ASIC

Australian Securities & Investments Commission

REPORT 317

Audit inspection program report for 2011–12

December 2012

About this report

This report summarises the observations and findings identified by ASIC's audit inspection program in the 18 months to 30 June 2012.

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

About ASIC regulatory documents

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

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

Regulatory guides: give guidance to regulated entities by:

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

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

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

Scope

Sections of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices or conduct of some of the 20 audit firms inspected. The absence of a reference in this report to any other aspect of a firm's systems, policies, procedures, practices or conduct is not an approval by ASIC of those aspects, or any indication that in ASIC's view those aspects comply with relevant laws and standards.

In the course of reviewing specific areas in a limited sample of selected audit engagements, an inspection may identify ways in which a particular audit 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 apart from those 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. Our observations and findings can differ significantly, even between firms of similar size, and for that reason we caution against drawing conclusions about any individual firms.

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

Contents

Executive summary

1 This report covers the findings from our inspections of 20 Australian audit firms substantially undertaken in the 18 months to 30 June 2012. Our inspections focus on audits of financial reports of public interest entities prepared under the *Corporations Act 2001* (Corporations Act).

2 We are disappointed that there has not been an improvement in audit quality since our last report for the 18 months to 31 December 2010. Our risk-based reviews have shown an increase in instances where auditors did not perform all of the procedures necessary to obtain reasonable assurance that the audited financial report was not materially misstated.

3 Australia's audit regime is similar to the regimes in other major developed countries. We understand that audit oversight regulators in a number of other countries have experienced similar trends in audit quality.

4 Firms should increase their efforts to improve audit quality and the consistency of audit execution. This report identifies some important areas where the firms need to focus their attention and make improvements to ensure consistent audit quality.

5 We have identified three broad areas requiring improvement by audit firms:

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

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

(c) the extent of reliance that can be placed on the work of other auditors and experts.

6 We found that, in 18% of the 602 key audit areas that we reviewed across 117 audit files over firms of all sizes, auditors did not obtain sufficient appropriate audit evidence, exercise sufficient scepticism, or otherwise comply with auditing standards in a significant audit area. While the financial reports audited may not have been materially misstated, in these instances, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement: see Section A.

7 Some audit firms inspected need to improve their quality control systems: see Section B.

8 Further, we believe there are a number of actions that audit firms should consider to improve and maintain audit quality: see Section C.

9 In this report, we also outline future areas of focus for audit firms and our inspections: see Section D.

A Key findings: Audit file reviews

Key points

We have identified three broad areas requiring improvement by audit firms:

- the sufficiency and appropriateness of audit evidence obtained by the auditor;
- the level of professional scepticism exercised by auditors; and
- the extent of reliance that can be placed on the work of other auditors and experts.

We found that, in 18% of the 602 key audit areas reviewed by us across 117 audit files over firms of all sizes, auditors did not obtain sufficient appropriate audit evidence, exercise sufficient professional scepticism, or otherwise comply with auditing standards in at least one significant audit area.

While the financial reports audited may not have been materially misstated, in these instances, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement.

In this section, we also outline our findings on audits for specific industries.

Adequacy of audit procedures

10 Auditors are important 'gatekeepers' in our financial system. The quality of an audit supports high quality financial reports, informed investors and market confidence.

11 The objective of our inspections is to work co-operatively with firms to improve and maintain audit quality.

12 We are disappointed there has not been an improvement in audit quality since our last report for the 18 months to 31 December 2010. Our risk-based reviews have shown an increase in instances where auditors did not perform all of the procedures necessary to obtain reasonable assurance that audited financial reports were not materially misstated.

13 Australia's audit regime is similar to the regimes in other major developed countries. We understand that audit oversight regulators in a number of other countries have experienced similar trends in audit quality.

14 There are some important areas where the firms need to focus their attention and make improvements to ensure audit quality. While firms have indicated a commitment to improving audit quality, they should increase their efforts to improve audit quality and the consistency of audit execution.

15 We reviewed a number of key aspects in 117 audit files at the 20 audit firms that we inspected during the 18 months to 30 June 2012. Our inspections covered four to six key audit areas on each file. Across the 117 files, we reviewed 602 key audit areas in total. The appendix contains further information about our inspection approach and the 20 audit firms inspected.

16 In 18% of the 602 key audit areas reviewed in 117 audit files, in our view auditors did not obtain sufficient appropriate evidence, exercise sufficient professional scepticism, or otherwise comply with auditing standards. In these instances, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement. For the previous 18-month reporting period to 31 December 2010, we noted the same findings in 14% of the key audit areas we reviewed.

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

(a) Larger National firms—13% (10% in the previous 18-month period); and

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

Note: See paragraph 90 in the appendix for an explanation of the firm size categories.

18 Matters relevant to understanding our findings and the percentages reported above are outlined in Table 1. The percentages reflect findings in the areas discussed later in this section.

19 The auditing standards state that the fundamental objective of the audit is to obtain reasonable assurance that the financial report as a whole is free of material misstatement. Audit firms should consider ways to further improve audit quality and significantly reduce the number of instances where this assurance is not obtained.

20 Section C of this report outlines good practices adopted by auditors, and other matters for consideration by firms to promote improved audit quality. Section D contains specific focus areas for firms. We will also engage with firms on how they propose to address the findings in this report and reduce the percentages of findings.

21 Better auditors appropriately balance commercial pressures with risks and maintaining audit quality. They ensure that they understand the audited entity’s business model, its internal and external risks, and how these factors affect the nature and extent of audit procedures.

22 There will be instances where auditors detect material misstatements during the audit process and these misstatements are corrected before a financial report is completed and released. These instances are not measured in this report.

Table 1: Matters relevant to understanding findings

Matter	Explanation
Quality of financial reports	An adverse finding on a matter during our review does not necessarily mean that there will be material misstatements in the overall financial report. Rather it means that the auditor has not in ASIC's view obtained reasonable assurance that there are no such misstatements. In two separate instances, where we had identified concerns with audit work, we followed up the matters directly with the companies, resulting in material changes to their financial reports. In one case, where we identified inadequate audit work, the firm performed additional audit work and did not identify material misstatements in the financial report concerned. Generally, firms implement our suggested remedial actions for future company audits where we identify concerns. Auditors play an important role in checking financial information to ensure that it is accurate before financial reports are released to the market.
Level of assurance	An audit is not intended to provide absolute assurance that there are no material misstatements in the financial report. Our findings relate to instances where we believe that the auditor has not obtained reasonable assurance that the financial report as a whole is free of material misstatements.
What is measured?	The percentages listed in paragraph 17 relate to cases where auditors did not obtain sufficient appropriate audit evidence, exercise sufficient judgement, or otherwise comply with auditing standards in key audit areas, such that the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement. The percentages do not include other findings relating to audit quality and compliance with auditing standards, such as the adequacy of planning, obtaining an understanding of business, risk assessment, reviews and reliance on internal controls, non-substantive analytical procedures, documentation, supervision and review, auditor independence, firm quality control systems, and training of partners and staff. The percentages also exclude findings concerning insufficient work for related party transactions, reviews for unusual journal entries, review of legal expenses and legal representation letters, and subsequent event reviews. These matters could have resulted in material misstatements not being detected. Although excluded from the percentages, these remain important areas for improvement by firms.
Other National and Network firms	We inspected different groups of Other National and Network firms in the 18 months to 30 June 2012 and the 18 months to 31 December 2011. Firms inspected generally improve audit quality after our first inspection. In the 18 months to 30 June 2012, all firms had been previously inspected. In the 18 months to 31 December 2011, two firms had been inspected for the first time. This may have resulted in a smaller increase in the percentages above than would otherwise have been the case.
Subjectivity	Our findings relate to compliance with the auditing standards. Audits necessarily involve the application of professional judgement and there are some instances where different individuals will reach different judgements on whether the audit work performed is sufficient. Each of our inspection findings is subject to quality review within ASIC, and extensive discussion and consultation with the engagement partners and firms.

Matter	Explanation
Enforcement action	The objective of our inspections is to work co-operatively with audit firms to improve and maintain audit quality. We expect audit firms to make changes and to undertake work in response to our findings. However, there are some cases where findings are so serious as to warrant enforcement or similar action. We are currently considering possible enforcement action on concerns arising in the 2011–12 review period from our inspection of a Smaller firm. Further, as a result of inspections conducted in the 2009–10 review period and reported on in our previous report, one auditor from an Other National and Network firm and one auditor from a Smaller firm have chosen not to continue as registered company auditors.
Impact of risk-based approach	Our reviews of audit files do not cover all areas of an audit engagement or all subsidiaries and divisions in a group. Typically, four to six key audit areas are covered and, for groups, only one major operating component. We select audit engagements and key audit areas for review in our audit inspections using a risk-based approach. Some have suggested that this approach could result in the percentages reported being greater than would be the case with random reviews. On the other hand, more experienced partners and staff are usually allocated to such audits, and there are generally more extensive firm reviews and consultation processes for these audits and the key audit areas. Our experience is that there can be more findings relating to smaller audit engagements.
Documentation versus audit evidence	If audit work is not documented, our presumption is that the work has not been performed in the absence of evidence to the contrary. This is the same approach applied by other audit oversight regulators and by most firms in their internal quality review programs.
Surveillances and investigations	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 audit firms. These other activities include our financial reporting surveillance program, surveillances where there is a concern about a specific audit or an individual auditor, and investigations into corporate failures. Where our concerns about material misstatements in financial reports have originated from these other activities, the audits are not reviewed in our audit inspection program but are the subject of separate auditor surveillance activities. This report does not cover any of these other activities. The outcomes of these activities are reported in separate media releases and our regular enforcement reports. However, these other activities can inform our general areas of inspection focus and the timing of future audit firm inspections.
Number of procedures and findings	There may be a number of audit procedures in a key audit area. Findings have been included in the percentages reported where there was only one instance of the auditor not performing an audit procedure in any given key audit area, if that meant the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement. The percentages reported refer to audit areas where we had findings that insufficient work had been performed such that material misstatements would not be detected, irrespective of the number of findings for any particular audit area. There were a number of cases where we found more than one deficiency in a key audit area, each of which could have resulted in material misstatements not being detected.
Process improvement	Where firms put in place initiatives to improve audit quality, there can be a period before the benefits are realised through improved audits.

Audit evidence

23 Our reviews of audit files across the firms inspected raised a high number of concerns about the sufficiency and appropriateness of evidence obtained by auditors to support their conclusions on significant areas of the audit. Findings were mainly in the areas outlined below.

Impairment testing and fair value measurement

24 In an environment of global economic uncertainty, we continued to focus on impairment of assets and the measurement of assets and liabilities at fair value, which are important areas of judgement. In many audit files, auditors had not obtained sufficient appropriate audit evidence to support the values of assets and liabilities in the financial report. This included, but was not limited to, financial instruments, goodwill, other intangible assets, development property inventories, property plant and equipment, carrying values of a controlled entity or joint venture investment in an associate, capitalised expenditure and provisions.

25 In many files, we found the auditor had not adequately tested:

(a) the audited entity’s impairment model and assumptions, including the discount rates, forecast cash flows, growth rates, number of cash generating units (CGUs), and inclusion or exclusion of items such as working capital and tax losses; and

(b) the accuracy of the source data used by the audited entity in estimating future cash flows used for impairment assessments.

26 In some files, audit evidence was insufficient or inappropriate to confirm:

(a) the valuation of financial assets recorded at fair value because the auditor relied on external confirmations, which verified the existence but not necessarily the valuation of the assets;

(b) the annual assessment of impairment of goodwill (instead, the auditor relied on assessments prepared by the audited entity in a previous year); and

(c) consideration by the auditor of whether an expert may be required to assist the auditor, particularly with complex impairment calculations relying on significant judgement.

27 We also found insufficient evidence that the auditor exercised professional scepticism in:

(a) critically evaluating whether discount rates used by audited entities reflected the risks specific to the relevant industry or a particular CGU, or challenged the appropriateness of high growth rates used by clients even though the audited entity’s historical performance indicated otherwise; and

(b) considering whether disclosures in the financial report about fair value and impairment were in accordance with the relevant accounting standards. In particular, we noted that, even though impairment indicators and sensitivities about a reasonable possible change in assumptions leading to impairment were communicated to those charged with governance of the audited entity, these were not disclosed in the financial report. Where disclosure deficiencies were identified, it often appeared that the auditor was willing to agree with the audited entity's disclosures rather than challenge them.

Assessment of going concern

28 Our inspections continued to show that auditors had not always obtained sufficient appropriate audit evidence to demonstrate their consideration of the going concern assumption or whether an emphasis-of-matter paragraph (or qualification) should be included in the audit report.

29 In many of the audit files we reviewed, we had concerns about the adequacy of the audit procedures undertaken and the level of professional scepticism applied by the auditor in assessing whether:

(a) the auditor's report should be modified with an emphasis-of-matter paragraph about the use of the going concern assumption. In one instance, an emphasis-of-matter paragraph had previously been included in the auditor's report but was removed when there did not appear to be a substantial change in the financial performance of the audited entity;

(b) the entity's going concern assumption was appropriate, particularly where the entity operated in an environment of significant environmental and political risk; and

(c) the audited entity's budgeting and cash flow forecasting were reasonable and the auditor was able to rely on management's key assumptions about the budget and forecast.

Substantive analytical procedures

30 In many audit files, the auditor had not complied with auditing standards in the application of substantive analytical procedures used as the primary substantive test for a material balance.

31 When using substantive analytical procedures, the auditor should ensure that there are appropriate relationships between the data used and the balances tested, that the source data is adequately tested, and that suitable thresholds are developed and explanations for variances are obtained and corroborated.

32 While our findings relate to the audit of all types of companies and industries, the findings were particularly common in the audit of financial institutions: see paragraphs 48–54. We found many instances where auditors:

(a) relied on substantive analytical procedures as the only substantive test for a material balance where other procedures such as testing of controls and substantive tests of detail were not undertaken;

(b) did not ascertain the accuracy of the data used in the analytical procedure and whether there was an appropriate relationship between the data used and the population being audited;

(c) did not adequately set expectations before carrying out the analytical procedure;

(d) did not sufficiently investigate differences between the expectation set and the recorded balance;

(e) used disaggregated data for the substantive analytics, but did not set appropriate disaggregated thresholds for following up variances from expectations; and

(f) used simplistic analytical comparisons which did not satisfy the requirements of the auditing standard for designing and performing substantive analytical procedures.

Journal entry testing

33 Auditing standards require an auditor, in considering the risk of fraud in an audit of a financial report, to test the appropriateness of journal entries during the preparation of the final report. Further, the auditor should consider the need to test journal entries throughout the reporting period.

34 We found many audit files where the auditor:

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

(b) did not test journal entries throughout the year.

Related party transactions

35 In many audit files, the auditor did not perform adequate procedures to gain sufficient appropriate audit evidence about whether all related parties and related party transactions were fully identified and disclosed in the financial report. We often found that auditors:

(a) did not adequately assess, discuss and document, at the planning stage of the audit, the risk of undetected related parties and related party transactions;

(b) did not adequately discuss with management the risks of undetected related party transactions or obtain an understanding of the audited entity's systems and controls for identifying them, but instead relied on a list of related parties and related party transactions provided by the audited entity without undertaking additional work to determine whether there were any undetected related party transactions;

(c) did not document the design and operation of the audited entity's controls to detect related party transactions; and

(d) did not assess whether related party transactions were fully disclosed in the audited entity's financial report.

Subsequent events review

36 We noted many instances where auditors did not obtain sufficient evidence to support their conclusions about subsequent events. We found cases where:

(a) there was no evidence in audit files that subsequent event procedures were performed by the auditor;

(b) the auditor conducted subsequent event procedures but did not ensure they were carried out up to the date of signing the audit report; and

(c) a subsequent event was disclosed in a financial report but there was no evidence that the auditor had performed procedures on the item or considered whether other material subsequent events had occurred.

External confirmations

37 While there is no mandatory requirement to obtain external confirmations, we consider that they are a reliable source of independent evidence. Despite this, we found instances where the auditor:

(a) did not carry out adequate alternative procedures to verify the existence and valuation of assets held overseas where confirmations requested by the auditor for those assets had not been received; and

(b) did not evidence why external bank confirmations were not obtained for material cash balances but instead relied on bank statements provided by the audited entity.

Consideration of the risk of fraud

38 In many instances, we found that the auditor had not discussed with management, or those charged with the governance of the audited entity, the risks of fraud that could have a material impact on the financial report.

39 We found other instances where the auditor did not adequately consider the risk of fraud in relation to revenue recognition, which might be considered a heightened risk in the current economic environment.

Professional scepticism

40 Exercising professional scepticism is a critical part of conducting quality audits. Professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of the audit evidence obtained and the management's judgements on accounting treatments and estimates.

41 Our reviews of audit files showed insufficient professional scepticism was applied, particularly in relation to fair value measurement, impairment testing, and going concern assessments: see paragraphs 24–29.

42 We found many instances where auditors:

(a) appeared to have been over-reliant on, or readily accepted, the management's explanations and representations without challenging the underlying assumption, or instead sought out evidence to corroborate the estimations or judgements rather than challenging them;

(b) had not explored the evidence available in other parts of the audit file that appeared inconsistent or contradictory; and

(c) had not given sufficient consideration to historical outcomes in assessing the reasonableness of the forecasts and assumptions underlying the management's decisions.

43 Auditors did not always evidence why an accounting treatment proposed by management was accepted and whether alternative scenarios or accounting treatments were fully considered. In judgement areas, it is necessary at times to rely on evidence that is persuasive rather than conclusive. However, in some instances the auditor did not give sufficient weight to evidence that appeared to contradict the accounting treatment adopted.

Using the work of other auditors and experts

44 Often, if an auditor is responsible for the audit of a financial report consolidating many business components, the firm relies on the audit work performed by component auditors that may be affiliated, or separate firms, potentially located in a foreign jurisdiction.

45 Where financial reports include complex or subjective matters requiring specialist skills or knowledge (e.g. valuations of assets), audited entities may obtain advice from external or internal experts. Auditors may also use their own specialists to obtain sufficient appropriate audit evidence for significant account balances in the financial report.

46 For an auditor to rely on the work of other auditors and experts, the auditor needs to assess their competence and objectivity, and evaluate the appropriateness of the work performed by them.

47 We found instances where the audit files did not contain sufficient appropriate evidence of:

(a) the auditor's evaluation of the competence and independence of component auditors and the evaluation of the component auditors' work, including the resolution of matters raised by component auditors;

(b) the auditor's evaluation of the adequacy and reliability of the work of experts engaged by the audited entity, particularly in the case of financial institutions where experts are used to measure complex and material liabilities and provisions, or to provide pricing information;

(c) where financial institutions use a service organisation to process a material transaction stream, the auditor's assessment of the work of the auditor of the service organisation and whether it could be relied on; and

(d) the appropriate translation of source documents from a foreign language into English (e.g. bank statements).

Industry-specific findings

Financial institutions

48 We reviewed audit files for financial institutions, including banks, credit unions, insurance companies and managed investment schemes. We reviewed the audits of Australian financial services (AFS) licensee obligations (see paragraph 54) and compliance plan obligations (see paragraphs 55–57).

49 Our reviews of these files highlighted findings common to all industries, such as not obtaining sufficient appropriate evidence to support audit procedures conducted in relation to assessing impairment, the application of professional scepticism, the performance of substantive analytical reviews, and relying on the work of others: see paragraphs 23–47.

50 Key findings specific to the audit of banks and credit unions include:

(a) insufficient and inappropriate audit evidence obtained to support the valuation of significant financial assets, such as trading derivatives, trading securities and available-for-sale securities. In particular, we found instances where the auditor's substantive procedures were inadequate and the auditor placed inappropriate reliance on controls and external confirmations to validate the valuation assertion;

(b) insufficient testing to assess the adequacy of provisions for loan losses. In designing a disaggregated substantive analytical procedure, one auditor used an aggregated threshold for testing, and did not clearly identify a threshold for investigating differences or sufficiently corroborate variations identified; and

(c) insufficient testing of the reported net interest margin, including the inappropriate application of substantive analytical procedures or reliance on the audited entity's controls without detailed substantive testing where the balance was material.

51 Key findings specific to the audit of *insurance companies* include:

(a) not exercising sufficient professional scepticism about the sufficiency of the level of the 'liability adequacy' provision and the calculation of the 'probability of adequacy' for outstanding claim provisions where a significant amount of judgement is applied in the calculation. We found that the auditor accepted and relied on the audited entity's assumptions and assertions without sufficient challenge, including, in one instance, not questioning a material change to the probability of adequacy calculation;

(b) insufficient assessment by the auditor of whether work performed by the firm's internal actuarial experts on insurance liability provisions (including outstanding claims liabilities, premium liabilities and liability adequacy test) could be relied on and was sufficient to support their conclusions on the adequacy of the provisions;

(c) inappropriate assessment of risk and, consequently, insufficient substantive testing of material management fee revenue; and

(d) inadequate testing of key controls in the audited entity's underwriting system and insufficient testing to confirm internal controls operated for the entire audit period, where the controls were tested at the interim audit and the auditor relied on those controls.

52 The findings in paragraphs 50–51 do not necessarily mean that there were deficiencies in the systems of any of the regulated entities concerned.

53 In addition, our reviews of audits of banks, credit unions and insurance companies found that sampling procedures were often inappropriate. For example, there was often insufficient evidence that the auditor considered whether the sample selected was representative of the whole population or whether sampling was undertaken in accordance with the firm's policy.

54 We conducted reviews of audits of AFS licensees and found instances where the auditor's procedures for testing net tangible assets (NTA) could have been improved by selecting an adequate sample size to support conclusions on the maintenance of NTA requirements and by sufficiently reviewing the audited entity's adjustments to NTA.

Compliance plans

55 In this reporting period, we carried out inspections of compliance plan audits for managed investment schemes conducted under s601HG(1) of the Corporations Act.

56 Where functions such as custodial or investment administration or back-office accounting are outsourced, auditors often choose to rely on a report prepared by the auditor of the service organisation reporting on the design, implementation and/or effectiveness of operating controls, or in relation to specific assertions such as valuation and existence of investments.

57 We found that auditors of compliance plans did not always obtain sufficient and appropriate audit evidence on which to base their conclusions in areas such as:

(a) whether the compliance plan continued to meet the requirements of Pt 5C.4 of the Corporations Act;

(b) the adequacy of procedures for reporting and assessing breaches of the compliance plan;

(c) the assessment of whether the service organisation auditor's report could be relied on in relation to outsourced functions, risk assessments performed by the auditors, and the relationship to work performed on areas of the compliance plan audit; and

(d) the testing of specific areas, such as subsequent events up to the date of issuing the compliance plan audit report, NTA calculations (for the responsible entity), and cash flow projections.

Mining and energy

58 Companies in the mining and energy sector often have associations with overseas countries, including emerging economies where the materials and resources are situated. Consequently, auditors need to rely on the work of other auditors in the overseas countries, which may have different regulatory frameworks, professional standards and culture.

59 In the majority of mining and energy sector files reviewed, we found common cases where the auditor did not obtain sufficient appropriate audit evidence to:

(a) corroborate the existence of tenements;

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

(c) assess the reliance that could be placed on the work of the audited entity's expert.

60 In many of these cases, the auditor did not exercise professional scepticism. Often the auditor did not challenge the audited entity's key assumptions and relied on evidence presented by management to support judgements such as forecast cash flows. We noted that, although mining and energy entities often operate in an environment subject to significant uncertainty, or political and/or environmental risk, there was insufficient evidence of the auditor's procedures to objectively assess the going concern assumption.

B Key findings: Quality control

Key points

Some firms need to improve their quality control systems to ensure they comply with the independence requirements of the Corporations Act and professional standards. In particular, firms need to manage auditor rotation more effectively.

Although firms have generally implemented the Clarity auditing standards well, compliance with certain aspects of these standards can be improved.

Some of the Other National and Network firms and the Smaller firms can improve their human resources policies and systems, and the effectiveness of their internal monitoring programs.

Ethical requirements and independence

61 Larger National firms and Other National and Network firms have established independence policies and processes to facilitate compliance with the auditor independence requirements of the Corporations Act and professional standards. Across these firms, leaders remain committed to an appropriate ‘tone at the top’ that emphasises the importance of audit independence. However, we noted the following instances of non-compliance with legislative and professional requirements.

Contraventions of the auditor rotation requirement

62 One Larger National firm advised us of two contraventions of the Corporations Act, where the engagement quality control reviewer (EQCR) played a significant role on an engagement for more than five years. While the firm had a process for recording and monitoring the period of time an EQCR is assigned to an engagement, the contraventions occurred because the partner rotation information recorded in the audit file was not reconciled to the firm’s central record. After considering the circumstances specific to each case, the firm disciplined the engagement partner and EQCR in relation to one of the breaches. In addition, the firm reminded all audit partners to ensure that the rotation information recorded in the audit file agrees with the firm’s central record.

63 At a Smaller firm, we found that the auditor rotation requirements had been contravened for two listed audit clients, where both the engagement partner and EQCR had acted in their roles for more than five years, and there was a risk that the rotation requirements would be contravened for three other listed clients. The Smaller firm has since established an authorised audit company with three directors. This will enable the firm to meet the auditor rotation requirements.

64 Our inspection of Smaller firms identified that Smaller firms are at a higher risk of not managing mandatory auditor rotation effectively. Smaller firms need to put in place systems to ensure that they can comply with the auditor rotation requirements of the Corporations Act.

Contraventions of other independence requirements

65 At one Larger National firm, we found two instances of threats to perceived independence in connection with listed clients. One instance concerned the non-routine change of the engagement partner following a deterioration in the relationship with the Chief Financial Officer after the partner challenged an accounting treatment that was changed with agreement of the audit committee. The other instance concerned the provision of non-audit services to the client. We believe that more extensive and complete consultations, outlining all relevant circumstances, should have taken place within the firm in question and with those charged with governance of the clients. The assessment of threats and safeguards to independence should have been more thoroughly considered and documented by the firm.

Testing of independence systems

66 Many of the Other National and Network firms inspected did not test their independence systems and processes, including the declaration of financial interests, to ensure they were meeting the requirements of the Corporations Act and professional standards. While this is not a requirement of the Act, testing independence systems would enable the firms to place greater reliance on the effectiveness of their systems, and could highlight potential non-compliance with the independence requirements. Without an appropriate testing program, firms can only place limited reliance on the effectiveness of their independence systems and processes.

Acceptance and continuance

67 Client acceptance and continuance procedures should focus on independence considerations, possible conflicts of interest, and whether the firm has the requisite skills to conduct an engagement (as required by auditing standard ASQC 1 *Quality control for firms that perform audits and reviews of financial reports and other financial information, and other assurance engagements*).

Opinion shopping

68 A potential audit client sought assurances from one Larger National firm that the firm did not foresee challenging the company's existing accounting treatments, and questioned the potential for the firm to qualify its audit opinion on a particular accounting treatment where the firm had qualified its audit report on another company's financial statements on a similar matter. Leaders of firms should be vigilant about the possibility of 'opinion shopping' and ensure that firm acceptance and continuance processes and training for partners and staff specifically address this threat.

Conflict checking

69 One Smaller firm relied on a national database to check for conflicts of interest and threats to independence when accepting a new client. The national database appeared to be updated periodically and used on an ad hoc basis. The Smaller firm did not obtain positive confirmations from all partners and directors about potential conflicts and threats to independence when assessing the acceptance of a new listed client.

70 Leaders of all firms need to continue to give strong and clear messages about the importance of complying with independence requirements, and take strong and timely action where non-compliance is noted to ensure that an appropriate 'tone at the top' is maintained.

Engagement performance

71 Although the Clarity auditing standards have been implemented well across the firms, some Other National and Network firms can improve systems and processes for compliance with certain aspects of the standards relating to:

(a) relying on the work of component auditors (see paragraphs 44–47);

(b) testing journal entries throughout the year (see paragraphs 33–34); and

(c) related party transactions (see paragraph 35).

Human resources

72 Larger National firms have mature quality control systems with clear links between audit quality, independence and ethical requirements, and partner and director appraisal and remuneration. However, we found that some of the Other National and Network firms and the Smaller firms can improve their policies and internal systems in this area.

Monitoring

73 Larger National firms have comprehensive policies and procedures for monitoring their audit quality in accordance with legal and professional requirements. These firms undertake regular reviews of a selection of completed audit engagements. They use the results of these reviews to enhance their audit quality systems and direct the focus of staff training.

74 Although Other National and Network firms have procedures in place to facilitate the monitoring of audit quality as required by ASQC 1, we note that improvements can be made to these programs, including:

(a) ensuring that:

(i) monitoring programs cover an effective partner spread;

(ii) files are selected on the basis of risk;

(iii) files are reviewed for compliance with auditing standards; and

(iv) the results of reviews are documented and communicated to partners and staff;

(b) promptly following up and remediating issues identified through monitoring programs, including taking appropriate action against partners who are repeat offenders;

(c) ensuring that internal monitoring programs not only review individual audit files, but also review the firm's compliance with quality controls systems as required by ASQC 1; and

(d) sharing the results of internal monitoring programs and peer reviews across firms that are members of a network to further promote and enhance audit quality across the network.

75 Firms need to improve their processes for recording and notifying ASIC of contraventions and suspected contraventions of the Corporations Act, including contraventions of the independence requirements. Members of network firms should also implement a national register of notifications to ensure consistency in the identification, consideration and reporting of matters. For guidance about the auditor's obligation to report to ASIC, see Regulatory Guide 34 *Auditor's obligations: Reporting to ASIC* (RG 34) at www.asic.gov.au/rg.

76 We found that the majority of Smaller firms had not established a monitoring program to periodically review a selection of completed audit files. Through the evaluation and monitoring of their quality control systems, these firms can assess whether their systems are operating effectively to facilitate compliance with professional standards and other relevant legal and regulatory requirements. Some Smaller firms rely on the reviews undertaken by ASIC, The Institute of Chartered Accountants in Australia and CPA Australia, but these are not a substitute for the firm's own internal monitoring program.

C Improving and maintaining audit quality

Key points

Firms should consider ways to improve and maintain audit quality, particularly in relation to audit evidence, professional scepticism, and the use of other auditors and experts.

This section summarises matters raised by ASIC with individual firms to improve audit quality in their circumstances.

Areas to consider

77 Firms should consider ways to improve and maintain audit quality, particularly in relation to audit evidence, professional scepticism, and the use of other auditors and experts. There should be clear individual accountability for making improvements necessary to achieve a firm's overall plan.

78 Table 2 contains examples of good practice and suggested actions that ASIC has included in private audit inspection reports issued to audit firms inspected during the 18 months to 30 June 2012. These matters may also be of assistance to other firms.

79 Of course, the relative importance of each matter for a firm, and the extent of work to be done, will vary from case to case. Firms may have taken some actions in the areas outlined in Table 2, but may need to do more to reduce the cases where reasonable assurance is not obtained about whether the financial report as a whole is free from material misstatement.

Table 2: Examples of good practice and matters reported by ASIC to individual firms

Area	Good practice suggestions
Audit evidence	This table includes matters that are relevant to reducing the number of cases where sufficient appropriate audit evidence is not obtained to support the auditor's opinion. These include training, guidance, supervision and review, remuneration policies and firm quality reviews.
Professional scepticism	Professional scepticism must be maintained and exercised throughout the planning and performance of an audit. Engagement partners and staff should have questioning minds, obtain a full understanding of all relevant facts, not be over reliant on management's explanations and representations, and not just seek to obtain audit evidence that corroborates rather than challenges management's judgement. Partners and staff must have a sound knowledge of the accounting standards and framework to conduct an effective audit. When considering accounting treatments, partners and staff should consider the substance of arrangements, alternative views and the principles and intent of accounting standards in making their judgments.

Area	Good practice suggestions
	In our reviews, we observed that firms with better practices supported professional scepticism through measures including: • fostering a strong firm culture of promoting and supporting professional scepticism (e.g. through strong and consistent messages from firm leaders and supporting professional scepticism in individual cases); • sending clear, consistent and genuine messages from firm leadership, partners and managers that professional scepticism and audit quality must not be compromised to meet deadlines and budgets, to support a particular outcome desired by management, or to protect fees; • ensuring that partners and staff assigned to audit engagements had strong understanding of the audited entity's business, appropriate industry knowledge, experience and a sound understanding of the financial reporting requirements; • providing education and training, firm guidance and procedures, consultation processes, technical support, effective supervision and review (including engagement quality control reviews), and firm quality control reviews; • not using emphasis-of-matter provisions as an 'easy' alternative to issuing a qualified audit opinion; and • implementing independence policies, systems and processes to support objectivity. This includes re-evaluating decisions made in previous audits and regularly bringing fresh minds to bear.
Use of other auditors	We reported instances where firms should review their approaches to the use of other auditors to ensure that they obtain sufficient appropriate independent evidence to support their audit opinions. This included in the context of group audits (particularly in connection with business components in emerging markets), interests in joint ventures, and the use of service organisations. This work can include assessing the other auditors and reviewing their audit work. There may be a cost associated with this work.
Use of experts	Auditors should obtain independent assurance in relation to the work undertaken by company experts and experts engaged by companies. We reported instances where firms should have engaged their own independent expert as the auditor did not have the necessary skills, knowledge and experience. Where the auditor uses internal firm experts or external experts, sufficient audit work must be performed on any source information used by those experts.
Understanding the business and risks	In the better audits, engagement partners brought their knowledge and experience to the process of assessing the audited entity's business model, its internal and external environment and risks, and how these factors affect the nature and extent of audit procedures.
Expertise and experience	In some cases, firms needed to ensure that partners and staff assigned to particular individual engagements had suitable industry and audit experience, taking into account the nature of the audited entity, the risks associated with the audited entity and its business environment, any complexities (e.g. the use of complex financial instruments), the level of professional judgement required and the likely planned audit approach.
Training and guidance	Many firms have introduced additional training and guidance on audit evidence, professional scepticism, professional judgement and reliance on other auditors and the use of experts. We reported that consideration should be given to further training and guidance to address adverse findings. Smaller firms may outsource additional training and development of guidance, and/or use any relevant training courses and guidance produced by accounting bodies or others.

Area	Good practice suggestions
Supervision and review	Firms with better practices ensure strong and effective supervision and review at all stages of the audit, from planning and performance to concluding procedures, which are essential to audit quality. Reviews are timely and comments raised are properly addressed and cleared by the reviewer. The importance of supervision and review is emphasised through training and quality reviews.
Reliance on internal auditors	Given that internal auditors are employed by the audited entity and cannot be fully independent, firms with better practices consider the extent to which internal audit work can be relied upon in the external audit and limit the use work of internal auditors in important audit areas.
Deadline pressures	To deal with tight reporting deadlines, examples of better practices adopted by firms include reviewing major new transactions, contentious accounting treatments and financial report formats before year end.
Use of substantive analytical procedures	We reported that firms should ensure that any reliance on substantive analytical procedures is appropriate and does not lead to false efficiencies. For example, there should be strong messages from firm leadership and through training that: • models to predict balances in the financial report are based on relationships that make sense; • data used is independent of the population being predicted; • thresholds are appropriate and not revised based on variances identified; • auditors exercise scepticism in considering management's explanations for significant variances noted; and • independent audit evidence is obtained to corroborate explanations for variances.
Auditor independence	Larger firms have systems and monitoring processes relating to audit independence, as well as training, guidance and support in considering possible threats to independence. More should be done, particularly by other firms.
Remuneration	The remuneration of partners and managers should be linked to audit quality, as assessed through firm quality reviews and audit inspection findings. We reported that a number of firms need to improve their policies and processes in this area.
Material disclosures	We reported that some firms should consider additional training, guidance and quality reviews covering the materiality of disclosures.
Firm quality reviews	It is good practice for quality reviewers to have sufficient authority, knowledge and experience, as well as a commitment to audit quality. Findings need to be communicated throughout a firm to promote improvements in audit quality for engagements that are not reviewed.
Advice by firms that are not the auditor	A firm should have review processes in place to ensure that advice given to non-audit clients on accounting treatments is appropriate. Inappropriate accounting advice may place pressure on the external auditor to accept an inappropriate treatment.

Remediation

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

81 Given the risks associated with not remediating deficiencies, partners and firms should not hesitate to take remedial action because of possible embarrassment in revisiting a client. Firms should have processes in place to require partners to take remedial action. In significant cases, where firms do not accept and implement findings, we will consider issuing an audit deficiency report, or taking court or other regulatory action as needed.

D Areas of future focus

Key points

We will continue to inspect firms that audit significant public interest entities, focusing on entities and industries with perceived heightened risks.

Areas of future focus for firms and our inspections include:

- audit evidence, professional scepticism, and the use of other auditors and experts; and
- the focus areas identified in our six-monthly financial reporting surveillance media releases.

Inspection focus

82 Our audit inspection program will continue to focus on firms that audit entities that are likely to be of significant public interest, and those entities and industries that are more vulnerable to risks arising from existing and emerging market conditions.

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

84 Our reviews of audit files will focus primarily on financial statement audits of listed entities and other public interest entities such as financial institutions and large registered schemes. We will also review a smaller number of compliance plan audits for registered schemes and audits of AFS licensees.

85 In recent years, our inspections have shifted from focusing on processes to assessing the quality of judgements and decisions made by the auditor.

86 We will continue to monitor and examine the causes of recent corporate collapses. Where deficiencies in auditor conduct appear to have contributed to insufficient transparency in the financial position and financial performance of an entity leading up to the collapse, we will focus on these areas in our future audit inspections.

Specific areas of focus

87 Some specific areas of focus for firms and our coming inspections are listed in Table 3.

Table 3: 'Top 10' focus areas

Focus area	Details
Audit evidence	Whether auditors have obtained sufficient appropriate audit evidence to conclude whether the financial report is free of material misstatement and to support their audit opinions.
Professional scepticism	The professional scepticism exercised by auditors, focusing on significant judgements in relation to audit evidence, accounting estimates, going concern and accounting treatments.
Reliance on other auditors and use of experts	The reliance placed on: • the work of other auditors, including in the context of group audits (particularly in connection with business components in emerging markets), interests in joint ventures, and the use of service organisations; and • experts, whether employed or engaged by the audited entity or employed or engaged by the auditor. We will review the processes of a firm's internal specialist groups (e.g. technical accounting, business valuation, treasury, actuarial and taxation) in supporting audit engagement teams and the quality of their advice and judgements.
Financial reporting	Focus areas identified in our six-monthly financial reporting surveillance program media releases.
Fee reductions	Maintaining audit quality for engagements where there have been large fee reductions for new or existing audits without underlying changes to business operations. Attempts to sell additional services to these clients can also raise auditor independence issues. We will review audit files where there have been fee reductions that do not reflect changes in the business of the audited entity. We will also review whether there is evidence that firm leaders have given strong, consistent and genuine messages that, where fees are reduced, audit teams must still perform quality audits.
Audit efficiency measures	Whether audit efficiency measures have led to audit quality being compromised on individual engagements. In addition to our reviews of audit files, we will review whether there is evidence that firm leadership has given consistent and genuine strong messages to partners and staff that improvements in efficiency do not mean compromising on audit quality. We will also consider outcomes from firm quality reviews.
Business models and risk assessments	The adequacy of an auditor's understanding of the business model of the entity and risk assessment for individual engagements, and the auditor's interaction with the audit committee to ensure that key areas of risk are included in the audit strategy.
Supervision and review	The involvement of the engagement partners and EQCRs at all stages of the audit, including planning, and reviewing key judgements and the conclusions reached.
Auditor independence	Compliance with the auditor independence requirements, including: • complying with the auditor rotation requirements of the Corporations Act, including the rotation of EQCRs as they are required to be registered company auditors; and • resisting possible 'opinion shopping', particularly where an audit firm's views are sought on specific accounting treatments before a decision is made about whether to appoint the auditor.
Reporting matters to ASIC	The adequacy and timeliness of auditors reporting suspected contraventions under s311 and 601HG of the Corporations Act, reporting under s990K, and reporting under the national credit legislation.

Appendix: Our inspection approach

Scope of this report

88 Our audit inspection program focused primarily on the review of audits of listed entities and other public interest entities. We also reviewed some compliance plan audits and audits of AFS licensees.

89 This report outlines the results of the inspections of 20 audit firms substantially completed in the 18 months to 30 June 2012. These firms, in aggregate, audit 87% of listed entities by market capitalisation. In the 18-month period to 31 December 2010 (2009–10), we inspected 21 firms.

90 The firms we inspected ranged in size as follows:

(a) Larger National firms—large 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;

Note: 'Network' is defined in Accounting Professional and Ethical Standard APES 110 *Code of ethics for professional accountants* (APES 110).

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

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

91 A summary of the number of firms we inspected is provided in Table 4.

Table 4: Number of firms inspected

Firms	2011–12	2009–10
Larger national	4	4
Other national and network	6	9
Smaller	10	8
Total	**20**	**21**

Note: All of the Larger National and Other National and Network firms have been inspected more than once. All of the Smaller firms inspected in 2011–12 were inspected for the first time.

92 ASIC has arrangements to assist the Public Company Accounting Oversight Board (PCAOB) of the United States and the Canadian Public Accountability Board (CPAB) with their audit inspections of Australian auditors to ascertain compliance with the relevant requirements in each of those jurisdictions. During 2011–12, three inspections were conducted jointly with the PCAOB and two were conducted jointly with CPAB.

Our inspection process

Larger National and Other National and Network firms

93 We reviewed selected key audit areas in the audit working papers for selected audit engagements. Each review concentrated on the substance of work and on whether sufficient appropriate audit evidence was obtained to support the auditor's conclusions.

94 We focused on key risk areas for each audit. Our procedures are not designed to find minor instances of non-compliance. We challenge engagement partners on the basis on which significant judgements are made.

95 We assess whether each firm's quality control systems comply with ASQC 1, are designed to ensure that audits are performed in accordance with auditing standards, and ensure auditors comply with the auditor independence requirements.

96 During our inspections, we highlighted to each firm suggested areas for improvement.

Smaller firms

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

(a) conducting a review of certain aspects of, generally, one audit file of a listed entity for compliance with the auditing standards; and

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

Audit independence report

98 In July 2012, we issued our final report to the Financial Reporting Council (FRC) of our findings on auditor independence. This report covered the 12 months to 30 June 2012 and is included in the FRC's annual report. As the FRC no longer has responsibility to issue an annual report on such matters, we will report our findings in our future audit inspection reports.

Key terms

Term	Meaning in this document
AASB 101 (for example)	An accounting standard (in this example numbered 101)
accounting standards	Standards made by the Australian Accounting Standards Board under s334 of the Corporations Act
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
APES 110 (for example)	An accounting professional and ethical standard issued by the APESB (in this example numbered 110)
APESB	Accounting Professional and Ethical Standards Board
ASA 200 (for example)	An auditing standard (in this example numbered 200)
ASIC	Australian Securities and Investments Commission
ASQC 1	Auditing standard ASQC1 *Quality control for firms that perform audits and reviews of financial reports and other financial information, and other assurance engagements*
AUASB	Auditing and Assurance Standards Board
auditing standards	Standards made by the AUASB under s336 of the Corporations Act
CGU	Cash generating unit
Clarity auditing standards	Auditing standards revised and redrafted to conform with the ‘Clarity’ International Standards on Auditing issued by the International Auditing and Assurance Standards Board
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
CPAB	Canadian Public Accountability Board

Term	Meaning in this document
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
FRC	Financial Reporting Council
Larger National firms	Large 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
NTA	Net tangible assets
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
Smaller firms	Firms with a small number of audit partners that audit a limited number of listed entities

Related information

Regulatory guides

RG 34 *Auditor's obligations: Reporting to ASIC*

Legislation

Corporations Act, Pts 2M.3, 2M.4 and 5C.4, Divs 3, 4 and 5, s311, 334, 336, 601HG, 601HG(1), 761A, 913B, 990K

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 505 *External confirmations*

ASA 520 *Analytical procedures*

ASA 530 *Audit sampling*

ASA 540 *Auditing accounting estimates, including fair value accounting estimates and related disclosures*

ASA 550 *Related parties*

ASA 560 *Subsequent events*

ASA 570 *Going concern*

ASA 600 *Using the work of another auditor*

ASA 610 *Using the work of internal auditors*

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*