements of the Australian auditing standards and the Corporations Act and that are consistently followed by all the member firms in the network.

Monitoring

- 178 All of the Other National and Network firms have procedures in place to facilitate monitoring of audit quality in accordance with the requirements of ASQC 1. At the time of our inspection, one of the Other National and Network firms had not completed its first monitoring program. One of the Other National and Network firms can improve its monitoring processes by establishing a mandatory action plan for audit deficiencies identified from the monitoring process, including training and following up the proposed remedial action.
- 179 Many of the Other National and Network firms need to adopt formal policies and procedures to deal appropriately with complaints and allegations of non-compliance with professional standards and regulatory and legal requirements.

Human resources

- 180 The majority of the Other National and Network firms need to implement policies and procedures to ensure adequate consideration is given to audit quality and independence in partner performance evaluations. A clear understanding of audit quality and adherence to ethical principles should be key criteria for advancement and remuneration decisions.

- 181 Some of the Other National and Network firms do not document partner evaluations. One of the Other National and Network firms does not have a formal evaluation process for partners. A formal documented evaluation process is important to ensure that partners and staff are aware of the firm's expectations for audit quality and ethical principles. The evaluation process should also enable partners and staff to receive meaningful feedback on their performance, including advice on areas of improvement and additional training needs.
- 182 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 decisions at most Other National and Network firms.

Smaller firms

- 183 ASIC conducted limited-scope inspections on eight Smaller firms during the audit inspection program in 2009–10. The audit inspection program for Smaller firms is targeted in scope, taking into consideration the size, client profile and nature of these firms. In conducting the inspections of the quality control systems of Smaller firms we focused on core aspects of the systems as they related to audit quality on the nine engagement files we reviewed at the eight Smaller firms.

Quality control systems

- 184 While it is recognised that the size and characteristics of Smaller firms may limit the sophistication of their quality control systems, Smaller firms undertaking audits are still required to comply with their legal and professional obligations. On this basis, we found a number of areas where Smaller firms need to take action to ensure they can comply with the requirements of the Corporations Act and professional standards.
- 185 The majority of Smaller firms do not have a monitoring program in place that includes a periodic inspection of a selection of completed engagement files. Without ongoing evaluation and monitoring of their quality control systems, Smaller firms may not be able ascertain whether their systems are operating effectively to facilitate compliance with professional standards and other relevant legal and regulatory requirements. While some Smaller firms rely on the outcomes of The Institute of Chartered Accountants Australia (ICAA) quality reviews and ASIC inspections, these are not a substitute for an internal monitoring program within the firm.
- 186 Some Smaller firms are yet to formalise policies and procedures for the acceptance and continuance of client relationships and specific engagements.

Smaller firms need to ensure they develop, implement and are able to comply with such policies, so that they undertake or continue to undertake only those engagements for which they have the competence, capabilities and resources and, most importantly, from which they are free of conflicts.

- 187 One of the Smaller firms had not yet developed formal policies and procedures for the completion of annual independence declarations by personnel of the firm as required by ASQC 1. The collection and monitoring of such information is crucial to identify any potential conflicts of interests that could result in a contravention of the Corporations Act if the firm accepted a new engagement or continued with existing engagements.
- 188 We also suggested a number of improvements to some of the Smaller firms in relation to the resources being utilised, such as ensuring audit manuals or audit guidance are up-to-date, and provide adequate guidance to staff. The introduction of the Clarity auditing standards is the opportune time for Smaller firms to review their audit manuals and tools to ensure that they accurately reflect the requirements of the Australian auditing standards and the Corporations Act.

E Future focuses

Key points

Our future focuses will include:

- conducting inspections of those firms that audit significant public interest entities, focusing on entities and industries with perceived heightened risks based on current market conditions;
- refining our inspection approach to ensure that it continues to be effective and consistent with international best practices;
- following up the extent to which matters noted in our previous inspections have been addressed, with an emphasis on performing engagement file reviews, particularly of significant audit judgement areas, to assess audit quality;
- 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 auditing professionals.

Inspection scope and process

- 189 The focus of our audit inspection program will continue to be those firms that audit entities likely to be of greater public interest, and those entities and industries that are more vulnerable to the risks emanating from existing and emerging market conditions.
- 190 We will continue to conduct follow-up inspections of firms. Where significant issues were identified in previous inspections, we will escalate follow-up inspections to ensure the firms are taking prompt and appropriate action to address our observations and findings. Our inspections of Smaller firms will continue to extend to those firms that have not previously been subject to an audit inspection.
- 191 Our future reviews of engagement files will include financial institutions, managed investments schemes and audits of Australian financial services (AFS) licensees.
- 192 We will continue to monitor and examine the causes of recent corporate collapses. Where deficiencies in auditor conduct appear to have contributed to a lack of transparency in the financial position and financial performance of an entity on a timely basis leading up to the collapse, we will focus on these areas in our future audit inspections.

193 Our inspection process is continually reviewed to ensure that it remains effective. We are considering further refinements to the nature and extent of our engagement file selection processes, file reviews and other inspection processes, such as including a focus on reviewing the firm's internal specialist technical groups (e.g. technical accounting, treasury, actuarial, taxation) that support audit engagement teams to assess processes applied by those groups on matters referred and the quality of their advice.

Specific areas of focus

Audit quality and evidence

- 194 Given the issues noted in this inspection report, our future inspections will continue to focus on whether the auditors obtained sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base their opinion.
- 195 Where appropriate, we will challenge engagement partners on whether the evidence obtained and documented on engagement files for specific audit assertions is sufficient and appropriate and supports the significant judgements made to reach their conclusions and form their opinions.
- 196 If there is no documentation on an engagement file, we will presume that the auditor did not obtain the necessary audit evidence to support the procedures performed or conclusions reached.

Professional scepticism

- 197 The level of professional scepticism exercised by auditors has been in the spotlight during the global economic downturn and the resultant high profile corporate collapses worldwide.
- 198 In areas and circumstances that involve significant judgements by clients when preparing their financial statements, auditors should have a heightened level of professional scepticism. A lack of documented evidence of the exercise of professional scepticism by engagement partners and teams could lead to potential concerns relating to the objectivity and quality of audit work undertaken.
- 199 Based on the above and the findings in some of the 2009–10 inspections, professional scepticism exercised by auditors will be an area of continued focus in future inspections. We will review engagement files for evidence of the extent of professional scepticism exercised by engagement teams in significant judgement areas.

Relying on the work of others

- 200 In this report we have noted instances where we had concerns about the auditor relying on the work of experts (internal and external) and other auditors (in the same network as the principal auditor or in an unrelated network). In light of these concerns and changes resulting from the Clarity auditing standards—for example, the changes to ASA 600, noted in paragraph 82—we will continue to focus on areas where the auditor relies on the work performed by others to draw conclusions on which to base the audit opinion.
- 201 We will review engagement files for evidence that the auditor assessed the competence and objectivity of experts and other auditors, considered whether the scope of the work performed by others was adequate for the purposes of the audit, and evaluated the appropriateness of the work performed by others as audit evidence for the audit assertions being considered. In particular, we will consider whether the auditor has sufficient skills to review the work performed by an expert used by the audit client or should have engaged their own independent expert, and whether sufficient audit work has been performed on information used by experts. Our selection of audit engagement files will include entities where:
- (a) there were group audit arrangements;
 - (b) the entity used service organisations;
 - (c) joint venture operations were included in an entity's financial report; or
 - (d) experts were used by the entity.

Audit fees and audit efficiencies

- 202 While it is not ASIC's role to interfere in the setting of audit fees between a firm and its client, large reductions in audit fees have the potential impact on audit quality.
- 203 To understand the level of fee reductions, in 2010 we wrote to the 14 largest firms requesting a listing of all successful formal proposals for audits of financial reports of new or existing clients. We used this information to select and review a sample of entities with substantial fee reductions as part of some inspections. While our findings to date are not indicative of any negative impact on audit quality, we are aware that in most instances the impact on audit quality would only be evident in subsequent years.
- 204 We will continue to target engagement files where there is evidence of large fee reduction on new or existing audits without any apparent underlying changes to business operations. Our review of engagement files will focus on the sufficiency of the audit quality, and we will continue to focus on firms' acceptance and continuance processes in this regard.

205 In addition, we are aware that a number of firms have strategies in place to ensure audit engagements are conducted in the most efficient manner. We will focus on these initiatives to ensure that audit quality is not compromised as a result of their implementation.

Other areas of focus

206 Other specific areas that we intend to focus on in future inspections include:

- (a) any areas of deficiency in auditor conduct that may have contributed to a lack of transparency in the financial position and financial performance of an entity on a timely basis leading up to a corporate collapse; ;
- (b) the auditors' understanding of the business model of the entity and risk assessment for individual engagements, and the auditors' interaction with the audit committee to ensure that key areas of risk are included in the audit strategy;
- (c) application of the new 'Clarity' auditing standards, including standards that have undergone considerable change;
- (d) monitoring 'opinion shopping', particularly where there are communications with an audit firm about their views on specific accounting treatments prior to acceptance of a new engagement;
- (e) the involvement of the engagement partners and EQCRs at different stages of the audit, including planning, consultations with the engagement team and reviewing key judgements and conclusions reached;
- (f) the quality and extent of the auditor's communications with those charged with governance of the entity, particularly communication of unadjusted differences and the significant audit judgement areas of going concern assessments, fair value measurement and impairment testing;
- (g) the extent of audit procedures performed and internal consultations;
- (h) the audit of financial statement disclosures, to ensure that the investing public is properly informed;
- (i) compliance with financial reporting disclosure requirements through our financial reporting surveillances and targeting those entities with deficient disclosures for audit inspections;
- (j) the adequacy and timeliness of auditors reporting suspected contraventions of the Corporations Act under s311, s601HG and s990K; and
- (k) scrutinising compliance with the auditor rotation requirements of the Corporations Act, including EQCRs as they are required to be registered company auditors.

Regulatory developments

207 In the wake of the global financial crisis, questions are being asked about whether the role of auditors can be enhanced to mitigate any new financial risk in the future. A number of matters are being considered globally and locally by governments and regulators as a result of the global economic downturn, such as Treasury's consultation paper on audit quality in Australia.⁵ We will actively monitor future regulatory developments in auditing and consider their impact on the audit inspection program.

208 Specific areas of regulatory developments that we will focus on in the next cycle of audit inspections are detailed below.

Clarity auditing standards

209 Auditing standards have been revised and redrafted in the 'Clarity' format internationally. The Auditing and Assurance Standards Board (AUASB) issued revised and redrafted Australian auditing standards in the Clarity format in October 2009 and they are operative for financial reporting periods commencing on or after 1 January 2010.

210 During our more recent inspections, we have engaged in discussions with the firms' executive leaders and assessed the firms' readiness for the Clarity auditing standards. The firms were at various stages of effecting changes to policies, systems and processes and training staff, but the majority had plans in place and were progressing with their implementation strategies.

211 Firms need to invest time and resources into understanding the changed requirements of these new standards, particularly standards (such as ASA 600) that have substantial additional requirements, and ensure their audit methodology meets the new or amended requirements.

212 We will shortly commence reviews of audit engagement files under the Clarity auditing standards. To ensure that the profession is well informed on a timely basis, we intend to issue a media release on our initial overall findings from these reviews in early 2012.

New code of ethics: Revised APES 110

213 The APESB has released a revised APES 110, the Code of Ethics for Professional Accountants, which aligns Australia's professional requirements with international standards and introduces Australian specific requirements relating to inadvertent violations and multiple threats to auditor's independence.

⁵ Consultation Paper, *Audit Quality in Australia: A Strategic Review*, Treasury, 1 March 2010.

- 214 Effective from 1 July 2011, the revised APES 110 extends the current rotation provisions to all key audit partners and the independence requirements for audits of listed entities to all public interest entities. Among other changes made, the revised APES 110 further strengthens some of the requirements relating to the provision of non-assurance services to audit clients.
- 215 Firms will need to be aware of all the relevant changes, particularly provisions relating to the new concepts of public interest entities and key audit partners, which for transitional purposes will not take effect until 1 January 2012.
- 216 Firms will also need to be cautious in the interpretation and application of the requirements in the revised APES 110 that differ and, in some instances, are less stringent than those imposed by the Corporations Act.

International collaboration

- 217 ASIC continues to work to minimise the regulatory burden on Australian auditing professionals by seeking arrangements with other international audit oversight bodies. These arrangements involve reliance on ASIC by other regulators or conducting work either jointly with them or on their behalf.
- 218 The PCAOB has a responsibility to monitor compliance of Australian auditors with the Sarbanes-Oxley Act (US). In 2007, ASIC entered into an arrangement with the PCAOB to conduct joint audit inspections and has been doing so since this time.
- 219 In January 2011, the European Commission recognised the equivalence of the audit oversight system in Australia. EU audit regulators can now enter into cooperative arrangements with ASIC, in order to rely on ASIC's audit firm inspections carried out on Australian firms that audit Australian companies listed in the European Union, or Australian subsidiaries of EU companies.
- 220 We will continue to work with other international audit regulation counterparts to reduce any regulatory overlap. Where possible, we will concentrate on maximising cross-border recognition opportunities and establishing regulatory cooperation arrangements.
- 221 ASIC is an active member of the International Forum of Independent Audit Regulators (IFIAR), comprising audit oversight bodies from around the globe. IFIAR's goals include sharing knowledge of the audit market between regulators, promoting collaboration and consistency in regulatory activity, and providing a platform for dialogue with other organisations that have an interest in audit quality. ASIC chairs the International Co-operation Working

Group and is a member of the Global Public Policy Committee Working Group.

- 222 ASIC is also a member of the International Organization of Securities Commissions (IOSCO) and actively participates in IOSCO Standing Committee No.1 on Accounting, Auditing and Disclosure. We are members of the Auditing Subcommittee and the Accounting Subcommittee, as well as chairing the International Financial Reporting Standards Regulatory Interpretation and Enforcement Subcommittee.
- 223 Our contribution and participation at the IFIAR and IOSCO will continue to ensure that our inspection techniques and processes remain current and relevant in the changing global financial economy.
- 224 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: How we conducted our work

225 This report covers inspections of firms substantially completed between 1 July 2009 and 31 December 2010. 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

Larger National and Other National and Network firms

- 226 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 Australian auditing standards as required in Div 3 of Pt 2M.3 of the Corporations Act (i.e. audit quality).
- 227 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 suggested areas for improvement.
- 228 In particular, we considered the following areas of each of the firm's quality control systems:
- (a) leadership responsibilities for quality within the firm;
 - (b) ethical requirements;
 - (c) acceptance and continuance of client relationships and specific engagements;
 - (d) human resources;
 - (e) engagement performance; and
 - (f) monitoring.
- 229 Our inspections concentrated first 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.
- 230 Second, we examined each firm's audit methodology for compliance with Australian auditing standards operative for financial reporting periods commencing prior to the date of our inspection.

231 Third, we reviewed the conduct of aspects of a limited number of archived individual audit engagements for compliance with each firm's stated audit methodology and applicable Australian auditing standards as at the date of each audit or review. We also focused on specific areas most affected by the global economic downturn. Each review concentrated on the substance of work and on whether sufficient appropriate audit evidence was on file to support the conclusions reached for key decisions and significant judgements about the audit.

232 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

233 To reflect the size and client profile of Smaller firms, our inspection approach is limited compared with inspections of Larger National firms and Other National and Network firms.

234 A limited inspection of a Smaller firm comprised:

- (a) conducting a review of aspects of generally one archived audit engagement file of a listed entity for compliance with each firm's stated audit methodology and the applicable Australian 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) about the engagement file reviewed and certain policies and procedures relating to auditor independence and audit quality employed by the firm.

235 The inspection process is not designed to gain a comprehensive understanding of the firms' quality control systems; instead, it focuses 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.

236 Smaller firm engagement file reviews were mainly conducted at our offices, with on-site activities limited to discussions with firm personnel at the commencement and the completion of the inspection.

The inspection process

237 The inspection process was designed to gain an understanding of:

- (a) the quality of audit work by the firm;

- (b) the firms' executive leadership direction and strategic priorities for independence and audit quality;
- (c) the firms' policies and systems for ensuring audit quality and compliance with their independence obligations;
- (d) the firms' independence and audit methodology training programs;
- (e) the links between the firms' independence and audit quality policies and the performance management processes; and
- (f) internal monitoring programs conducted by the firms.

238

In conducting our inspections, we:

- (a) reviewed material provided by the firms under notice pursuant to the ASIC Act;
- (b) reviewed aspects of a selection of archived audit engagements at each firm, weighted towards listed entities;
- (c) reviewed the firms' systems and processes for managing compliance with the audit independence requirements of the Corporations Act and for ensuring audit quality;
- (d) conducted limited testing of the firms' compliance with its independence and audit quality policies, systems and processes
- (e) interviewed selected partners holding leadership roles in the firms;
- (f) interviewed selected human resources representatives;
- (g) interviewed a number of the firms' other partners and staff; and
- (h) in the case of Larger National, and Other National and Network firms, visited some of their capital city offices and interviewed selected partners and staff.

Key terms

Term	Meaning in this document
AASB 101 (for example)	An Australian accounting standard (in this example numbered 101)
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
APES 110 (for example)	An Australian accounting professional and ethical standard (in this example numbered 110)
APESB	Accounting Professional and Ethical Standards Board
ASA 200 (for example)	An Australian auditing standard (in this example numbered 200)
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i> (Cth)
ASQC 1	An Australian auditing standard on quality control
ASX	The exchange market known as ASX, operated by ASX Limited
AUASB	Auditing and Assurance Standards Board
Australian accounting professional and ethical standards	Standards issued by the APESB
Australian accounting standards	Standards issued by the Australian Accounting Standards Board pursuant to s334 of the Corporations Act
Australian auditing standards	Standards issued by the AUASB pursuant to s336 of the Corporations Act
Clarity auditing standards	Australian auditing standards revised and redrafted to conform with the 'Clarity' International Standards on Auditing issued by the International Auditing and Assurance Standards Board
Clarity format	The format of auditing standards resulting from the International Auditing and Assurance Standards Board 'Clarity' project to enhance the understanding and implementation of auditing standards, as well as to facilitate translation.
CLERP 9 Act	<i>Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004</i> (Cth)

Term	Meaning in this document
Corporations Act	<i>Corporations Act 2001</i> (Cth), including regulations made for the purposes of that Act
engagement quality control review	A process designed to provide an objective evaluation, before the auditor's report is issued, of the significant judgements the engagement team made and the conclusions they reached in formulating the auditor's report
EQCR	Engagement quality control reviewer
firm	An audit firm inspected by ASIC as part of the audit inspection program
FRC	Financial Reporting Council
ICAA	The Institute of Chartered Accountants Australia
IFIAR	International Forum of Independent Audit Regulators
IOSCO	International Organization of Securities Commissions
Larger National firms	Firms that audit numerous listed entities (more than 5% by market capitalisation) and are national partnerships and members of a global network with multiple offices
Other National and Network firms	Firms with national partnerships or individual offices that audit many listed entities and are members of a national or international network
PCAOB	Public Company Accounting Oversight Board (US)
s311 (for example)	A section of the Corporations Act (in this example numbered 311), unless otherwise specified
Sarbanes-Oxley (US)	<i>Sarbanes-Oxley Act 2002</i> (US)
Smaller firms	Firms with small number of audit partners that audit a limited number of listed entities

Related information

Legislation

ASIC Act

CLERP 9 Act

Corporations Act, Pt 2M.3, Div 3, s311, Pt 2M.4, Div 3, 4, 5

Sarbanes-Oxley Act (US)

Standards

AASB 101 *Presentation of Financial Statements*

AASB 136 *Impairment of Assets*

APES 110 *Code of Ethics for Professional Accountants*

APES 320 *Quality Control for Firms*

ASA 200 *Objective and General Principles Governing an Audit of a Financial Report*

ASA 220 *Quality Control for Audits of Historical Financial Information*

ASA 230 *Audit Documentation*

ASA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report*

ASA 250 *Consideration of Laws and Regulations in an Audit of a Financial Report*

ASA 330 *The Auditor's Procedures in Response to Assessed Risks*

ASA 500 *Audit Evidence*

ASA 520 *Analytical Procedures*

ASA 545 *Auditing Fair Value Measurements and Disclosures*

ASA 570 *Going Concern*

ASA 600 *Using the Work of Another Auditor*

ASA 620 *Using the Work of an Expert*

ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements*