ASIC

Australian Securities & Investments Commission

REPORT 397

Audit inspection program report for 2012–13

June 2014

About this report

This report summarises the observations and findings identified by ASIC's audit inspection program in the 18 months to 31 December 2013.

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 describe deficiencies or potential deficiencies in the systems, policies, procedures, practices or conduct of some of the 17 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.

In the course of reviewing specific areas in a limited sample of a risk-based selection of 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.

We adopt a risk-based approach to selecting audit files and areas for review, and a random approach could result in a different level of findings.

This report covers findings from audit firm inspections only and does not count matters arising from other ASIC regulatory activities, such as our financial reporting surveillance program, and separate investigations or surveillances of the firms or the entities that they audit. However, these other activities may inform the general areas of focus in inspections. Section G also includes lessons from our audit surveillances in recent years.

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.

Contents

Executive summary

Overall findings

1 This report outlines the findings from our inspections of 17 Australian audit firms undertaken in the 18 months to 31 December 2013. Our inspections focus on audits of financial reports of public interest entities prepared under the *Corporations Act 2001* (Corporations Act).

2 In our view, in 20% of the total 454 key audit areas that we reviewed across 107 audit files at firms of different sizes, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 18% in the previous 18 month period ending in June 2012: see Section A.

3 There is a need for audit firms to improve audit quality and the consistency of audit execution. While firms have made good efforts to improve audit quality, these are yet to be reflected in our risk-based inspection findings.

4 While our overall level of findings has not yet improved, the largest six audit firms only finalised their action plans on audit quality for 30 June 2013 year ends and these plans are still to have full effect.

5 Our findings do not necessarily mean that the financial reports audited were materially misstated. Rather, in our view the auditor did not have a sufficient basis to support their opinion on the financial report. We do not report on areas where auditors perform beyond the relevant standards and so, to that extent, the report does not represent a balanced scorecard. Our surveillance also focuses on higher risk audit areas and so caution is needed in generalising the results across the entire market. The results should be viewed as an indication of how some firms address more challenging audit situations.

6 In eight cases, we followed up matters with the companies concerned with the cooperation of the relevant audit firms. In six of these cases, our inquiries led to material adjustments to the amounts of both the net assets and profits. One company made additional disclosures. One matter is still under discussion.

7 Our audit inspection work complements our separate risk-based surveillance of the financial reports of public interest entities. This financial reporting surveillance has led to material changes to 4% of the financial reports of public interest entities reviewed by us for reporting periods ended 30 June 2010 to 30 June 2013.

8 Our inspections suggest that the following three broad areas continue to require 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) ensuring appropriate reliance on the work of experts and other auditors.

9 Many of our findings related to accounting estimates (including impairment of assets) and accounting policy choices: see Section B.

10 Some audit firms inspected also need to further improve their quality control systems: see Section C.

Our methodology

11 Matters relevant to understanding the percentage measure in paragraph 2 above are discussed in Table 1 in Section A of this report. ASIC was assisted with feedback from an external consultative panel on our method of measuring findings.

12 We select audit engagements and key audit areas for review in our audit inspections using a risk-based approach. We generally select some of the more complex, demanding and challenging audits, and some more significant or higher risk areas of the financial reports. Our inspections exclude cases where known or suspected reporting or audit issues have been identified in our financial reporting surveillance program, in our investigations or by other means. Hence, purely random reviews could result in a different level of findings than indicated in paragraph 2.

13 We also exclude a number of inspection findings from the percentages in paragraph 2. Deficiencies in many audit areas that have been excluded from the percentages are summarised in Table 2 in Section A.

14 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. The percentages in paragraph 2 do not include instances where we consider that individuals could reasonably reach different judgements.

15 Our inspections do not attempt to measure cases where auditors have performed their role and challenged an entity’s draft financial report, resulting in material changes to those reports.

Initiatives to improve audit quality

16 During 2013, the largest six audit firms responded to ASIC's requests to prepare action plans to improve audit quality and the consistency of audit execution. We welcomed the firms' response to our request to develop, implement and monitor these comprehensive plans to improve audit quality. However, the full effect of these plans is still to be seen because:

(a) the firms commenced implementing key aspects of the plans for audits of financial reports for the year ended 30 June 2013, which is 12 months into the 18 month period covered by this report. Therefore, more than half of the audit files we reviewed were completed before the implementation of the plans; and

(b) the plans concern matters such as a culture focused on audit quality and other initiatives, which can take time to have effect.

17 We encourage firms to consider reviewing their staffing structures to ensure that sufficient and appropriate experience and expertise is available for increasingly complex entities and audits that require significant judgements.

18 We outline areas that auditors might consider to improve audit quality and the consistency of audit execution: see Section D.

19 We discuss actions that directors and audit committees, standard setters, accounting bodies and others can take to support audit quality: see Section E.

20 We outline our future areas of focus for our inspections in Section F.

Other matters

21 We discuss lessons identified from our surveillance work, which is separate from our audit inspections: see Section G.

22 We also reviewed audit transparency reports, which were first required in the reporting year ended 30 June 2013: see Section H.

A Overall findings

Key points

In our view, in 20% of the total 454 key audit areas reviewed across 107 audit files, at firms of different sizes, auditors did not obtain reasonable assurance that the overall financial report was free of material misstatement.

In our view, while financial reports may not have been materially misstated, the auditor did not have a sufficient basis to form an opinion on the financial report.

In 2013, we welcomed the six largest firms' response to our requests to develop action plans to improve audit quality. These plans require more time to have full effect.

This section includes information on our approach to audit quality and the basis that we have used to measure our findings.

The importance of audit quality

23 The quality of financial reports is key to confident and informed markets and investors. The objective of the statutory requirement for the independent audit is to provide confidence in the quality of financial reports. Auditors are important 'gatekeepers' in our financial system.

24 If a company fails and the financial report did not properly show the declining financial position and results or going concern issues of the company, it is reasonable that questions would be raised as to the role of the company directors and the auditor. Questions may also be raised if investment decisions are made on financial reports that do not otherwise reflect a company's true financial position and performance. If the auditor did not obtain reasonable assurance that the financial report was free of material misstatement, apply sufficient scepticism on accounting estimates and treatments, or address any deficiencies detected, investors and other users of financial reports would be concerned.

25 It is important for the interests of investors, other users of financial reports, companies, directors and auditors that we are transparent about our inspection findings.

Our approach to audit quality

26 For our regulatory purposes, audit quality concerns matters that contribute to the likelihood that the auditor:

(a) achieves the fundamental objective of obtaining reasonable assurance that the financial report as a whole is free of material misstatement; and

(b) ensures material deficiencies detected are addressed or communicated through the audit report.

27 This includes appropriately challenging key accounting estimates and treatments that can materially affect the reported financial position and results.

28 Our view is consistent with the objective of the audit, as outlined in the auditing standards: see paragraph 11 of Auditing Standard ASA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with Australian auditing standards*, and has been adopted by Australia's Financial Reporting Council and most major foreign audit regulators.

29 While firms have made good efforts to improve audit quality, these are yet to be reflected in our risk-based inspection findings. To improve and maintain audit quality, we encourage firms to consider their staffing structures to ensure that appropriate experience and expertise is available for increasingly complex audits. This includes access to experts. This is discussed further in Section D.

30 The objective of our audit firm inspections is to promote the improvement and maintenance of audit quality. We work cooperatively with firms to achieve this objective.

Our findings

31 Our recent risk-based inspections show examples where, in our view, auditors did not obtain reasonable assurance that audited financial reports were not materially misstated.

32 Audit regulators in other major countries have indicated similar types and levels of findings in relation to audit quality.

33 We inspected 17 audit firms of different sizes in the 18 months to 31 December 2013. We reviewed a total of 454 key audit areas across 107 audit files. The appendix to this report contains further information about our inspection approach and the 17 audit firms inspected.

34 In our view, in 20% of the 454 key audit areas reviewed, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. The corresponding figure for the 18 months to 30 June 2012 was 18%.

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

(a) the Largest Four National firms—16% (13% in the previous 18 month period); and

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

Note: We inspected different Other National and Network firms in the 18 months ended 31 December 2013 and in the 18 months ended 30 June 2012. See paragraph 161 in the Appendix for an explanation of the firm size categories.

36 It should be noted that we use a risk-based approach to selecting audit files and key audit areas for review during our firm inspections.

37 Other matters relevant to understanding our findings and the percentages reported above are outlined in Table 1. The percentages reflect findings in the areas discussed in Section B.

38 Our findings do not necessarily mean that the financial reports audited were materially misstated. Rather, in our view, the auditor did not have a sufficient basis to support their opinion on the financial report.

39 An audit does not provide absolute assurance. Our findings are based on the requirement for the auditor to obtain reasonable assurance.

40 In eight cases, we followed up matters with the companies concerned with the cooperation of the relevant audit firms. In six of these cases, our inquiries led to material adjustments to the amounts of both the net assets and profits. One company made additional disclosures. One matter is still under discussion.

41 Our audit inspection work complements our separate risk-based surveillance of the financial reports of public interest entities. This financial reporting surveillance work has led to material changes to 4% of the financial reports of public interest entities reviewed by us for reporting periods ended 30 June 2010 to 30 June 2013.

42 Many of our findings related to accounting estimates (including impairment of assets) and accounting policy choices. Further information appears in Section B of this report.

43 We consider there is still a need for audit firms to improve audit quality and the consistency of audit execution.

Table 1: Matters relevant to understanding our findings

Matter	Explanation
Quality of financial reports	As noted in paragraphs 38 and 39, our findings do not necessarily mean that there is a material misstatement in the overall financial report. Rather, in our view, the auditor did not have a sufficient basis to form an opinion on the financial report.
Inspection findings	Our findings are based on the objective of an audit in the auditing standards to obtain reasonable assurance that the financial report as a whole is free of material misstatement. There have been no significant changes in auditing standards between the 18 months to 30 June 2012 and the 18 months to 31 December 2013 that could have had an impact on the level of findings in each period. Table 7 in the appendix shows that the key audit areas that we reviewed were broadly consistent between the 18 months to 30 June 2012 and the 18 months to 31 December 2013. The split of deficiencies between each category of key audit area was also broadly consistent between the periods. For that reason, we cannot attribute the level of our findings to any change in our inspection approach. All findings in inspections of individual firms are discussed with the firm to ensure that we have fully understood all of the relevant facts and we have properly taken into account all relevant audit work. During the 18 months to 31 December 2013, our private reports to the firms identified instances where we considered that the firm did not obtain reasonable assurance that the overall financial report was free of material misstatement. These private reports better enable the firms to challenge our findings and to undertake remedial action. The approaches of individual firms to our findings range from full acceptance and willingness to remediate to disagreement with most findings from individual file reviews. Firms that disagree with our individual file review findings nevertheless generally agree to either take actions recommended by us in relation to individual audits or on an overall basis for the firm.
Subjectivity	All of the matters reported in Section B are supported by findings that we reported to audit firms inspected following our reviews of selected audit files. Our findings relate to compliance with the principles-based 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. Our percentage measure does not include instances where we consider that individuals could reasonably reach different judgements. Each of our inspection findings is subject to quality review within ASIC, and discussion with the engagement partners and firms. Our staff have considerable practical experience in auditing. Our inspection activities also expose our staff to a range of firms and audits. There are cases where auditors disagree with our findings from reviews of individual audit files. In most of these cases, the auditor asserts that the necessary work was performed but not documented, rather than disagreeing with the work that should have been performed or the judgements that should have been reached.

Matter	Explanation
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 regulators and by most firms in their internal quality review programs. We apply professional scepticism to assertions that work has been performed without any documentation. Significant testing, analysis and challenging of estimates and accounting policy choices is generally not possible without some documentation. In addition, auditing standards require sufficient documentation so that another professional can understand the work performed and the basis for the conclusions reached.
Remediation	During the 18 months to 31 December 2013, where we identified that a firm did not obtain reasonable assurance that the overall financial report was free of material misstatement, we generally suggested that the firm should perform additional audit work for the financial period that was the subject of the audit. However, we cannot follow up all matters arising from inspections with companies. Auditors have an obligation to complete their audits to support their opinions on financial reports and to undertake the audit work that has not been performed. In a number of cases, where we identified inadequate audit work, the relevant firm performed additional audit work and did not identify material misstatements in the financial report concerned. While one of the Largest Four National firms performed additional audit work for the financial year reviewed, in most cases other firms generally addressed our findings for subsequent year audits. Firms cooperated by allowing us to refer to company-prepared information from their audit files when we contacted some of these companies about our concerns with the company's financial reporting that we had identified in our audit inspections. Given the risks associated with not remediating deficiencies, partners and firms should not hesitate to take remedial action and revisit the audited entity to undertake additional work. We consider it is important that firms undertake the work necessary to complete their audits for the reporting period in question where we have findings from our inspections. This will ensure that the audit report was supportable and that the market can be properly informed if any material misstatements are detected.
Level of assurance	An audit is not intended to provide absolute assurance that there are no material misstatements in the overall financial report. That is, reasonable assurance implies a confidence level of less than 100% that a financial report is free of material misstatement. 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.
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 is covered. We select audit engagements and key audit areas for review in our audit inspections using a risk-based approach. This means that we generally select some of the more complex, demanding and challenging audits, and some more significant or higher risk areas of the financial reports. However, we also include a spread of audited entities and areas outside this group.

Matter	Explanation
	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 for these reasons. Our audit inspection program generally does not include cases where we have already addressed material misstatements through our financial reporting surveillance program. However, these matters may be followed up through our separate audit surveillances, the results of which are not counted in the findings in this report.
Inspection focuses	Our inspections focus on key audit evidence and judgements. We do not adopt a mere checklist approach. Our file reviews concentrate on the substance of work and on whether sufficient appropriate audit evidence was obtained to support the auditor’s conclusions. 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.
Adjustments	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. It is a key aspect of the role of the auditor in conducting an adequate audit that material misstatements are detected and addressed. Due to the nature of the audit process, it can be difficult to distinguish adjustments resulting from a company’s own processes from those resulting from the audit process. Adjustments resulting from the audit process are not measured in this report.
Key audit areas	A key audit area generally relates to a financial statement line item that we specifically select for review on an audit engagement file before commencing our review. The areas relate to: • financial statement line items that are significant and considered higher risk due to factors such as the need for judgement or estimation; and • other key audit procedures that historically have been problematic (e.g. group audits). As shown in Table 7 in the appendix to this report, our approach to selecting key audit areas has been consistent over the three most recent 18 month audit inspection cycles. For that reason, we cannot attribute the level of our findings to any change in our inspection approach. In any event, audit quality should be maintained in all key audit areas. Although we do not review every working paper on an audit file, evidence or explanations of the audit approach on other parts of the audit file are taken into account in reaching our findings. This is covered through our reviews of audit planning documents and discussion of findings with engagement partners and firms. There is also written correspondence between ASIC and the firm on our findings, which ensures that all aspects of an audit that may be relevant to our findings are taken into account. Draft comments and our final private reports include written responses from the firm to each individual file review finding.

Matter	Explanation
What is measured?	The percentages provided in paragraphs 34 and 35 relate to cases where the auditors, in our view, 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, reviews of legal expenses and legal representation letters, and subsequent event reviews. In our view, findings in these areas could have resulted in material misstatements not being detected. Although excluded from the percentages, these remain important areas for improvement by firms. The results of our findings in some of the areas that are excluded from the percentages are shown in Table 2. Where we consider that a risk of misstatement would not be material to the overall financial report or where the risk that it is material to the overall financial report is remote, the finding is excluded from our percentage measure. However, it is possible that such matters could aggregate with matters relating to areas of an audit that we did not review to create a risk of material misstatement to the financial report as a whole.
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. Where multiple separate findings in a key audit area each individually meant that separate material misstatements would not be detected, the percentages reported only include one of those occurrences. 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.
Other National and Network firms	Although the percentage of reported findings for Other National and Network firms has remained unchanged at 21%, we inspected different groups of Other National and Network firms in the 18 months to 31 December 2013 and the 18 months to 30 June 2012. All of the Other National and Network firms have previously been inspected. The same Largest Four National firms were inspected in the 18 months to 31 December 2013 and the 18 months to 30 June 2012.
Surveillances and investigations	ASIC is both an audit 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 the quality of financial reports and audits where there have been corporate failures.

Matter	Explanation
	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. The findings in Sections A to C of this report do not count findings from any of these other activities. The outcomes of these activities are reported in separate media releases and our regular enforcement reports. The findings are not reflected in the percentages in paragraphs 34 and 35. However, these other activities can inform our general areas of inspection focus and the timing of future audit firm inspections. Section G of this report includes lessons from ASIC surveillances in recent years. This section is intended to inform auditors of additional matters that may require their attention.
Enforcement action	The objective of our inspections is to work cooperatively 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 have recently taken enforcement action on concerns arising in the 2012–13 review period from our inspection of a Smaller firm.
Process improvements	Where firms put in place initiatives to improve audit quality, there can be a period before the benefits are realised through improved audits.

Consultative panel

44 ASIC established a panel to consult on the method of measuring and reporting aggregate findings from our inspections. The panel did not consider the individual underlying findings from specific audit engagement files or our assessment of those individual findings. The panel consisted of Messrs Peter Day, Brian Long and Des Pearson AO who have extensive qualifications and experience in business and accounting and audit requirements, and are considered independent of the audit firms and professional bodies. The panel concurred with our approach.

Additional indicators of audit quality

45 We review the adequacy of certain audit procedures on most engagement files selected during our audit firm inspections. Table 2 shows the deficiencies that we reported in private reports to the firms inspected in these areas as a percentage of the total files reviewed in our inspections over the relevant period.

Table 2: Deficiencies reported in other audit areas as a percentage of total files reviewed (2011–12 and 2012–13)

Audit area	18 months to 31 December 2013	18 months to 30 June 2012
Journal entry testing	15%	8%
Consideration of risk of fraud	11%	8%
Planning analytical procedures	11%	3%
Planning and risk assessment	8%	5%
Litigation and claims	8%	1%
Materiality determination	6%	0%
Related party transactions	6%	9%
Remuneration report	6%	0%
Laws and regulations	5%	6%
Subsequent events	5%	5%
Final analytical procedures	4%	3%
Financial report disclosures	3%	8%
Segment reporting	2%	4%

46 The absence of findings in these areas does not necessarily mean that the work was adequate because:

(a) we do not review these areas on all audit files;

(b) findings are excluded where the area was regarded as a key audit area;

(c) we do not consider all aspects of the work in each of the areas listed;

(d) there may be findings in these areas that were not reported in a private report to a firm but which were dealt with through discussion with the firm; and

(e) an area may not be relevant for all files reviewed (e.g. segment reporting).

47 The findings show the need for improvement in the areas listed.

48 Our findings in relation to some of these audit areas are explained further in Section B.

B Key findings: Audit file reviews

Key points

Our inspections suggest that the following three broad areas continue to require improvement by audit firms:

- the sufficiency and appropriateness of audit evidence obtained by the auditor;
- the level of professional scepticism exercised by auditors; and
- ensuring appropriate reliance on the work of experts and other auditors.

This section provides further examples of our inspection findings in each of these areas.

Audit evidence and professional scepticism

49 Across all of the firms inspected, our review of audit files identified many cases where we had concerns about the sufficiency and appropriateness of evidence obtained by auditors to support their conclusions on significant areas of the audit.

50 Our reviews of audit files showed, in our view, insufficient professional scepticism was applied, particularly in relation to fair value measurement, impairment testing, and going concern assessments. 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 management's judgements on accounting estimates and treatments.

51 In particular, we found examples where auditors appeared to have:

(a) been over-reliant on, or readily accepted, the explanations and representations of the management of audited entities without challenging matters such as key underlying assumptions; or

(b) sought out evidence to corroborate estimates or treatments rather than appropriately challenging them.[1]

52 These examples are summarised below.

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[1] Our view that professional scepticism involves challenging rather than merely seeking to corroborate is consistent with auditing standards and is supported by guidance by the Auditing and Assurance Standards Board (AUASB) in its bulletin, *Professional scepticism in an audit of a financial report*, issued in August 2012. It is also consistent with literature from standard setters in other countries that use auditing standards based on the International Standards on Auditing, such as the UK Financial Reporting Council.

Impairment testing and fair value measurement

53 During the 18 months to 31 December 2013, we continued to focus on impairment of assets and the measurement of assets and liabilities at fair value, which are important areas of estimation and judgement. In many audit files that we reviewed, we believe that 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; and provisions.

54 In a number of audits we reviewed, we found the auditor:

(a) had not adequately considered the appropriateness and reasonableness of forecast cash flows and key assumptions (including growth rates and discount rates) used in discounted cash flow models, having regard to matters such as historical cash flows, how an entity is funded, and economic and market conditions;

(b) had not questioned whether estimates included elements such as increasing cash flows after the fifth forecast year that were sufficiently reliable to use fair value less costs to sell, rather than value in use;

(c) had not given sufficient consideration to reasons why forecasts were appropriate, despite a history of management forecasts not being met;

(d) had not had regard to other information in the audit file or annual report that was inconsistent with the assumptions applied in impairment calculations;

(e) had not considered whether all cash generating units (CGUs) had been appropriately identified;

(f) had not considered whether there was a mismatch between the cash flows used and the assets being tested, such as incorrectly ignoring receivables, inventories and tax balances; and

(g) had not tested the source data used by the audited entity in its impairment models.

55 For example, inadequate work was performed on complex impairment calculations and the auditor had not considered whether an expert might be required to assist the auditor with complex impairment calculations. In some cases, insufficient work was carried out by the firm’s expert valuation or corporate finance teams.

56 In a number of cases, we found the auditor had not given appropriate consideration to the fair value of financial assets and whether pricing information provided by a third party was appropriate evidence to support the valuation. There was also insufficient testing of the classification of assets into the fair value hierarchy.

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

(a) critically evaluating whether optimistic cash flow forecasts and high growth rates used by audited entities were appropriate, 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 and accurately reflected information that the auditor had reviewed. 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.

Provisions, other liabilities and contra assets

58 In some cases, we considered the auditor had not obtained sufficient or appropriate evidence in relation to restoration obligations, impairment of receivables, obsolescence of inventory, or the need for other liability and asset provisions.

Accounting policy choices

59 We found examples where auditors had not, in our view, considered or adequately questioned the accounting policy choices adopted by entities in relation to matters such as revenue recognition, expense deferral and non-consolidation of off-balance sheet arrangements. Auditors did not apply appropriate scepticism, consider alternative treatments, or involve technical accounting experts.

Assessment of going concern assumption

60 Our inspections continue to suggest that auditors had not always obtained sufficient appropriate audit evidence to demonstrate their consideration of the appropriateness of the going concern assumption.

61 In some cases, 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 entity's going concern assumption was appropriate, particularly where the entity operated in an environment of significant risk; and

(b) the audited entity's budgets and cash flow forecasts (including key assumptions) were reasonable and appropriate.

Testing of revenue

62 In many audits we reviewed, we believe the auditor did not perform adequate procedures to gain sufficient appropriate evidence about the accuracy and completeness of revenue. We found examples where auditors:

(a) did not appropriately test controls in revenue processes that were relied on;

(b) applied substantive testing procedures that were flawed in light of not placing reliance on or testing internal controls, particularly in the samples selected for testing and the analytical procedures used; and

(c) did not have appropriate regard to relevant contracts that supported the revenue.

Substantive analytical procedures

63 In some cases, auditors did not comply with auditing standards in the application of substantive analytical procedures. Substantive analytical procedures can be effective if done well, but in our experience often continue to have problems in their design and execution.

64 We continued to find examples in the audits we reviewed where auditors:

(a) did not consider whether the assumed relationship between the data used and the population audited made sense;

(b) did not consider whether the data used and the population audited were independent;

(c) did not test source data used to ascertain the reliability of that data;

(d) did not set and fix thresholds for identifying exceptions before carrying out the analytical procedure;

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

(f) did not seek explanations for differences between the expectation and the recorded balance;

(g) did not consider the appropriateness of explanations received for variances or apply appropriate scepticism;

(h) did not corroborate explanations for variances with appropriate independent audit evidence; and

(i) used non-substantive analytical procedures to eliminate substantive testing.

Journal entry testing

65 Auditors should test the appropriateness of journal entries, particularly those made during the preparation of the financial report, due to the risk of fraud.

66 The auditor should consider the need to test journal entries throughout the reporting period. There may be a greater risk of errors or irregularities with journals because they are generally not systematically processed and may not be well controlled.

67 In a number of audits we reviewed, the auditor:

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

(b) did not provide sufficient explanation as to why appropriate journal entry testing was not performed.

Consideration of the risk of fraud

68 The auditor should consider the risks of material misstatement in the financial report due to fraud.

69 In many audits we reviewed, 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.

70 We found other examples where the auditor did not adequately consider the risk of fraud in relation to revenue recognition.

Analytical procedures at the planning stage

71 In some audit files we reviewed, the auditor did not undertake appropriate analytical procedures at the planning stage of the audit. The use of analytical procedures at the planning stage can identify aspects of the entity, its operations and results of which the engagement team was unaware, and help identify the possible existence of unusual transactions or events, and risks of material misstatement.

72 Where analytical procedures at the planning stage were undertaken they were, in our view, often not adequate to be considered a risk assessment procedure because they were either not performed at an appropriately disaggregated level or did not use the most current financial information.

Using the work of experts and other auditors

73 Where financial reports involve complex or subjective matters requiring specialist skills or knowledge (e.g. valuation of assets), audited entities may obtain advice from external or internal experts. Auditors may need to use

their own specialists to obtain sufficient appropriate audit evidence for significant account balances in the financial report where the auditor does not have sufficient knowledge or expertise.

74 In the audit of a financial report consolidating many business components, the auditor often relies on the audit work performed by component auditors that may be affiliated, or separate firms, potentially located in a foreign jurisdiction.

75 The auditor needs to assess the competence and objectivity of experts and other auditors that they rely on, and evaluate the appropriateness of the work performed by them.

76 We continued to find instances where, in our view, auditors:

(a) did not use their own experts where members of the audit team did not have sufficient knowledge, skill and experience in specialist areas;

(b) did not appropriately review the work and reports of experts engaged by the auditor;

(c) did not review, or did not adequately review, the work of other auditors relied on where such reviews should have been performed;

(d) did not adequately review and evaluate reports from their experts or component auditors, including the resolution of matters raised by those experts or component auditors;

(e) did not evaluate the adequacy and reliability of the work of experts engaged by the audited entity, including in the case of financial institutions where experts are used to measure complex and material liabilities and provisions, or to provide pricing information;

(f) did not evaluate the competence and independence of experts or component auditors;

(g) did not assess the work of the auditor of service organisations used to process material transaction streams and whether that work could be relied on; and

(h) did not assess the completeness and accuracy of the data used by experts engaged by the audited entity or by the auditor.

Industry-specific findings

77 We reviewed audit files for selected financial institutions and investment funds, including banks, credit unions, insurance companies and registered schemes. We also reviewed the audits of compliance with Australian financial services (AFS) licensee obligations (see paragraphs 81–82) and registered scheme compliance plan obligations (see paragraphs 83–85).

Financial institutions

78 Our findings for audits of financial institutions included matters 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 procedures, and relying on the work of others: see paragraphs 49–76.

79 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*: In some audits we reviewed, the auditors did not undertake procedures to obtain sufficient assurance that third party information used to support the valuation of financial instruments was reliable and that the financial instruments were classified into the appropriate fair value hierarchy categories. In addition, in testing the valuation of financial assets the auditors relied on the work of their own specialist but did not assess whether the thresholds set by the specialists for assessing variances were sufficiently precise to generate an appropriate level of assurance.

(b) *Insufficient testing to assess the adequacy of provisions for loan losses*: One auditor did not obtain an appropriate understanding of the audited entity's control environment over provisions, did not adequately explain the method for selecting the sample for substantive testing and further work was not performed when significant errors were identified.

(c) *Inappropriate reliance on the work of an internal auditor in substitution for external audit work*: Even if reliance was appropriate, there was insufficient evaluation and testing of the work undertaken by the internal auditor.

(d) *Inadequate testing of the net interest margin as a result of using incorrectly designed substantive analytical procedures*: The auditors did not determine appropriate expectations, did not adjust thresholds for disaggregated parts of the population being tested and did not calculate the difference between the expected balances and the actual balances.

80 Key findings specific to the audit of insurance companies include:

(a) *Insufficient assessment by the auditor and their internal actuarial expert on policy liabilities and premium revenue for a life insurance company*: For example, the work performed by the auditor in relation to policy liabilities involved insufficient testing of source data, the completeness of data in the valuation process, whether assumptions and changes in assumptions were properly reflected in policy liability valuation systems, the valuation of individual policies and any adjustments made for classes of policies, the allocation of profits between policyholders and shareholders, units and unit prices for investment linked policies, and balances of investment account policies. The auditor's actuarial specialist undertook procedures, but the auditor's reliance on the company's actuarial controls was not undertaken in accordance with auditing standards. Accordingly, the auditor relied on the entity's system of internal control without sufficiently reviewing or testing controls, and on a non-substantive review of the company's explanations of movements in the liabilities.

(b) *Inadequate testing of valuation of investments*: One auditor relied on the information in a prior year file without updating and testing the information for the current year. One auditor did not use an appropriate sampling methodology to gain assurance over the pricing of the whole investment balance and did not investigate large variances that were found during the testing.

(c) *Not exercising sufficient professional scepticism about the sufficiency of the level of the 'liability adequacy' provision in a general insurer*: One auditor accepted the audited entity's calculation of the provision at the business division level without making appropriate inquiries or challenging management as to how their approach complied with accounting standards. The auditor had not questioned why a liability adequacy deficiency identified and provided by a controlled entity was not also provided on consolidation.

(d) *Inadequate consideration and insufficient testing of key controls in the audited entity's underwriting system, no testing of the underwriting decisions or whether products were priced within approved guidelines*.

AFS licensee

81 We reviewed audits of selected AFS licensees and found instances where auditors issued incorrect audit reports due to:

(a) the omission of a breach of the licensee's net tangible assets (NTA) requirement; and

(b) the incorrect identification of the licensee as a 'market participant' on the basis of its listing on the Australian Securities Exchange, which affected the relevant licence conditions.

82 Some audits of whether AFS licensees complied with applicable financial resource and cash needs requirements throughout the financial year could have been improved. One auditor did not adequately test the AFS licensee's compliance because of the incorrect conclusion that the financial requirements did not apply to the audited entity. Another auditor identified an error in the AFS licensee's NTA calculation but did not perform any additional work to ascertain whether other NTA and surplus liquid funds calculations prepared during the year complied with the licensee's financial requirements.

Registered scheme compliance plans

83 We reviewed aspects of selected compliance plan audits for registered schemes under s601HG(1) of the Corporations Act.

84 Registered schemes must have a compliance plan. A scheme's responsible entity might have responsibility for more than one scheme and the schemes may use an umbrella or master compliance plan.

85 In the cases we reviewed, some auditors of compliance plans did not always obtain sufficient and appropriate audit evidence on which to base their conclusions. We found examples of auditors:

(a) relying on the processes of the responsible entity or testing of master compliance plans across a number of schemes managed by the responsible entity, even though there were important differences in the types of schemes or differences between the compliance rules in the master compliance plan and the compliance measures of the individual schemes. The auditors did not test all relevant compliance plan measures;

(b) not testing areas such as compliance with the financial conditions of the entity's AFS licence, related party transactions and external reports supporting the entity's compliance with specific compliance plan measures;

(c) not appropriately assessing risk and consequently not testing relevant compliance plan measures—for example, auditors assessed all compliance plan measures as either a low or medium risk rating, resulting in a reduction in the frequency of testing of each of the measures; and

(d) not considering whether the compliance plan continued to meet the requirements of Pt 5C.4 of the Corporations Act.

Mining and energy

86 Auditors often need to rely on experts in reviewing valuations of the reserves and other assets of mining and energy companies. Where these companies have operations and resources overseas, auditors may need to rely on the work of other auditors.

87 Common findings in the audit of mining and energy companies included examples of:

(a) not confirming the existence and valuation of significant and material asset balances, such as capitalised exploration, evaluation or development expenditure;

(b) not corroborating the existence of tenements; and

(c) not engaging their own expert or, where they had sufficient expertise, not auditing the work of the audited entity's expert.

C Key findings: Quality control systems

Key points

Some firms need to further improve their quality control systems to:

- comply with the auditor rotation requirements of the Corporations Act;
- ensure there is appropriate supervision and review of audit engagements, including appointing an engagement quality control reviewer (EQCR); and
- create clear links between audit quality and partner evaluation and remuneration.

Auditor independence

88 The Largest Four National firms and the Other National and Network firms have established policies and processes to facilitate compliance with the auditor independence requirements of the Corporations Act and professional standards. Nevertheless, we found the following instances of non-compliance with legislative and professional requirements, which could undermine the actual or apparent independence and objectivity of auditors.

Contraventions of the auditor rotation requirements

89 Examples of contraventions of the Corporations Act where the engagement partner played a significant role in the audit of a listed entity for more than five years included:

(a) The audited entity listed close to the end of a financial year and the independence expert in one of the Largest Four National firms overlooked the specific Corporations Act requirements. The firm identified the matter.

(b) At one Other National and Network firm the requirement was contravened by both the engagement partner and the EQCR. In response to our finding, the firm:

(i) imposed monetary penalties on the lead audit partner and the EQCR;

(ii) provided audit rotation/independence training to partners affected by auditor rotation requirements; and

(iii) disclosed the matter in the s307C independence declaration that accompanied the entity's next financial report.

(c) After we identified contraventions at two Smaller firms, one firm enhanced its internal registers so that such a situation would not arise in the future. The other firm undertook additional training and other measures.

90 In all of these cases, the partners were subsequently rotated off the audits.

91 Our inspections in recent years have identified examples of Smaller firms 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

92 Examples of other contraventions of independence requirements at Smaller firms included:

(a) At two firms we found that some audit engagement team members did not provide annual independence confirmations as required by the auditing standards.

(b) One firm did not address potential threats to independence arising from the relationship between the firm and an executive director of an audited entity. The executive director owns another company that provides accounting services to the audited entity. The engagement partner and the executive director are also directors, principal consultants and shareholders of an international professional services and consulting firm. The company and the firm are also members of the international firm.

Acceptance and continuance: Conflict checking

93 One Other National and Network firm had not updated its prohibited securities list. In addition, some partners of the network did not respond to requests for conflict checking from other network offices.

94 One Smaller firm was not assessing the potential threats to independence when considering whether to accept a new audit engagement or continue with an audit engagement. The timing of the reacceptance process at another Smaller firm might not allow the firm to withdraw from an engagement on a timely basis if potential threats to independence were identified.

Engagement performance

95 While the Largest Four National firms and the Other National and Network firms have established quality control systems, we noted some instances where firms were not complying with legislative and professional requirements.

96 One Smaller firm did not appoint an EQCR to an audit engagement for a listed entity. The auditing standards require an EQCR for the audits of listed

entities. We also noted instances across all firms inspected where there was insufficient evidence of appropriate supervision and review by either the engagement partner or the EQCR. The engagement files did not contain appropriate sign-off by the relevant reviewer, or the time charged by the partner or EQCR was low relative to the total hours charged for the audit. Greater involvement by the engagement partner and the EQCR should help reduce the number of findings from our file reviews as set out in this report.

97 One Other National and Network firm did not have a formal audit methodology in place, making it difficult to ensure that audits were consistently performed in accordance with auditing standards and other requirements. One Other National and Network firm did not have a formal policy about the timely assembly of the final audit file. At a number of Smaller firms, engagement teams provided us with documents to show evidence of work performed during the audit that were not contained on the engagement file. Auditing standards require audit files to be assembled and completed on a timely basis.

Monitoring audit quality

98 The Largest Four National firms have comprehensive policies and procedures for monitoring their audit quality by undertaking regular reviews of selected completed audit engagements. Other National and Networks firms also have mature policies and procedures for monitoring their audit quality in accordance with legal and professional requirements. However, some Other National and Network firms could improve their monitoring processes by changing the basis for selecting files to be reviewed and applying risk criteria.

99 We found that many of the 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 requirements. Reviews undertaken by ASIC, the Institute of Chartered Accountants in Australia (ICAA) and CPA Australia are not a substitute for the firm's own internal monitoring program.

Linking partner appraisal to audit quality

100 The Largest Four National firms have mature quality control systems with links between audit quality, compliance with independence and ethical requirements, and partner appraisal and remuneration. However, some of the Other National and Network firms and the Smaller firms can improve the accountability of partners and directors for quality and compliance through clearer linkages in their policies and internal systems.

D Improving and maintaining audit quality

Key points

In 2013 the six largest audit firms responded to ASIC's request to develop action plans to improve audit quality.

We encourage other firms to develop action plans to improve audit quality. This section includes suggested areas of focus for action plans and examples of possible initiatives to improve and maintain audit quality.

We also discuss:

- how audit firms could consider reviewing their staffing structures so as to have the experience and expertise needed for increasingly complex audits; and
- the importance of taking remedial action.

Implementing action plans to improve audit quality

101 Better auditors focus on maintaining audit quality and appropriately balance this imperative with risks and commercial pressures. They ensure that appropriate resources are applied to undertake and review the audit, give appropriate messages about the importance of audit quality and ensure personnel at all levels of the firm are accountable.

102 During 2013, the six largest audit firms responded to our requests to prepare action plans to improve audit quality, focusing on the consistency of the execution of audits. We asked the firms to address the three broad areas requiring improvement identified in our last public audit firm inspection report concerning audit evidence, professional scepticism, and the use of experts and other auditors.

103 Each firm developed a genuine and comprehensive action plan to improve audit quality and took full ownership for the timely implementation of the plan and monitoring its effectiveness.

104 We worked actively with the firms during the preparation of their action plans. The firms responded to encouragement from ASIC for the action plans to particularly focus on:

(a) the culture of the firm, including messages from the leadership of the firm focused on audit quality and consultation on complex audit issues;

(b) the experience and expertise of partners and staff, including increased and better use of experts;

(c) supervision and review, including greater partner involvement in working with audit teams in the planning and execution of audits, and new or increased real-time quality reviews of engagements; and

(d) accountability, including impacts on remuneration of engagement partners and review partners for poor audit quality, often extending to firm leadership.

105 The plans are still to have full effect because:

(a) the firms commenced implementing key aspects of the plans for audits of financial reports for the year ended 30 June 2013, which is 12 months into the 18 month period covered by this report. Therefore, more than half of the audit files we reviewed were completed before the implementation of the plans;

(b) the plans concern matters such as a culture focused on audit quality and other initiatives, which can take time to have effect; and

(c) there were delays in implementing some audit quality initiatives where, for example, they are being actioned by a firm's global network.

106 Firms that have not yet done so should consider preparing action plans to improve the quality of the audits they conduct.

107 The initiatives in firm action plans should vary from firm to firm having regard to the circumstances of each firm and its assessment of the underlying causes of any deficiencies in audit quality and the inconsistent execution of audits. Considerations may include:

(a) the firm's size and the nature and complexity of the entities it audits;

(b) existing initiatives to improve audit quality; and

(c) existing circumstances such as the extent of a culture focused on audit quality, the existing experience and expertise within the firm, and the effectiveness of existing quality review processes and incentives focused on quality.

108 For similar reasons, action plan initiatives may also vary from office to office with a national firm or network.

109 Action plans should be regularly reviewed and updated as to matters such as:

(a) timely and effective implementation;

(b) effectiveness in practice through quality review results and other measures of audit quality; and

(c) the need for new initiatives because earlier initiatives may become less effective over time.

Example initiatives to improve audit quality

110 Table 3 provides some suggested areas of focus and examples of initiatives to improve and maintain audit quality that might appear in action plans. The initiatives should also be considered by firms that do not implement formal action plans.

Table 3: Examples of possible initiatives to improve audit quality

Focus areas	Example actions
Firm culture	Ensuring clear and frequent communications about the importance of audit quality. Fostering a strong firm culture of promoting and supporting professional scepticism, including strong and consistent messages from firm leaders, and supporting professional scepticism in individual cases. Ensuring clear, consistent and genuine messages from firm leadership and partners 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. Firm leadership emphasising the importance of accepting and addressing findings from quality reviews and external reviews. Creating a culture of accepting the need for change and that approaches taken in the past do not necessarily continue to be appropriate. Promoting a culture of consultation with colleagues and specialists.
Experience and expertise	Ensuring that partners and staff assigned to particular audit engagements have a strong understanding of the audited entity's business, appropriate industry knowledge, appropriate experience, and a sound understanding of financial reporting requirements. Ensuring assignments of partners and staff take into account the nature of the audited entity, risk areas and any complexities (e.g. the use of complex financial instruments), the level of professional judgement required and the likely planned audit approach. Ensuring that experts are assigned to audits requiring specialist expertise in areas such as valuation of complex financial instruments. Forming separate panels of experts for each high risk engagement to advise on the audit approach and focuses. Implementing processes to ensure that the firm does not undertake work that is not adequately resourced or for which there is insufficient expertise. Resources to enhance audit quality are funded and promoted, including dedicated partners to promote and support audit quality, industry specialists and technical specialists. Increasing partner involvement on engagements, and working with the audit team in the planning and execution of the audit engagement. Engagement partners bring 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. Mandating the use of specialists in defined circumstances, including where the auditor does not have the necessary skills, knowledge and experience. 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 judgements.

Focus areas	Example actions
	Reviewing the reasons for not retaining skilled and experienced staff.
	Inwards and outwards secondments to enhance experience and expertise available for audit engagements, including bringing in experience in complex industry or other matters.
	Providing training, firm guidance and procedures, consultation processes and technical support.
	Providing additional training and guidance on audit evidence, professional scepticism, professional judgement and reliance on other auditors and the use of experts. This includes developing core skills, such as interview and negotiation skills.
	Ensuring active participation by partners in training and knowledge-sharing sessions with staff to communicate experiences and drive audit quality messages.
	Training audit staff to better understand the work undertaken by specialist staff.
	Training specialist staff who undertake audit work to understand the audit process and how their work will be used.
	Using real-life case studies for training on areas of focus, including professional scepticism and impairment testing.
	Providing additional training on substantive analytical procedures with regard to the matters outlined in paragraph 64.
	Providing additional training, guidance and quality reviews covering the materiality of disclosures.
	Ensuring partners and staff must have a sound knowledge of the accounting standards and framework to conduct an effective audit.
Supervision and review	Appointing specialists or champions for particular areas (e.g. substantive analytical procedures and impairment testing) to advise teams and review planned procedures.
	Ensuring earlier EQCR involvement to focus on whether partners and staff have obtained a good understanding of the client’s business and associated risks.
	Enhancing the role descriptions and assessment of EQCRs and specialist's effectiveness.
	Introducing coaching during the audit to challenge the audit team’s decisions in particular areas (e.g. impairment, substantive analytical procedures).
	Ensuring firm quality reviewers have sufficient authority, knowledge and experience, as well as a commitment to audit quality.
	Ensuring quality reviewers are independent, preferably having strong practical experience but no current audit entity portfolio. Consider more cross-border reviews.
	Ensuring quality reviewers report directly to the chair of the firm rather than the head of assurance.
	Ensuring quality review findings are communicated throughout the firm to promote improvements in audit quality for engagements that are not reviewed.
	Introducing or increasing real-time reviews by an expert external to the engagement team for key areas of the audit before the audit is finalised.
	Implementing real-time and post-completion quality reviews to ensure that any reliance on substantive analytical procedures is appropriate, having regard to the matters identified in paragraph 64.
	Introducing reviews to ensure that any reliance on internal audit is not excessive.

Focus areas	Example actions
	Increasing the number and depth of quality reviews. Ensuring quality reviews include the work of internal firm specialists. Ensuring quality reviews focus on documentation of key judgements, as well as audit evidence. Quality reviews ensure that any efficiency measures do not compromise audit quality. Ensuring quality reviews consider adequacy of engagement partner and EQCR involvement at all stages of the audit.
Accountability	Linking the remuneration of partners and managers to audit quality, as assessed through firm quality reviews and audit inspection findings. Linking a meaningful proportion of partners' income to audit quality. Ensuring partner performance evaluations have regard to the results of surveys of audit teams in relation to the adoption of audit quality initiatives. Ensuring staff at all levels have specific accountability for audit quality and their performance is assessed accordingly.
Other matters	Planning for deadlines, including reviews of major new transactions, contentious accounting treatments, key accounting estimates and financial report formats before year end. Ensuring adequate resourcing for audit completion. Increasing the use of, and reliance on, internal control reviews. Re-evaluating decisions made in previous audits and regularly bringing fresh minds to bear. Ensuring appropriate use and reliance on other auditors 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. Ensuring appropriate systems and monitoring processes relating to audit independence, as well as training, guidance and support in considering possible threats to independence. Reviewing 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. Ensuring that where audited entities grow, there is not a mismatch between the audited entity and the size or professional capacity of the auditor and the breadth of audit team experience.

Firm staff structures

111 Firms might consider reviewing their staff structures as to whether changes are needed over time to ensure the firm has access to resources with appropriate experience and expertise for increasingly complex audits.

112 Some firms have already recognised a need to move away from the traditional pyramid staffing structure, where there are a small number of experienced partners and a relatively large number of junior staff.

113 Audits now require audit staff with greater experience and expertise. There is also a greater need for the use of valuers, actuaries, geologists, financial instrument experts, IT experts and other experts.

114 Over recent decades, there has been:

(a) increasing complexity in financial reporting and financial reporting requirements;

(b) more complex company business models, often operating across borders and with the use of complex financial products;

(c) more complex accounting standards and other requirements;

(d) more difficult judgements on accounting estimates, including asset values; and

(e) changes to audit approaches to require understanding of the business, risk assessment, and more judgement.

115 Further developments in financial reporting and audit, such as greater use of computer assisted audit techniques and substantive analytical procedures (sometimes known as ‘data analytics’), may continue this trend. Opportunities for auditors to provide assurance in new areas may also require greater experience and expertise.

116 There are challenges that mean changes may need to be made over time, including:

(a) obtaining recognition within firms and audited entities of the need for change can take time;

(b) potential delays in the supply of new auditors and experts with appropriate experience and expertise;

(c) improving training, knowledge transfer and retention of skilled and experienced partners and staff; and

(d) recovering or absorbing any additional costs to the extent that changes are not offset by more efficient and effective audits.

Ensuring remedial action is taken when needed

117 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.

118 Given the risks associated with not remediating deficiencies, partners and firms should not hesitate to take remedial action and revisit an audited entity to undertake additional work. Undertaking the work necessary to complete

their audits for the reporting period in question will ensure that the audit report was supportable and that the market can be properly informed if any material misstatements are detected.

119 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 to the directors or audit committee of the audited entity, or taking other appropriate action.

E How others can contribute to audit quality

Key points

While auditors have the primary responsibility for audit quality, there are actions that others can take to promote and support audit quality.

This section discusses the role of the following parties in improving audit quality:

- directors and audit committees;
- auditing and ethics standards setters;
- professional accounting bodies;
- international regulators; and
- legislators.

120 A combination of matters contributes to audit quality. While auditors have the primary responsibility for audit quality, there are actions that others can take to promote and support audit quality. This includes directors and audit committees, standard setters and professional accounting bodies.

Directors and audit committees

121 We recently released Information Sheet 196 *Audit quality: The role of directors and audit committees* (INFO 196) to assist directors and audit committees in their role in ensuring the quality of the external audit of a financial report.

122 Among other matters, INFO 196 suggests that directors and audit committees consider:

(a) non-executive directors recommending audit firm appointments and setting audit fees;

(b) assessing the commitment of the auditors to audit quality;

(c) reviewing the resources devoted to the audit, including the amount of partner time;

(d) reviewing the need to use experts and the reliance on other auditors;

(e) accountability of the engagement audit partner, the EQCR, specialists and audit team members for quality;

(f) facilitating the audit process, including support by the audited entity's management for the audit process;

(g) two-way communication with the auditor on concerns and risk areas;

(h) assessing the level of professional scepticism exhibited by the auditor in challenging estimates and accounting policy choices;

(i) ensuring independence of the auditor;

(j) asking for the results of any review of the audit engagement files by ASIC; and

(k) reviewing audit firm responses to findings from ASIC audit inspections.

123 We plan to send INFO 196 to the audit committee chairs of the top 200 ASX-listed companies, along with Information Sheet 183 *Directors and financial reporting* (INFO 183). We will also ask an industry body to survey audit committee chairs to determine whether they ask their auditors for the results of any ASIC review of the audit engagement files relating to their entity.

Auditing and ethics standard setters

Auditing standards

124 Audit quality is underpinned by quality auditing standards. In late 2012 and early 2013, we wrote to the International Auditing and Assurance Standards Board (IAASB) suggesting opportunities for improved guidance in the International Standards on Auditing (ISAs).

125 Our suggestions included improved guidance in auditing standards on internal control reviews, determining sample sizes, substantive analytical procedures and the use of experts.

126 The IAASB is currently considering feedback on its proposed strategy for 2015–19.

127 The ISAs are the basis for the auditing standards that apply for audits of financial reports under Ch 2M of the Corporations Act. Our suggestions have also been provided to Australia's Auditing and Assurance Standards Board.

Ethical standards

128 During 2013 we also prepared a submission for the International Organization of Securities Commissions (IOSCO) suggesting improvements to the international ethical code of the International Ethics Standards Board for Accountants that includes auditor independence requirements. This code is the basis for the professional ethical code issued by the Accounting Professional and Ethical Standards Board, which has the force of law through the auditing standards.

129 The submission included suggestions to adopt a clarity format that clearly distinguishes between requirements and guidance, and to review the appropriateness of 'safeguards' that provide exemptions to the independence requirements.

Professional accounting bodies

130 Professional bodies such as the ICAA and CPA Australia have undertaken a number of important initiatives to improve audit quality, such as their quality review programs and ongoing training opportunities.

131 We have suggested to the professional accounting bodies ways in which their firm quality review programs could be even further enhanced.

132 We have also suggested that the bodies provide additional training and workshops on core skills to assist auditors in exercising professional scepticism. The ICAA and CPA Australia have responded to our suggestions with initiatives in this area.

133 The bodies also have a key role to play in considering the supply of future auditors.

International regulators

134 It is important that we work with securities and audit regulators in other countries to promote improved audit quality. Many corporations operate across borders, the larger audit firms are part of global networks, our auditing and ethical standards are based on international standards, and our markets are affected by international economic, regulatory and other developments.

135 Through our participation in IOSCO we have worked with other securities regulators on matters such as an international guide on audit transparency reporting.

136 We also suggested the formation of an IOSCO working group, which is currently considering possible initiatives for international regulatory bodies directed at improving audit quality. For example, audit regulators could consider:

(a) developing a minimum set of audit quality principles to which national audit regulators can refer;

(b) developing a globally consistent system for measuring firm audit quality;

(c) developing recommendations about the routine communication of findings from the review of individual company audit files to company audit committees; and

(d) establishing principles about the consequences of an audit firm achieving consistently low measures of audit quality for an engagement.

137 Through the International Forum of Independent Audit Regulators, we have worked with other major regulators in discussing actions to improve audit quality with the largest six firms internationally. We are also leading work on the development of a multilateral memorandum of understanding on information sharing between audit regulators.

Legislators

138 Reforms to audit regulation are being considered, or have been introduced, in some other jurisdictions. These include mandatory audit firm rotation and caps on the level of non-audit services provided to audited entities. Any possible legislative reforms would be a matter for government.

139 While we continue to monitor these international developments, our focus is on key initiatives that can be undertaken by auditors, directors, audit committees, standard setters and regulators to improve audit quality.

140 Our aim is to improve audit quality and the consistency of execution within the existing regulatory framework.

F Areas of future focus

Key points

We will continue to inspect firms that audit significant public interest entities, using a risk-based approach.

Areas of future focus for our inspections include:

- firms developing and implementing action plans to improve audit quality;
- audit evidence, professional scepticism, and the use of experts and other auditors;
- partner involvement and supervision and review; and
- the focus areas identified in our six-monthly financial reporting focus area media releases.

Our continuing general approach to inspections

141 Our reviews will continue to focus on:

(a) firms that audit entities that are likely to be of significant public interest;

(b) files for audits of financial reports of listed entities and other public interest entities such as financial institutions and large registered schemes;

(c) files for audits of entities and industries that may be more vulnerable to risks arising from existing and emerging market conditions; and

(d) assessing the quality of judgements and decisions made by the auditor and not on matters of mere process.

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

Our 'top 12' specific areas of focus

143 We consider that developing, maintaining and updating action plans to address the underlying causes of audit deficiencies is a key part of improving audit quality and inconsistent execution of audits. This is one of 12 areas of focus for firms and our coming inspections: see Table 4.

144 While it appears likely that international auditing standard setters will introduce a requirement for expanded audit reports containing key audit matters, there are no such requirements at present. If expanded audit reports are introduced in Australia at some future date, it will be important to ensure that these reports contain useful and meaningful information specific to the risks and audit of each entity concerned.

Table 4: 'Top 12' areas of focus for firms and our inspections

Focus area	Details
Action plans	Firms that have developed action plans to improve audit quality and the consistency of execution should continue to review and update those plans to ensure they are effective in improving and maintaining audit quality. Firms that do not have action plans should consider developing and implementing such plans. This would include identifying underlying causes of audit deficiencies identified by internal and peer reviews, as well as in ASIC inspections and this report, and developing solutions and actions to address those underlying causes.
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 level of professional scepticism exercised by auditors, focusing on significant judgements in relation to audit evidence, accounting estimates, going concern assumptions and accounting treatments.
Reliance on experts and other auditors	The reliance placed on: • experts, whether employed or engaged by the audited entity or employed or engaged by the auditor; and • the work of other auditors, including in the context of group audits, interests in joint ventures, and the use of service organisations. This includes focusing on 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 as audit evidence.
Financial reporting focuses	Areas identified in our six-monthly financial reporting surveillance program media releases, including audit work on accounting estimates and accounting policy choices.
Fee reductions	Whether audit quality is being maintained 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.

Focus area	Details
Audit efficiency measures	Whether a firm's 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 assessment	The adequacy of an auditor's understanding of the business model of the entity and risk assessment for individual engagements. We will also consider whether the auditor has identified and appropriately responded to key areas of risk.
Partner involvement	The partner's involvement and active participation at key stages of the audit, including the planning and execution of the audit as well as concluding procedures and key judgements. We will look for evidence on the partner's involvement on the engagement file, including sign-off and the quality of the work on the file. We will also consider the time the partner has charged to the engagement.
Supervision and review	Areas of focus will include: • whether there is strong and effective supervision and review at all stages of the audit, including planning, performance and concluding procedures; • whether reviews by senior team members, the partner and the EQCR are timely and comments raised are properly addressed and cleared by the reviewer; • whether the importance of supervision and review is adequately emphasised by firm leadership, and through training and quality reviews; • whether firm quality reviews are frequent, timely, have depth and are undertaken by independent reviewers; and • whether firms have considered real-time quality reviews and coaching for key areas during execution of the audit.
Internal controls	Areas of focus will include: • whether consideration is given to audited entities where assessing controls can give rise to a more effective audit and add value; • whether internal control reviews are conducted and the impact of deficiencies identified for institutions with large numbers of systematically processed transactions, where an effective audit may be difficult without relying on controls; • whether auditors appropriately identify and understand the internal controls of the audited entity that they rely on; and • whether auditors undertake adequate tests of the controls that have been relied on to address risk or in determining the level of substantive testing.
Tax	Areas of focus will include whether the auditor has independently reviewed the tax calculations of the audited entity and used their own tax expert. This includes the extent to which auditors and their tax experts have communicated effectively in reviewing and testing tax calculations, including ensuring that: • tax experts understand the business and general ledger items; • the auditor understands the potential implications of tax treatments affecting the entity on the financial report; and • differences between tax and accounting treatments are properly identified and accounted for appropriately.

G Lessons from audit surveillances

Key points

This section outlines lessons arising from our separate audit surveillance activities and enforcement outcomes in recent years. These lessons may inform auditors of additional matters requiring their attention for current audits.

The findings in the earlier sections of this report do not count the findings from our separate auditor surveillance activities.

Our surveillance activities

145 In addition to regular audit firm inspections, we review audits based on specific concerns that may lead to action against auditors. These surveillances focus on concerns with specific audits arising from complaints and other intelligence, including corporate collapses where there are questions over the adequacy of information on the financial condition and results provided in the financial report and questions over the audit.

146 While auditors are not responsible for the failure of companies, the audit is important to quality financial reporting so that markets, investors and other users are properly informed.

147 Our surveillance reviews have led to enforcement outcomes. For example, over the past three years, nine auditors have been removed from practice for varying periods or had their registration cancelled through enforceable undertakings and decisions of the Company Auditors and Liquidators Disciplinary Board. These cases reinforce the need to improve audit quality and the consistency of audit execution, particularly in relation to the adequacy of audit evidence, the exercise of professional scepticism, and the use of experts and other auditors.

148 The inspection findings detailed in the preceding sections of this report do not count the results of our audit surveillance activities because:

(a) the activities are not part of our regular inspection activities;

(b) surveillance matters may take time to resolve by way of an enforceable undertaking or decision by the Companies Auditors and Liquidators Disciplinary Board, and so may relate to audits in periods before the inspection periods covered in this report; and

(c) including surveillance outcomes might reduce comparability with the public inspection reports of audit regulators in some other major jurisdictions.

149 Results from our surveillance activities are published in individual media releases and our six-monthly public enforcement reports.

Lessons that may be relevant

150 Lessons that may be relevant for auditors from those of our audit surveillances that have resulted in enforcement outcomes include the matters summarised in Table 5.

Table 5: Lessons that may be relevant from audit surveillances

Area	Comments
Complex groups	Groups may have a significant number of entities with complex financial and operational interrelationships. Entities may be controlled, subject to significant influence, or owned by common individuals. Some entities may not present audited financial reports. Auditors should understand the reasons for a complex group, and the financial and operational interrelationships between group entities. Auditors should identify, assess and respond to risks, and apply appropriate scepticism in auditing group entities.
Different auditors in group	Before accepting an engagement, auditors should understand why group entities have different auditors. Where management restricts communications between the auditors, additional work may be required and greater scepticism applied. An auditor must gain assurance on financial information of subsidiaries, associates and joint arrangements, and should consider reviewing or re-performing work of their auditors with regard to any risks or concerns. Additional work on the existence or value of underlying assets may be necessary, particularly where parties or assets are located overseas, where there are no audited financial reports, or the party is audited by another firm.
Related parties	Auditors must identify the existence and terms of related party transactions, including those on non-arm's length terms. Auditors should assess the risk of unidentified related parties, the effectiveness of controls to detect transactions, the impact of transactions, the recoverability of investments or receivables, and the ability of related parties to provide any necessary financial support.
Foreign operations and assets	The work of auditors of foreign operations and investments may require increased review. It may be necessary to obtain direct audit evidence of the existence and value of underlying assets and operations. Cultural differences may affect the reliability of audit evidence in some countries, including third party confirmations.
Management integrity	Where there is reason to doubt the integrity of management, an auditor should respond to the risk of material misstatements by increasing the nature and extent of audit procedures, and applying heightened scepticism.
Dominant CEOs	Dominant CEOs may override controls or compromise corporate governance. Risks or concerns may not be properly disclosed to, or considered by, the directors. Accounting policies, valuations and other estimates may be inappropriate or disclosures inadequate. The auditor may also have insufficient access to information or officers. Auditors should apply heightened scepticism, and challenge and corroborate management representations with other evidence.

Area	Comments
Company/auditor mismatch	Smaller audit firms must ensure that they have the necessary experience and expertise to audit larger and more complex entities, and be mindful of circumstances where their independence may be perceived to be compromised by dependence on audit fees. Auditors should be able to consult on complex transactions and issues, and have access to expert advice on accounting treatments, asset valuations and other estimates. Auditors should be mindful that company growth may outstrip the ability of the auditor to conduct an effective audit.
Business models	Auditors need to understand the business models of the entities that they audit. For example, where there is rapid growth internally or from acquisitions, additional attention may be needed on the recoverability of any assets acquired, the treatment of start-up costs, the company's ability to manage and integrate new businesses, and the ability to meet borrowing commitments and loan covenants. There have been cases where property developer and debenture issuer auditors did not understand the risk of impairment of loans receivable, apply sufficient professional scepticism or perform adequate audit work. Debt may pay above market rates and equity may be minimal. In some cases, property developers inappropriately capitalised interest, fees and commissions paid to related parties.
Going concern	There have been cases where an entity has failed shortly after the auditor gave an unmodified opinion on its financial report, or gave an emphasis of matter when a qualified opinion should have been issued. Auditors need to be sceptical of optimistic cash flow and growth assumptions, as well as the ability to meet loan covenants and commitments.
Accounting treatments and estimates	Auditors need to apply appropriate scepticism in considering accounting treatments and estimates. This includes revenue recognition, expense deferral, off-balance sheet exposures, and the classification of assets and liabilities between current and non-current. The reasonableness of assumptions used in impairment testing should be challenged, including where cash flow estimates have not been met in the past, cash flows are negative, or net asset values exceed the entity's market capitalisation.
Special purpose financial reports	In determining compliance with accounting standards, the auditor must consider whether classification as a non-reporting entity is appropriate with regard to financial report users. For example, financial reports of internal group investment vehicles may be used by investors in the entities that fund those vehicles. Financial instrument, related party and consolidated information may be necessary to understanding underlying risks, exposures and performance.

H Audit transparency reports

Key points

Audit transparency reports were first required for the year ended 30 June 2013. We have provided guidance in an information sheet to help auditors when preparing audit transparency reports.

We reviewed the audit transparency reports lodged with us and most appeared to provide the minimum information required by legislation. Some provided additional information. We wrote to seven auditors where audit transparency reports did not appear to contain the information required.

Purpose and requirements

151 Audit transparency reports may help to inform the market about audit firms and audit quality. Transparency about indicators of audit quality may encourage audit firms to increase their focus on audit quality and may also provide information to help those responsible for selecting an audit firm.

152 All individual auditors, audit firms and authorised audit companies (collectively, 'auditors') must publish an audit transparency report on their website and lodge it with ASIC if they have conducted audits under Div 3 of Pt 2M.3 of the Corporations Act of 10 or more entities of certain types in the reporting year ended 30 June. The types of entities are listed companies, listed registered schemes, authorised deposit-taking institutions and bodies mentioned in s3(2)(c) or 3(2)(e) of the *Australian Prudential Regulation Authority Act 1998*.

153 In broad terms, the information required to be presented in an audit transparency report includes information about internal quality control systems, independence practices, financial information about the auditor, and a list of the entities audited under the Corporations Act.

Our guidance

154 To help auditors when preparing audit transparency reports, we issued Information Sheet 184 *Audit transparency reports* (INFO 184) in August 2013. INFO 184 summarises the requirements for audit transparency reports and explains what information must or may be included in the report. It also explains whether information can be included from reviews by ASIC and other bodies.

155 Audit transparency reports must not include information that is false or misleading in a material particular, including by way of omission. INFO 184 provides guidance to help auditors reduce the risk that an audit transparency report is misleading. This includes presenting information that is unbiased and not oriented towards marketing or selling services.

Quality of audit transparency reports

156 We reviewed all of the 27 audit transparency reports lodged by auditors for the year ended 30 June 2013. Most reports appeared to provide the information required by legislation. Some provided additional information they considered relevant to audit quality.

157 We wrote to seven auditors, noting some areas where their audit transparency reports did not meet the statutory requirements. We asked one Smaller firm to lodge a replacement audit transparency report that complied with the requirements of the Corporations Act.

158 In preparing audit transparency reports for the year ended 30 June 2014, auditors are reminded to provide information that is unbiased and not oriented towards marketing or selling services.

Appendix: Our inspection approach

The firms we inspected

159 Our audit inspection program focuses primarily on the review of audits of listed entities and other public interest entities. We also review some registered scheme compliance plan audits and audits of AFS licensees.

160 This report outlines the results of the inspections of 17 audit firms substantially completed in the 18 months to 31 December 2013. These firms, in aggregate, audit 93% of listed entities by market capitalisation. In the 18 month period to 31 June 2012 (2011–12), we inspected 20 firms.

161 The firms we inspected ranged in size as follows:

(a) the Largest Four 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;

(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.

162 The number of firms we inspected in each category is provided in Table 6.

Table 6: Number of firms inspected (2011–12 and 2012–13)

Type of firm	18 months to 31 December 2013	18 months to 30 June 2012
The Largest Four National firms	4	4
Other National and Network firms	4	6
Smaller firms	9	10
Total	**17**	**20**

Note: All of the Largest Four National and Other National and Network firms have been inspected more than once. All but two of the Smaller firms were inspected for the first time in 2012–13.

Key audit areas selected for review

163 The spread of key audit areas reviewed in the 18 months to 31 December 2013 (compared with the previous two review periods) is shown in Table 7.

Table 7: Key audit areas selected for review as a percentage of total key audit areas reviewed (2010–11, 2011–12 and 2012–13)

Key audit area	18 months to 31 December 2013	18 months to 30 June 2012	18 months to 31 December 2010
Revenue/receivables	22%	20%	15%
Impairment/asset valuation	17%	13%	16%
Loans/borrowings	6%	9%	8%
Cash	6%	9%	5%
Provisions	5%	3%	2%
Mining exploration and evaluation	5%	5%	6%
Inventory	5%	4%	4%
Goodwill	4%	2%	5%
Investments	4%	2%	4%
Expenses/payables	4%	10%	3%
Financial instruments	3%	4%	4%
Group audit	2%	2%	2%
Share-based payments	2%	1%	1%
Experts and other auditors	1%	1%	2%
Joint ventures	1%	1%	0%
Tax	1%	2%	3%
Acquisition accounting	1%	1%	2%
Other	11%	11%	18%

Our inspection process

The Largest Four National and Other National and Network firms

164 We reviewed selected key audit areas in the audit working papers for selected audit engagements.

165 We also assessed whether each firm's quality control systems:

(a) comply with Auditing Standard ASQC1 *Quality control for firms that perform audits and reviews of financial reports and other financial information, and other assurance engagements*;

(b) are designed to ensure that audits are performed in accordance with auditing standards; and

(c) ensure auditors comply with the auditor independence requirements.

166 During our inspections, we highlighted to each firm areas where we consider that they had not obtained reasonable assurance that the financial report as a whole was free of material misstatement and suggested remedial actions they should take.

Smaller firms

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

(a) conducting a review of, generally, the audit files relating to 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.

Joint inspections

168 ASIC has arrangements to assist the Public Company Accounting Oversight Board (PCOAB) of the United States and the Canadian Public Accountability Board with their inspections of Australian auditors to ascertain compliance with the relevant audit requirements in each of those jurisdictions. During 2012–13, four inspections were conducted jointly with the PCAOB.

Key terms

Term	Meaning in this document
accounting standards	Standards issued 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.
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 issued by the AUASB under s336 of the Corporations Act
CGU	Cash generating unit
Corporations Act	*Corporations Act 2001*, 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
IAASB	International Auditing and Assurance Standards Board
ICAA	The Institute of Chartered Accountants in Australia
IOSCO	International Organization of Securities Commissions

Term	Meaning in this document
ISA	International Standards on Auditing
Largest Four 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
PCOAB	Public Company Accounting Oversight Board
professional ethical standards	Ethical standards issued by the Australian Professional Ethical Standards Board, including APES 110 *Code of ethics for professional accountants*
public interest entities	Listed entities and other entities of public interest with a large number and wide range of stakeholders considering factors like the nature and size of the business and the number of employees
s311 (for example)	A section of the Corporations Act (in this example numbered 311), unless otherwise specified
Smaller firms	Firms that audit a limited number of listed entities and have a small number of audit partners

Related information

Reports

Report 317 *Audit inspection program report for 2011–12*

Information sheets

INFO 183 *Directors and financial reporting*

INFO 184 *Audit transparency reports*

INFO 196 *Audit quality: The role of directors and audit committees*

Legislation

Australian Prudential Regulation Authority Act 1998, s3(2)(c) or 3(2)(e)

Corporations Act, Pt 2M.3, Div 3; Pt 2M.4, Divs 3, 4 and 5; Pt 5C.4, Ch 2M; s307C and 601HG(1)

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 *Overall objectives of the independent auditor and the conduct of an audit in accordance with Australian auditing standards*

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*