



ASIC

Australian Securities & Investments Commission

REPORT 130

Audit inspection program public report for 2006–07

June 2008

About this report

This public report sets out key themes and issues identified by ASIC's audit inspection program for 2006–07.

We expect this report to be beneficial to firms we have inspected as well as those we have not inspected, the investing public, companies, audit committees and other interested stakeholders.

About ASIC regulatory documents

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

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

Regulatory guides: give guidance to regulated entities by:

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

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

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

Disclaimer

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

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

Unless stated otherwise, not all matters in this report apply to every firm and, where they do apply to more than one firm, there will inevitably be differences in degree. It is important to note that our observations and findings relate only to the individual Firms inspected and cannot be extrapolated across the auditing profession in Australia, including where firms form part of the same network. Our observations and findings can differ significantly even between firms of similar size and for that reason we caution against drawing conclusions about any firms not yet inspected by ASIC.

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Executive summary

The audit inspection program

Australia significantly enhanced its regulatory requirements for auditors on 1 July 2004 with the enactment of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9). This is our third report on our audit inspection program since the enactment of CLERP 9. This report summarises the results of our audit regulation activities during the period from 1 July 2006 to 31 December 2007 (Year 3), which includes audit inspections and other projects.

This report includes observations and findings from the inspections of 19 audit firms (Firms) across the profession conducted in Year 3. Of these Firms:

- 9 were inspected for the first time (Group A)
- 6 have been inspected twice (Group B)
- 4 have been inspected three times (Group C).

The Firms inspected range in size from national partnerships with multiple offices, to individual offices of firms that are separate legal entities. All of the Firms were involved in the conduct of audits of listed entities.

A strong audit profession helps maintain and promote confidence and integrity in Australia's capital markets. Our audit regulation activities help maintain and raise the standard of conduct in the auditing profession by educating and influencing the behaviour of industry participants (registered company auditors and audit firms) through compliance monitoring activities. We focus on audit quality by promoting compliance with the requirements of the *Corporations Act 2001* (Corporations Act), Australian auditing standards, and professional and ethical standards.

Observations and findings from the audit inspection program are presented in Section A of this report, which focuses on strengths and improvements since our first inspections, where relevant, together with areas requiring action.

We expect this report to be beneficial to the Firms as well as those firms we have not yet inspected, the investing public, companies, audit committees and other interested stakeholders.

Industry overview

Around 28,000¹ entities must prepare an annual financial report and have this financial report audited in accordance with the Corporations Act.

An audit of an Australian company, disclosing entity, registered scheme or financial services licensees for the purposes of the Corporations Act may only be performed by a registered company auditor (RCA) or an authorised audit company (AAC). ASIC registers both individuals as RCAs and, less commonly, companies as AACs.

Our policy on registration imposes minimum standards of both competence and integrity, to help protect investors and other users of financial reports. The qualifications, experience and other requirements for registration are set out in the Corporations Act. RCAs must lodge annual statements with ASIC to provide up-to-date information that helps us to monitor their activities after registration.

There are nearly 6,000 RCAs across Australia, with about three quarters in city and metropolitan areas. Approximately 90% of RCAs are sole practitioners or work in small firms with less than 10 RCAs. Around two thirds of RCAs have been registered with ASIC for more than 20 years.

Collectively, RCAs in the four largest audit firms conduct the audits of over 46% of all listed entities in Australia, and approximately 97% by market capitalisation of the 300 largest entities listed on the Australian Securities Exchange (ASX).

Observations and findings

General observations

Australia has a skilled audit profession committed to independence and audit quality. Firms generally have robust systems and processes in place that are designed to ensure compliance with auditor independence requirements and the conduct of quality audits. Our inspections in Year 3 observed that the quality of auditing in Australia is fundamentally sound.

The engagements we reviewed ranged from years ended 30 June 2007 back to periods ended 31 December 2005. The downturn in market conditions experienced since late 2007 has introduced challenges for auditors that were not necessarily present during our Year 3 inspections. It is not possible to extrapolate our findings, particularly the observations about the quality of

¹ Based on information for the 12 months to 30 June 2007

audits, across other engagements conducted by the same Firms, or across other firms in the profession.

The Firms have responded positively to the Australian legislative requirements for auditor independence and audit quality. Many Firms have committed, and continue to commit, dedicated technical resources and, where required, have developed or further enhanced existing policies and systems to assist them in complying with legislative requirements.

Systems of quality control

The diversity of audit firms is an essential element of the audit market. Firms differ on many factors including their size and nature, their types of clients and their risk management strategies.

As a result, observations and findings vary considerably between the Firms. There are noticeable differences in the quality and maturity of policies and systems, and variations in the levels of application of, and compliance with policy, in Group A, Group B and Group C.

The Firms in Group B and Group C have taken appropriate action in relation to previous observations and findings. Issues had been addressed and good progress was noted in most areas with very few instances in which insufficient action had been taken. Improvements we have observed include:

- creation of quality control policies and procedures
- employment of dedicated technical resources
- employment of external experts to conduct monitoring activities
- changes of auditor in relation to a small number of listed audit clients
- registration by partners on specified training courses.

In contrast, some Group A Firms had not taken a proactive approach to planning and implementing effective policies, systems and processes to ensure compliance with the legislative requirements and professional and ethical standards for independence and audit quality. More action could have been taken, given:

- The legislative requirements have been in effect for three years.
- We have issued two public reports on the results of our inspection program, identifying common observations and findings, which should have been considered and proactively acted upon.
- In a number of cases, we had previously visited another member firm of the association to which the Group A Firms belong.
- The three professional accounting bodies have been actively focussing on raising awareness including regular communications and training.

Engagement file reviews

For the substantial majority of the engagement files we reviewed, sufficient appropriate audit evidence was gathered to support both the conclusions reached and that the audit was conducted in accordance with the auditing standards. However, our reviews revealed a number of instances where documentation on the engagement file failed to provide enough evidence to support certain audit assertions. Most Firms need to continue to reinforce to their partners and staff the need for compliance with the mandatory requirements of the auditing standards.

Many of the deficiencies relate to a failure to record on the engagement file all the audit work that the auditor performed and relied on in forming his or her conclusions about key audit assertions. In these instances, it can be difficult for an inspector to determine how the audit opinion was formed. These documentation deficiencies may increase the risk that the audit work was not adequately performed and that the conclusions reached were not appropriate.

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

Other projects

Our regulation activities in 2006–07 also included specific targeted projects on auditor rotation and the implementation of Australian Auditing Standard on Review Engagements 2410 *Review of an Interim Financial Report Performed by the Independent Auditor of the Entity* (ASRE 2410). Observations and findings from these projects are presented in Section B of this report.

Scope of ASIC audit inspections

Regulatory developments

ASIC monitors compliance by RCAs with the requirements of the Corporations Act, including auditor independence and audit quality requirements.

Australia significantly enhanced its regulatory requirements for auditors on 1 July 2004 with the enactment of CLERP 9. The enactment of the *Australian Securities and Investments Commission Amendment (Audit*

Inspection) Act 2007 in February 2007 expanded ASIC's functions to assist foreign regulatory bodies with ascertaining compliance by Australian auditors with overseas audit requirements.

ASIC entered into an arrangement with the Public Company Accounting Oversight Board (PCAOB) of the United States of America on 17 July 2007 to assist the PCAOB ascertain compliance by Australian auditors with the *Sarbanes-Oxley Act 2002*. During the period covered by this report, two inspections were conducted jointly with the PCAOB.

Previous inspections

Our 2004–05 (Year 1) inspections assessed whether firms had documented and implemented a quality control system that provided reasonable assurance of compliance with the auditor independence requirements of the Corporations Act. Accordingly, quality control elements outside the scope of our Year 1 inspections do not have any comparable data in Section A of this report.

In 2005–06 (Year 2), our scope broadened to also assess whether firms' audit methodologies facilitated the conduct of audits in compliance with the audit quality requirements of the Corporations Act.

Focus in Year 3

In 2006–07 (Year 3), inspections continued to focus on the Firms' independence policies, systems and processes, to assess compliance with the auditor independence requirements in Division 3, 4 and 5 of Part 2M.4 of the Corporations Act and relevant professional and ethical standards (independence).

We also focused on the Firms' audit methodology to facilitate the conduct of audits in accordance with Division 3 of Part 2M.3 of the Corporations Act and the Australian auditing standards (audit quality). Specifically, we increased the number of audit and review engagements selected for review, with particular focus on those auditing standards that our previous inspections showed required continued attention.

Our review of aspects of selected engagement files extends beyond monitoring compliance with the specific regulatory requirements and includes an assessment of significant audit judgements. It is designed to ensure that the firm has obtained sufficient appropriate audit evidence to support its conclusions in relation to significant audit judgements. It is not designed to find minor instances of non-compliance, nor is it intended to confirm the audit opinion. Our review therefore focuses on the substance of work and on whether sufficient appropriate audit evidence is recorded on file to support the conclusions for key decisions and significant judgements on the audit.

For more details about how we conducted this work, see the Appendix.

A Observations and findings

Key points

This section summarises Firms' compliance with the auditor independence requirements, Australian auditing standards and professional and ethical standards over the last three years of our audit inspection program.

It covers the following elements of quality control as set out in ASA 220 *Quality Control for Audits of Historical Financial Information* and APES 320 *Quality Control of Firms*:

- leadership responsibilities for quality within the firm (executive leadership)
- ethical requirements (independence)
- acceptance and continuance of client relationships and specific engagements
- human resources
- engagement performance (audit quality)
- monitoring.

Diversity of audit firms

The diversity of audit firms is an essential element of the audit market. Firms differ on many factors including their size and nature, their types of clients and their risk management strategies. How each Firm complies with its legal and professional obligations will be impacted by these factors. For example, governance practices and methods of communication to support compliance and drive audit quality will vary from firm to firm. In determining our observations and findings, we recognise the diversity and give consideration to a number of factors, including the following factors outlined in APES 320.96:

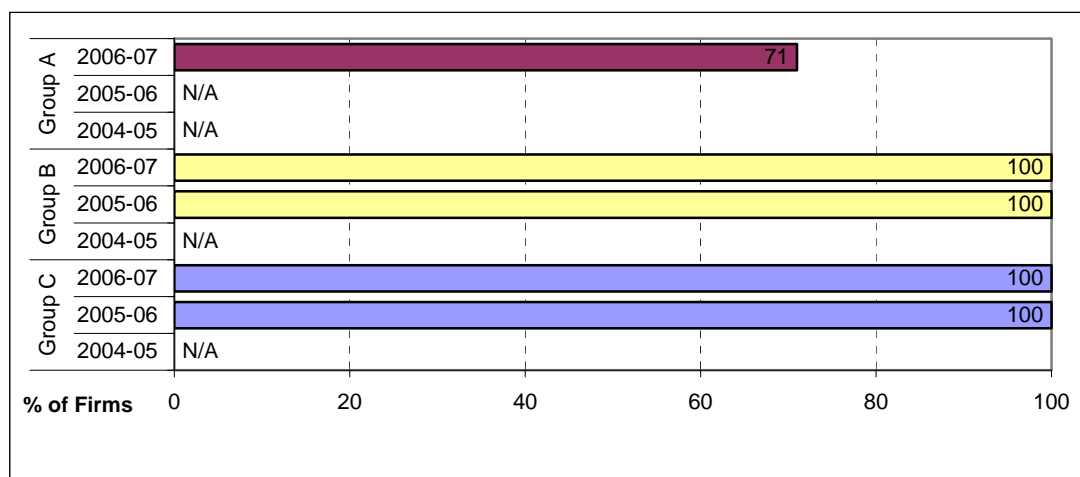
- the size of the Firm and the number of offices
- the degree of authority both personnel and offices have
- the nature and complexity of the Firm.

Executive leadership

Table 1: Summary of key executive leadership requirements²

Source	Requirements
Paragraph 9 of ASA 220	The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.
Paragraph 9 of APES 320	The firm shall establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements.
Paragraph 12 of APES 320	Any person or persons assigned operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners shall have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.
Paragraph 89 of APES 320	The firm shall establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with: <ol style="list-style-type: none"> complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and allegations of non-compliance with the firm's system of quality control.

Figure 1: Firms that have established policies and procedures that recognise that quality is essential in performing audits



² These requirements are not exhaustive

Figure 2: Firms that have a code of conduct/strategy document that incorporates elements of audit quality and ethical requirements

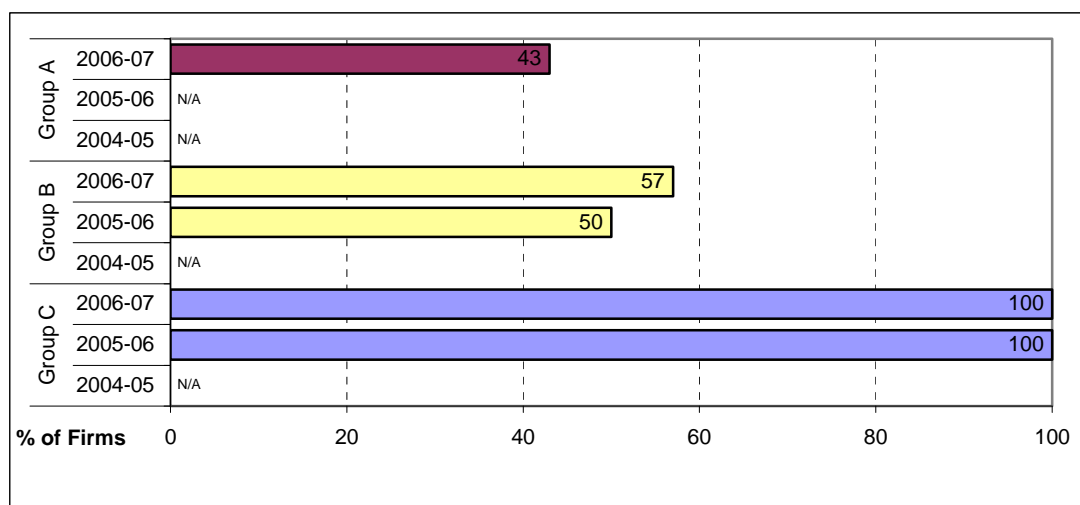
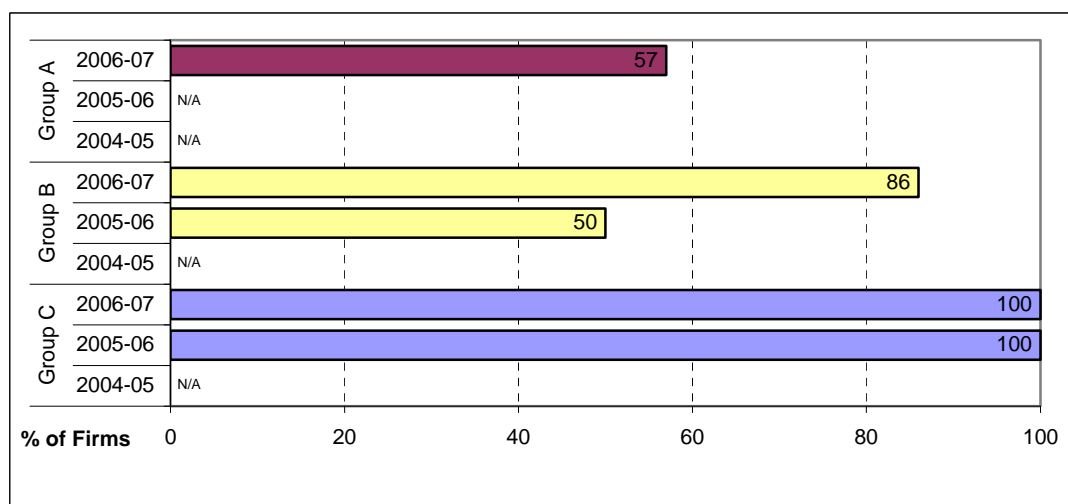


Figure 3: Firms that have a system in place to handle complaints about audit quality and independence



Observations

- All Group B and C Firms have policies and procedures that recognise that quality is essential in performing audits in accordance with legal and professional requirements.
- In 2005-06, we noted that a significant number of firms visited for the first time had not taken a proactive approach to planning and implementing effective communication strategies to ensure that key messages from the firms' leadership on audit quality and independence had been communicated to staff on a regular basis. Group B Firms continue to enhance their policies to include whistleblower and complaints handling and to implement better communication strategies to ensure key messages on the importance of audit quality and independence are constantly reinforced with staff.

- Most Group A Firms have not taken a proactive approach to ensure that staff are aware of the Firms’ ‘tone at the top’ for independence and audit quality on a timely basis.
- Our key observations and findings for some Group A and Group B Firms included a lack of regular verbal and written communication from the Firms’ leadership on the importance of audit quality and independence, a lack of audit quality and independence attributes in the Firms’ strategic plan or other similar documents, a lack of formalised whistleblower or complaints handling processes and a lack of clarity around the consequences for staff of non-compliance with the Firms’ policies.

Independence

Table 2: Summary of key independence requirements³

Source	Requirements
Part 2M.4 Div 3, Corporations Act	General and specific independence requirements
Paragraph 11 of ASA 220	The engagement partner shall consider whether members of the engagement team have complied with relevant ethical requirements relating to audit engagements.
Paragraph 14 of APES 320	The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.
Paragraph 18 of APES 320	The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Code of Ethics for Professional Accountants. Such policies and procedures should enable the firm to: <ul style="list-style-type: none"> (a) communicate its independence requirements to its personnel and, where applicable, others subject to them; and (b) identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.
Paragraph 20 of APES 320	The assurance practice shall establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations.
Paragraph 23 of APES 320	At least annually, the assurance practice shall obtain written confirmation of compliance with its policies and procedures on independence from all assurance practice personnel required to be independent by Section 290 of the Code of Ethics for Professional Accountants.

³ These requirements are not exhaustive

Figure 4: Annual independence confirmations and testing

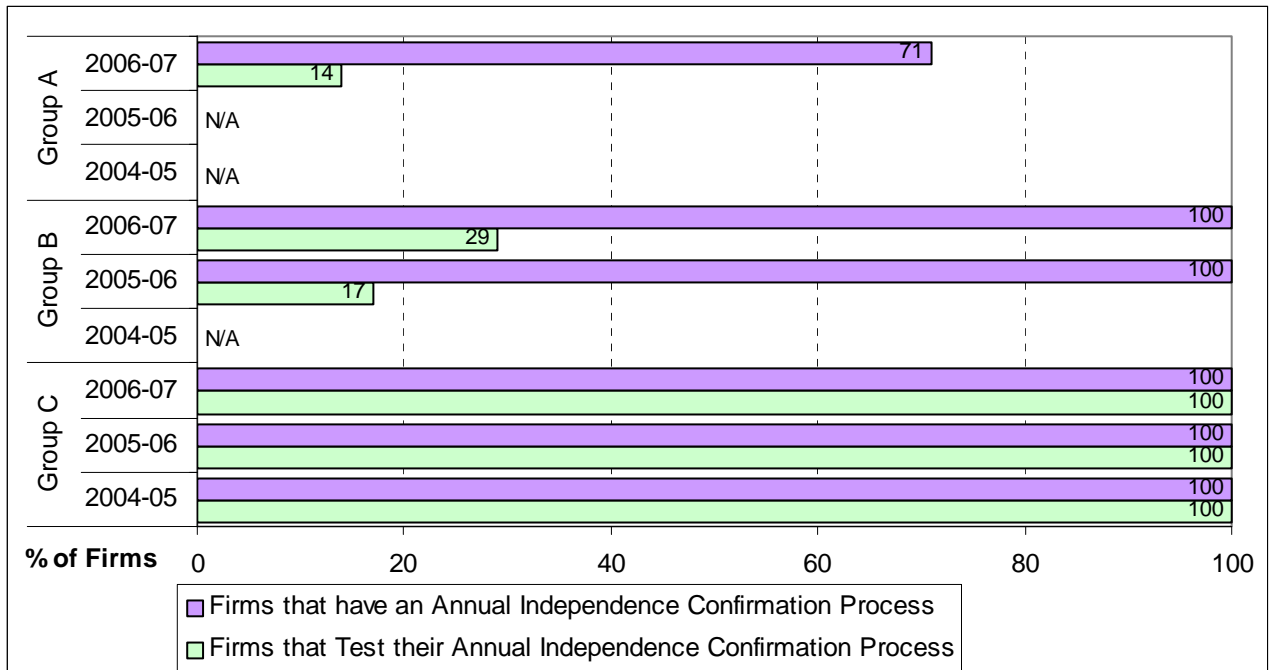


Figure 5: Engagement level independence confirmations and testing

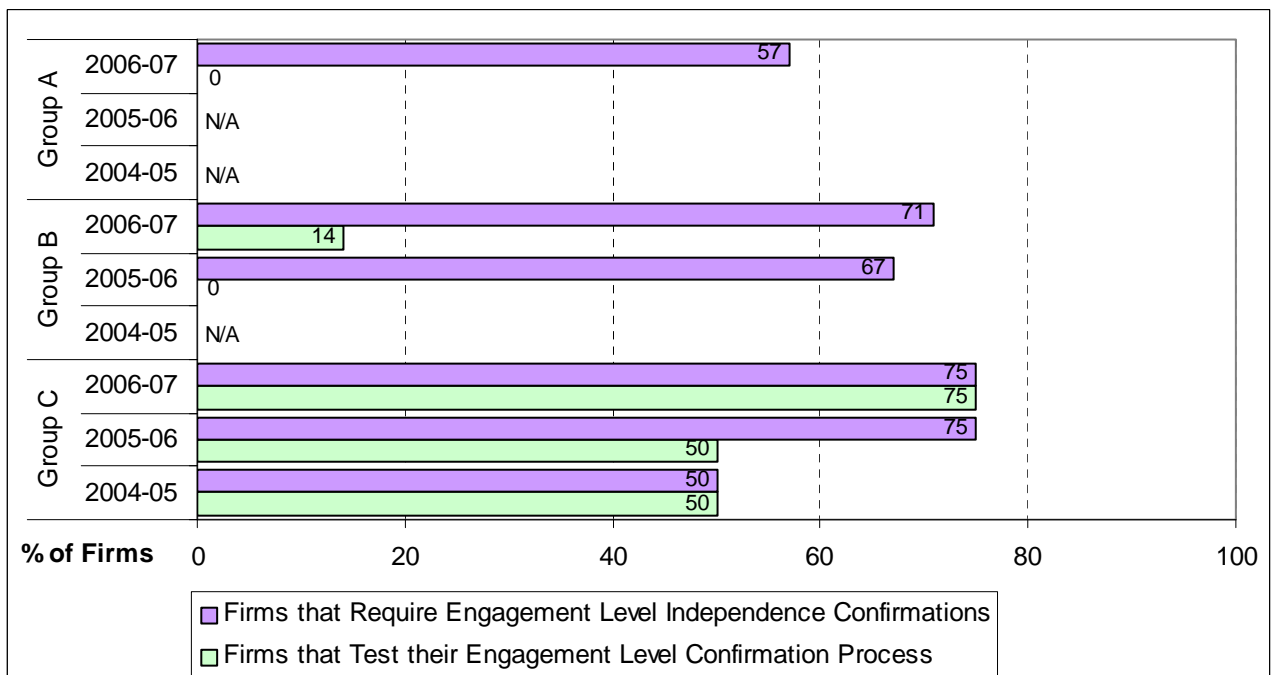
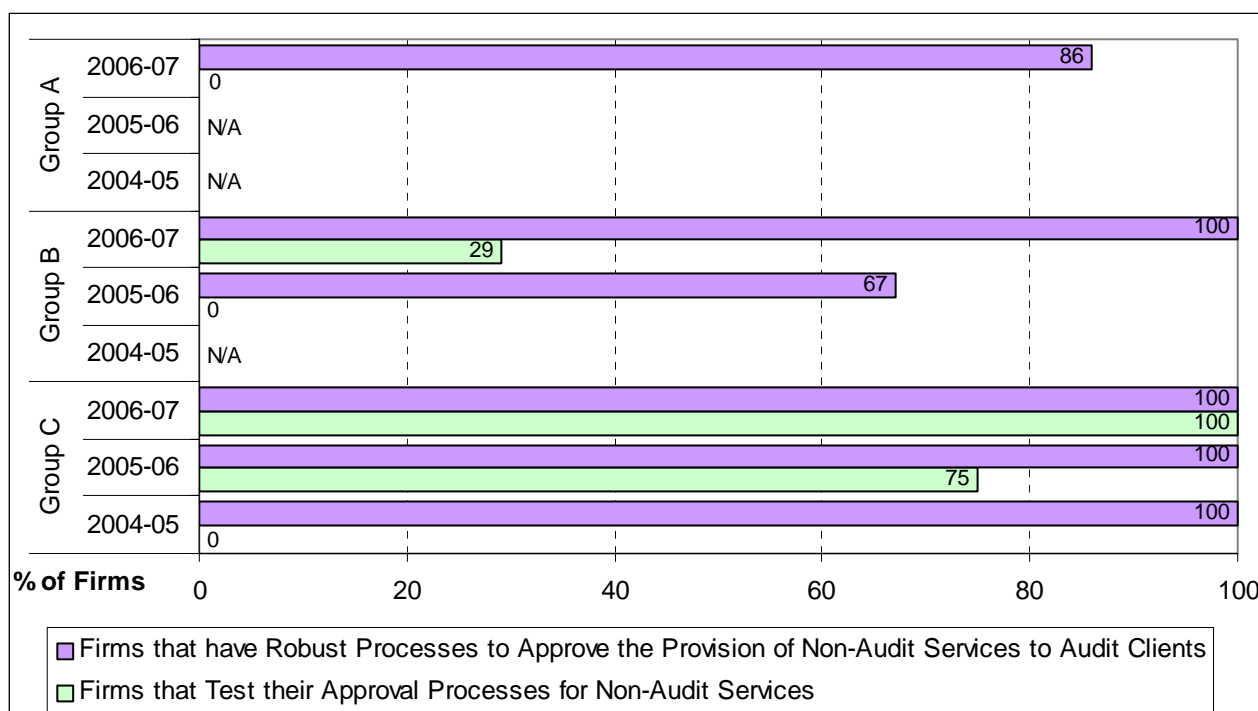


Figure 6: Approval of non-audit services and testing

Observations

Annual independence confirmations

- All Group B and Group C Firms have established policies, systems and processes that comply with the requirements of the Corporations Act and professional and ethical standards in relation to annual independence confirmations. These Firms have continued to enhance their policies, systems and processes for auditor independence and continue to commit significant resources and effort to independence initiatives.
- Group A Firms had varying levels of documented independence policies, systems and processes in place. Some Group A Firms need to take action to ensure their independence policies are in full compliance with the Corporations Act and professional and ethical standards.
- All Group C Firms and some Group B Firms test annual independence confirmations on a sample basis to verify compliance with their independence policies. Group C Firms have increased their sample sizes for testing from the previous year and some Firms have extended testing to staff below partner level.
- The internal testing by Firms of partner and staff annual independence confirmations continues to identify breaches of the independence provisions of the Firms' policies, such as the requirement for partners and staff to keep information up to date in the Firms' independence monitoring systems. These monitoring systems are part of each Firm's

quality control mechanism to ensure compliance with the auditor independence requirements of the Corporations Act. If partners and staff do not maintain these systems on a timely basis, Firms are exposed to an increased risk of non-compliance.

- A large number of Group A and Group B Firms were not testing annual independence confirmations to ensure that partners and staff are complying with provisions of the Corporations Act, professional and ethical standards, and firm policy. In the case of Group A, this was partly due to some Firms not having documented policies or established processes that were capable of being tested. Although not a mandatory requirement, these Group A and Group B Firms need to consider implementing a testing regime to ensure that their independence systems and processes are operating satisfactorily and to evidence compliance with their independence policies. The Firms can place only limited reliance on their independence systems and processes without introducing an effective testing program. The Firms should continue to monitor any decisions on the scope and frequency of independence testing programs as the nature of their clients and practice may change.

Engagement level independence confirmations

- Although not a mandatory requirement, a majority of Group A, Group B and Group C Firms have implemented policies and processes that require staff to complete engagement level independence confirmations. Typically this involves all staff working on an audit engagement to confirm their independence for that specific audit client when they start and/or finish each audit. The Firms that have implemented this policy believe that it reinforces their commitment to maintaining independence and helps them ensure compliance with the independence requirements of the Corporations Act, including signing the independence declaration required by s307C.
- All Group C Firms that have voluntarily adopted engagement level independence confirmations have also started testing this process as part of their monitoring processes.
- Our engagement file reviews continue to identify issues with timing and completeness of the engagement level independence confirmations. Where the engagement level independence confirmation is an important component of the firm's independence policies and processes, its completion should be consistent with those policies. We note, however, that most Group C Firms and some Group B Firms that have voluntarily implemented this policy have implemented or are in the process of implementing electronic processes to facilitate easier completion of the confirmations by staff, and that compliance levels are improving over time.

Non-audit services

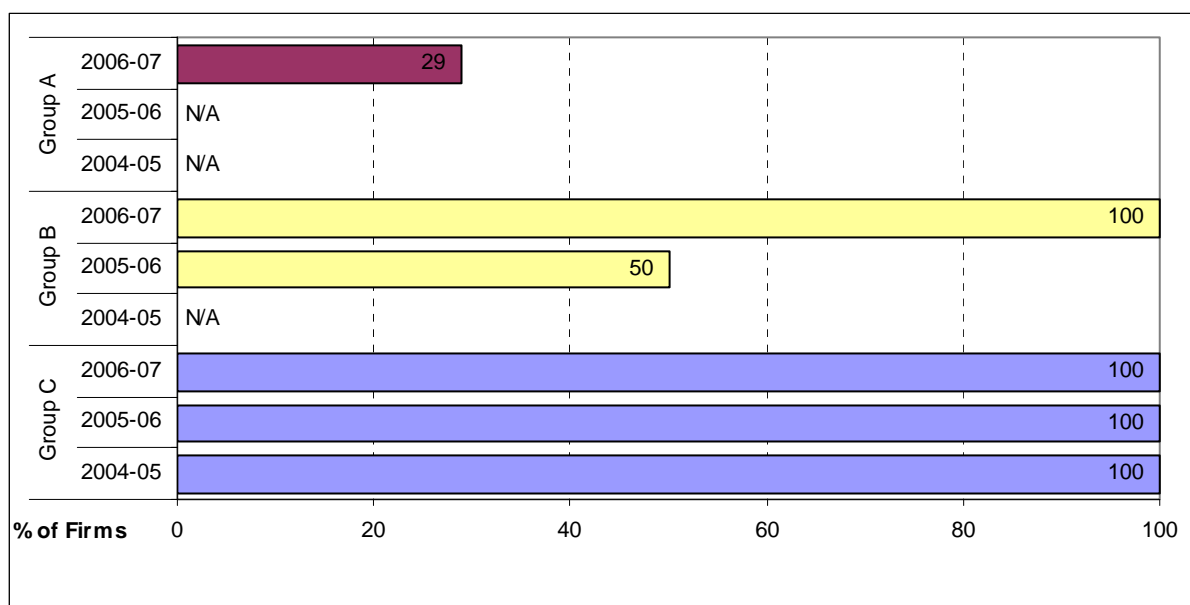
- All Group B and Group C Firms had developed policies and procedures relating to the acceptance and approval of non-audit services for existing audit clients. However, these policies do not always specify whether the approval should be documented.
- The extent of documentation for approving non-audit services varied among Firms. Some Firms did not have adequate documentation supporting decisions to provide non-audit services to audit clients.
- Most Group B Firms and all Group A Firms have yet to commence testing of non-audit services, on a sample basis. Without appropriate and timely approval documentation, firms are unable to test whether the provision of non-audit services is in line with their policies, professional and ethical standards, and the Act.

Acceptance and continuance

Table 3: Summary of key acceptance and continuance requirements⁴

Source	Requirements
Paragraph 17 of ASA 220	The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements have been followed, and that conclusions reached in this regard are appropriate and have been documented.
Paragraph 28 of APES 320	The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will only undertake or continue relationships and engagements where it: <ol style="list-style-type: none"> has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity; is competent to perform the engagement and has the capabilities, time and resources to do so; and can comply with ethical requirements.

⁴ These requirements are not exhaustive

Figure 7: Firms that have a robust client acceptance and continuance process

Observations

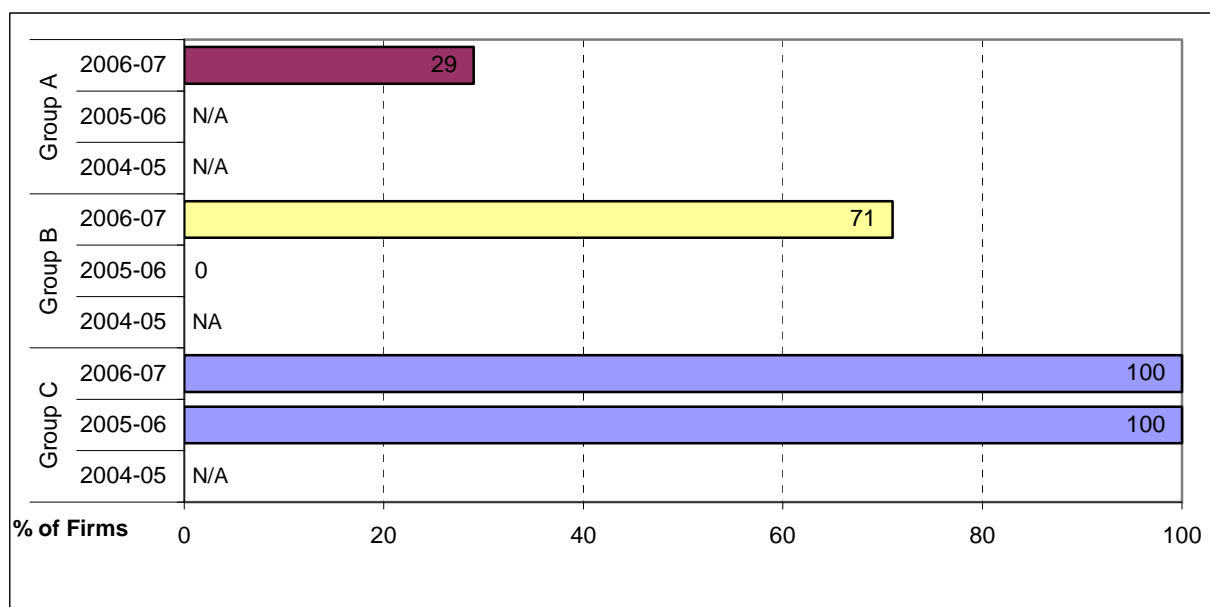
- All Group B and Group C Firms have robust policies and processes for client and engagement acceptance and continuance. All Firms continue to enhance their policies and to implement better integrated systems that facilitate conflict checking processes and more timely recording of acceptance and continuance decisions.
- Where deficiencies were noted in client acceptance and continuance policies and procedures in Year 2, these deficiencies were actioned by the Firms by the time of our follow-up inspection in Year 3.
- However, the majority of Group A Firms did not have appropriate policies and procedures for the acceptance and continuance of client relationships and specific engagements. It has been a legal requirement to have appropriate procedures in place since 1 July 2006.
- Across most Firms, we continue to note deficiencies in the application of policy for both the adequacy of documentation supporting the decision to provide non-audit services for audit clients, and the timing of issuance of engagement letters, for both new clients and new services to existing clients, before completing the relevant continuance or acceptance processes.

Human resources

Table 4: Summary of key human resources requirements⁵

Source	Requirements
Paragraph 23 of ASA 220	The engagement partner shall be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with the Auditing Standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued.
Paragraph 36 of APES 320	The firm shall establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.
Paragraph 40 of APES 320	The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles.

Figure 8: Firms that give due recognition and reward to audit quality and commitment to ethical principles in evaluation, compensation and promotion procedures



Observations

- All Group C Firms had established policies and procedures that give due recognition to audit quality, commitment to ethical principles, and maintenance of competence in staff and partner evaluation,

⁵ These requirements are not exhaustive

compensation and promotion procedures. We consider that this is fundamental to demonstrating strong and transparent leadership within firms, and to demonstrating the firm's commitment to promote a culture of balance between audit independence, quality and commercial considerations.

- Where deficiencies were identified in human resources policies and procedures in Year 2, these deficiencies were actioned by the majority of Firms by the time of our follow-up inspections in Year 3.
- Most Group A Firms did not have appropriate policies and procedures that adequately considered audit quality and independence attributes in partner and staff performance evaluations. In most cases, deficiencies related to:
 - partner performance reviews not being completed or documented
 - partner and staff competencies not including explicit audit quality and independence considerations
 - lack of clear linkages between audit quality and independence considerations and partner performance evaluation and remuneration.
- Some Group A and Group B Firms continue to enhance their policies and documented criteria for partner promotions and to implement systems to better manage and monitor staff training attendance and consequences for non-attendance. Shortfalls in training and continuing professional education (CPE) hours may adversely impact audit quality, particularly when there have been changes to auditing and accounting standards.

Audit quality

Table 5: Summary of key audit quality requirements⁶

Source	Requirements
Section 307A(2), Corporations Act	The lead auditor for the audit or review must ensure that the audit or review is conducted in accordance with the auditing standards.
Paragraph 30 of ASA 220	Before the auditor's report is issued, the engagement partner, through review of the audit documentation and discussion with the engagement team shall be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

⁶ These requirements are not exhaustive

Source	Requirements
Paragraph 42 of ASA 220	An engagement quality control review shall include an objective evaluation of: (a) the significant judgments made by the engagement team; and (b) the conclusions reached in formulating the auditor's report.
Paragraph 46 of APES 320	The firm shall establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances.
Paragraph 73a of APES 320	The firm shall establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalised.

Figure 9: Firms that have a comprehensive audit methodology designed to ensure audits are conducted in compliance with the auditing standards

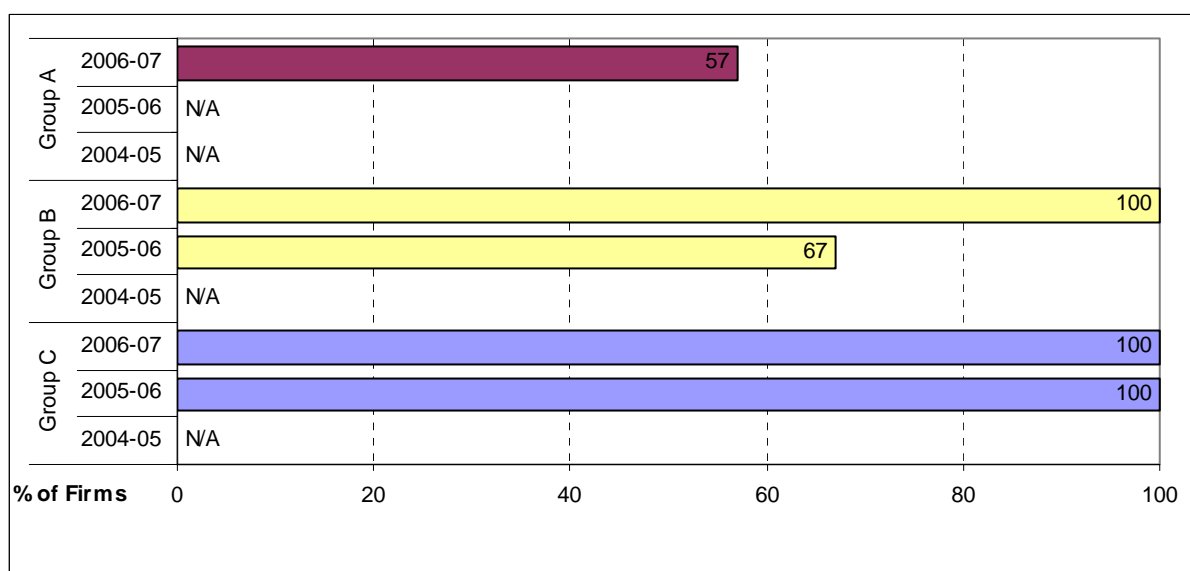


Figure 10: Number of file reviews by ASIC inspection year end

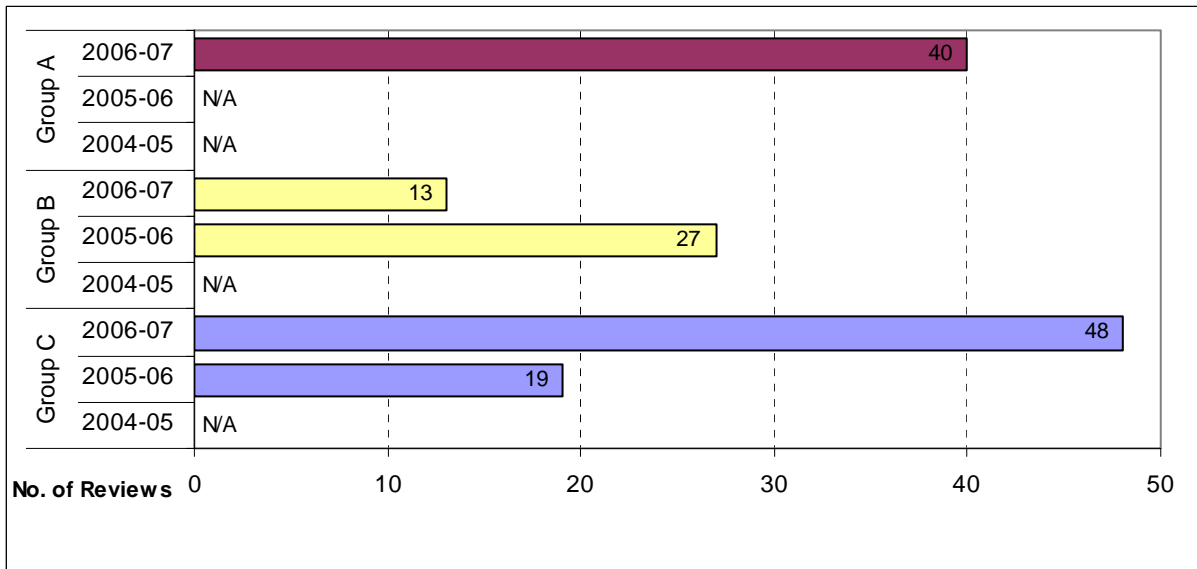


Figure 11: Files reviewed by sector

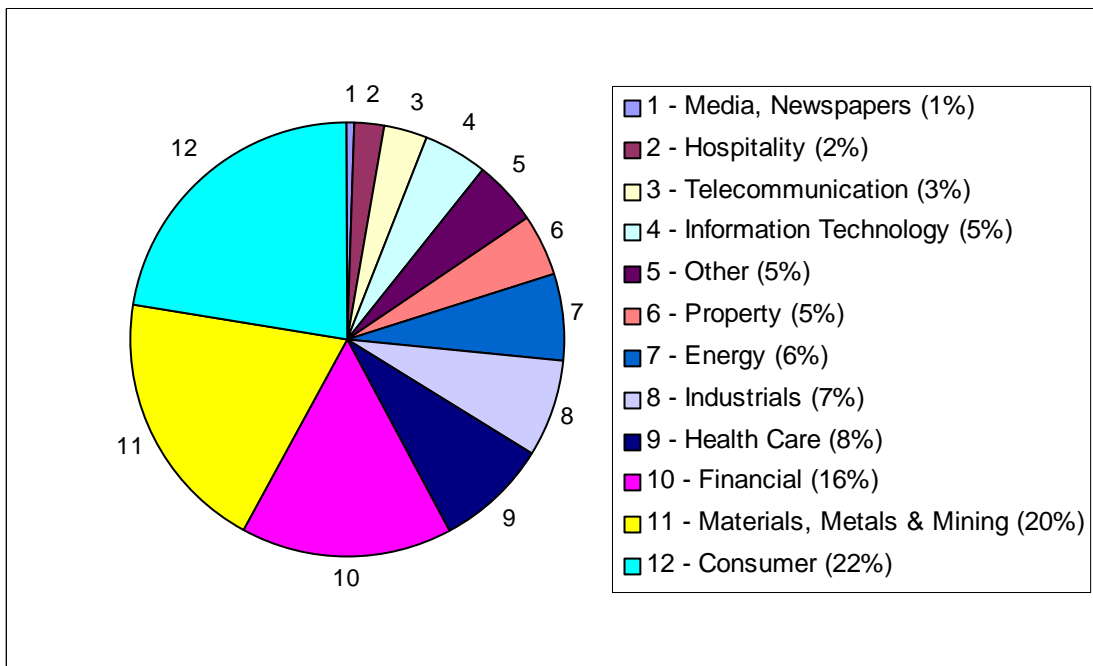


Figure 12: Percentage of files reviewed which contained sufficient appropriate audit evidence to support key conclusions reached

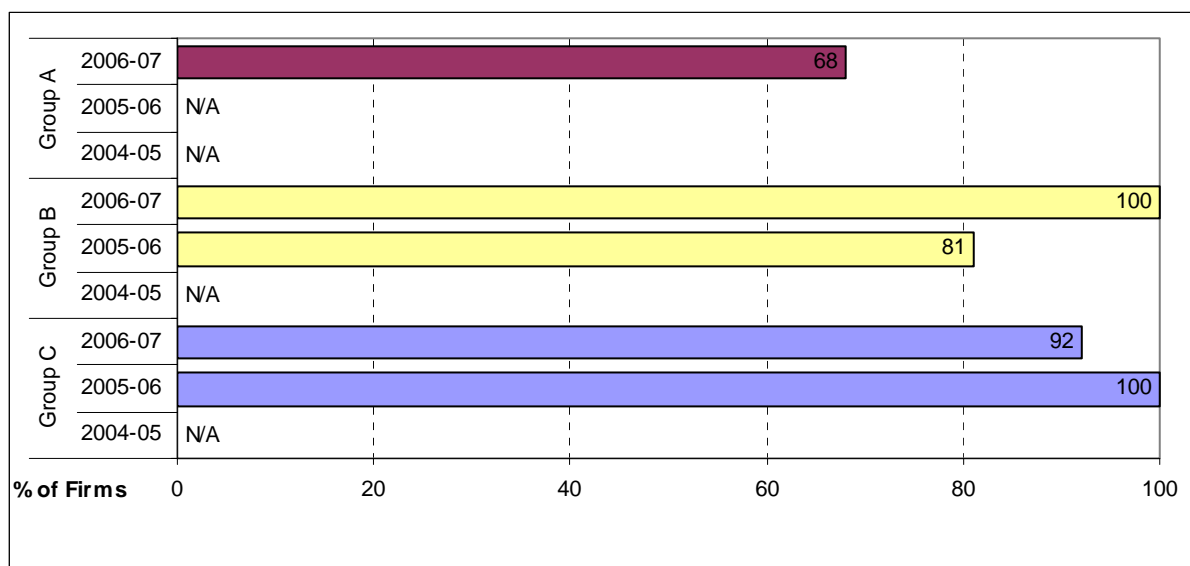
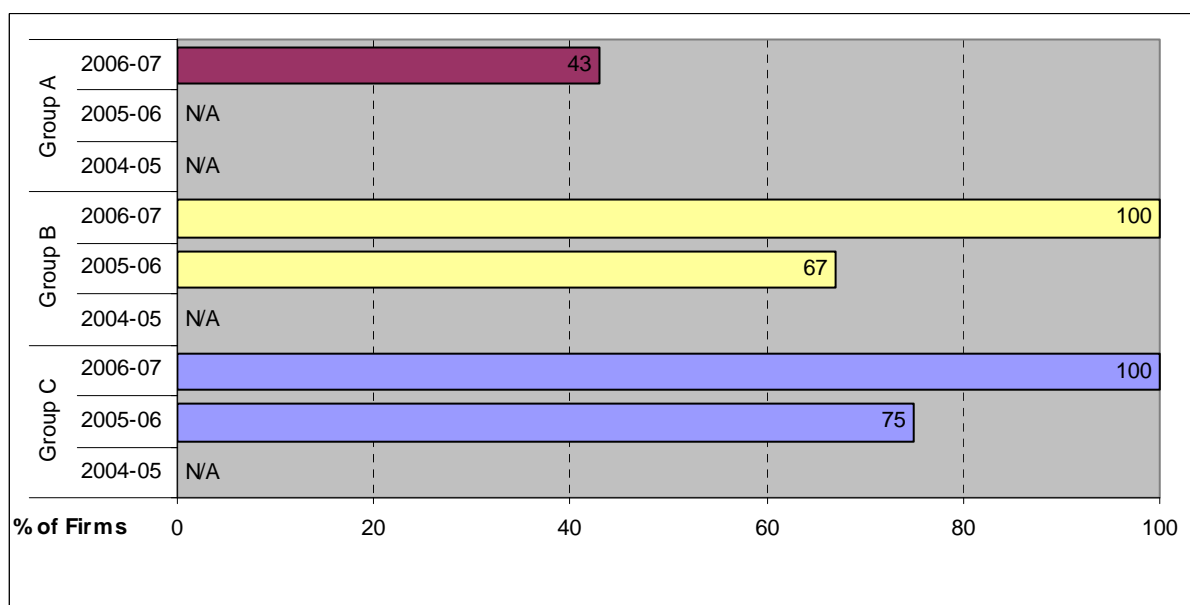


Figure 13: Firms that have timely and appropriate engagement quality control reviews



Observations

Audit methodology

- All Group C Firms' audit methodologies complied with the requirements of the auditing standards, and Group B Firms had also rectified the deficiencies noted in the previous year by the time of our follow-up review in Year 3. Most Firms have also well managed the transition to 'force of law' auditing standards applicable from financial periods beginning 1 July 2006 by mapping the legal requirements to the

Firm's technology and methodology and continue to enhance their systems and processes to better integrate audit technology with methodology.

- However, almost half of the Group A Firms need to ensure that their audit methodology fully reflects the requirements of the auditing standards. For some Firms using external proprietary software we identified instances where requirements of recently revised auditing standards were not incorporated into the Firms' audit manuals or work programmes.

Engagement file reviews

- In Year 3 we continued to focus on the practical application of the Firms' audit methodology by increasing the number of audit and review engagements selected for review. During Year 3 we performed 19 inspections and reviewed aspects of 82 audit and 19 review engagements. The engagements selected were for the financial years ended 30 June 2006 and 30 June 2007, and periods ended 31 December 2005 and 31 December 2006. This compares with 10 inspections and 46 audit engagement reviews for Year 2. No engagements were reviewed in Year 1, as the scope of these inspections was limited to assessment of the firms' independence systems.

Audit quality

- Before 1 July 2006, auditing standards were mandated by the professional bodies in Australia. Since 1 July 2006, the Corporations Act has required audits to be conducted in accordance with the auditing standards, but the fundamental requirements of the standards are unchanged. Auditing standards are designed to ensure high quality auditing that enhances the credibility of information provided to users of audit reports. Compliance with these mandatory requirements facilitates the conduct of a quality audit. *ASA 500 Audit Evidence* requires the auditor to obtain sufficient, appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. *ASA 230 Audit Documentation* requires timely preparation of audit documentation, which provides a sufficient and appropriate record of the basis for the auditor's report and evidence that the audit was performed in accordance with auditing standards and applicable legal and regulatory requirements.
- Our review of aspects of 101 selected engagement files was therefore designed to focus on audit quality by ensuring that the key components that contribute to an audit opinion had been adequately considered. It was not designed to find minor instances of non-compliance or to confirm the audit opinion. Our reviews focused on the substance of work and on whether sufficient appropriate audit evidence was on file

to support the conclusions reached in relation to key decisions and significant judgements on each audit.

- For the substantial majority of the engagement files we reviewed, sufficient appropriate audit evidence was gathered to support both the conclusions reached and that the audit was conducted in accordance with the auditing standards. However, our reviews revealed a number of instances where documentation on the engagement file failed to provide enough evidence to support certain audit assertions. Most Firms need to continue to reinforce to their partners and staff the need for compliance with certain mandatory requirements of the auditing standards.
- Specifically, a substantial number of the deficiencies identified involved a failure to record on the engagement file all the audit work that the auditor performed and relied on in forming his or her conclusions about key audit assertions. In these instances, it can be difficult for an inspector to assess whether sufficient appropriate audit evidence was gathered, and whether the requirements of auditing standards were complied with, even allowing for oral evidence. Ordinarily, oral explanations on their own do not represent adequate support for the work performed or conclusions reached, although they may be used to explain or clarify other information contained in the audit documentation. Timely documentation of the audit procedures performed helps enhance the quality of the audit and facilitates effective review and evaluation of the audit evidence obtained and conclusions reached before the audit report is finalised. Failing to comply with the documentation requirements may increase the risk that the audit work was not adequately performed and that the conclusions reached were not appropriate.
- In a small number of instances, deficiencies related to a failure by the auditor to perform or to document certain mandatory audit procedures that are necessary to support the audit opinion. We have reported separately to each firm in relation to these deficiencies and have asked each firm to commit to tangible improvements in this area.
- Deficiencies may be isolated to the conduct of one audit and cannot be extrapolated across any other audits conducted by the same auditor or audit firm.

Quality control review

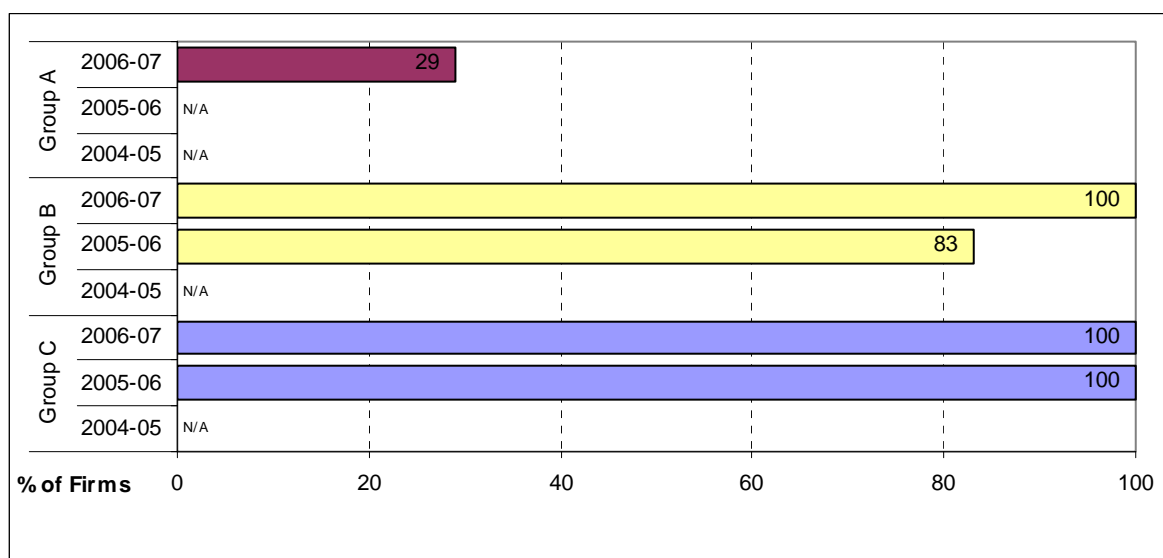
- The engagement quality control reviews performed by the Firms generally seem to be at an appropriate level of detail and have improved significantly for Group C and Group B Firms. However, on some of the Group A Firms' engagement files reviewed, there was inadequate documentation to evidence the timing and extent of engagement quality control reviews. In addition, time records did not always demonstrate that engagement quality control reviewers were spending sufficient time on the audits for which they performed this role.

Monitoring

Table 6: Summary of key monitoring requirements⁷

Source	Requirements
Paragraph 74 of APES 320	The firm shall establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice.

Figure 14: Firms that have effective policies and procedures to monitor compliance with the system of quality control



Observations

- Firms continue to enhance their policies and to implement better integrated systems that facilitate monitoring of independence and audit quality requirements.
- All Group B and Group C Firms have comprehensive policies and procedures to govern the monitoring of independence and audit quality that comply with professional requirements.
- One element of monitoring is the periodic inspection of a selection of completed engagement files, ordinarily at least one engagement per partner every three years. Many of the Group A Firms that had established monitoring policies and procedures had not implemented their policies and had failed to conduct any reviews of engagement files in the last three years. This monitoring is particularly important for the Firms given the significant changes in the legal and professional requirements in recent years.

⁷ These requirements are not exhaustive

B Other projects

Key points

To help raise and maintain audit quality, ASIC focused on compliance with these topical and emerging issues in Year 3:

- auditor rotation
- implementation of ASRE 2410.

Auditor rotation

Auditor rotation was introduced into Part 2M.4 of the Corporations Act under CLERP 9 and was effective for periods commencing 1 July 2006.

Our inspection program focused on the processes in place at the Firms to ensure compliance with the auditor rotation provisions. All Group C Firms and most Group B Firms and Group A Firms had robust processes in place to manage auditor rotation. However, our inspection work highlighted the need for two Group A Firms to address the rotation requirements as a matter of urgency to ensure compliance with the Corporations Act. These firms were not adequately prepared to comply with the new rotation requirements and for one firm, resignation from the audit was the only solution to comply with the Act.

To gain a broader appreciation of the potential rotation issues being faced by the profession we undertook a review of the annual statements⁸ lodged by RCAs. In respect of those instances where the RCA declared significant involvement in a client in excess of 7 years (7 years being the professional requirement preceding 1 July 2006) and for those entities with market capitalisation exceeding \$10 million, we communicated with the RCA and related audit firm. For all instances reviewed, the RCA rotated off the client for periods commencing 1 July 2006. We will continue to monitor compliance with the auditor rotation requirements of the Corporations Act.

⁸ Registered company auditors are required to submit annual statements to ASIC. These statements include a declaration of the number of years of significant involvement in audits of listed entities, for those entities that are one of the RCA's 10 largest audit clients.

Implementation of ASRE 2410

ASRE 2410 *Review of an Interim Financial Report Performed by the Independent Auditor of the Entity* applies to a review of a half-year financial report in accordance with the Corporations Act and is operative for 31 December 2006 half-year reviews conducted under the Act.

In February 2007, ASIC inspected 77 review reports for 31 December 2006 half-year financial reports that were lodged with the ASX. Of these 77 review reports, 9 per cent appeared to have been prepared in accordance with the superseded AUS 902 *Review of Financial Reports*, not ASRE 2410. As a result:

- letters were sent to auditors at three firms reminding them of their obligations and the new requirements
- two firms were included in the Year 3 audit inspection programme.

ASIC has communicated this issue to the profession in a number of different forms and will continue to monitor compliance with this and other legally enforceable auditing and review standards.

C Future focus

Key points

Our audit inspection program will continue to focus on those firms who audit significant public interest entities.

Key priorities for ASIC in 2008 include enhancing our relationship with the profession, and further developing our communication strategy with smaller firms.

Future inspections will focus on how firms are complying with auditing standards and professional and ethical standards, paying particular attention to those auditing standards that were poorly applied in previous years, and to ASA 230 *Audit Documentation*.

We will actively monitor future developments in auditing such as the revised definition of a 'network firm', and will respond to trends and issues through our inspection process and other targeted project work.

Overall scope

Our audit inspection program will continue to focus on those firms who audit significant public interest entities such as listed companies.

We will conduct follow up inspections of the Group A Firms to ensure that prompt and appropriate action is being taken to address our observations and findings. Our experience is that firms take this remediation process seriously.

Some Group A Firms failed to take proactive action until our inspections in Year 3. In 2008, we will conduct more first time inspections, both of other members of associations visited previously, and also extend our reach to other firms and associations.

We will communicate, through the professional associations, our expectation that firms will focus on their legal responsibilities well before they are contacted for an inspection. Key priorities for ASIC in 2008 are enhancing our relationship with the profession, and further developing our communication strategy with smaller firms.

Specific areas of focus

The inspections will continue to examine independence and audit quality. Given the legal enforceability of auditing standards and certain professional and ethical standards since 1 July 2006, our future inspections will focus on

how firms are complying with these standards. We will continue to review the practical application of the auditor rotation requirements, which became effective for financial years beginning on 1 July 2006.

We will continue to focus our attention on engagement file reviews, paying particular attention to those auditing standards that inspections show to have been poorly applied in previous years. In particular, given the level of findings in our Year 3 inspections relating to audit documentation, we will focus on:

- compliance with the legally enforceable auditing standard ASA 230 *Audit Documentation*.
- whether sufficient appropriate audit evidence is recorded on file to support the significant judgements made by auditors in reaching their conclusions and framing their audit opinions.

Other specific areas of focus will include technical consultations; using the work of experts, particularly in relation to fair value measurements; sectors that are at risk given the current market turbulence; and using the work of other auditors.

Network firms

The Accounting Professional and Ethical Standards Board (APESB) has recently issued ‘Amendments to Network Firm in Section 290: Independence—Assurance Engagements of APES 110’, redefining network firms. This follows changes made by the International Federation of Accountants (IFAC) to its *Code of Ethics for Professional Accountants* in July 2006, revising the definition of what constitutes a network firm. The revised definition will be effective for periods commencing on or after 1 July 2008.

These developments will have a significant impact on which firms will be classified as part of a network under the revised definition, in particular those firms that operate under a common brand name. Network firms will have to establish processes and procedures to address auditor independence requirements for all partners and other personnel within that network.

Our inquiries of firms potentially affected by this change in definition indicate that there is an awareness of the amendment and its projected 2008 deadline. The firms are preparing for the transition and are starting to put in place the infrastructure needed to operate effectively under the new definition.

Other work

We will actively monitor future developments in auditing and will respond to trends and issues through our inspection process and other targeted project work.

We will continue to liaise with the PCAOB and other international audit oversight bodies with the intention to conduct work jointly with them or on their behalf to minimise the regulatory burden on Australian audit firms.

Appendix: How we conduct our work

We conducted our inspections of the Firms between July 2006 and December 2007. The nature of our monitoring approach means that inspections were spread throughout the period, with inspections starting and concluding at some Firms earlier than at others.

Our monitoring approach

We focused on assessing whether each Firm had documented and implemented a quality control system that provides reasonable assurance that:

- the Firm complies with the auditor independence requirements in Divisions 3, 4 and 5 of Part 2M.4 of the Corporations Act (independence)
- the Firm's audit methodology facilitates the conduct of its audits in accordance with the auditing standards as required in Division 3 of Part 2M.3 of the Corporations Act (audit quality).

It is not the purpose of the inspection program to benchmark the Firms or to make specific recommendations on how to improve independence or audit quality policies and systems. However, during our inspection we highlighted to each Firm some suggested areas for improvement.

In particular, we considered the following areas in respect of independence and audit quality:

- executive leadership
- independence
- client acceptance and continuance
- human resources
- engagement performance
- monitoring.

Our inspections concentrated firstly on a review of each Firm's independence systems and processes, including an examination of each Firm's testing results. We conducted only limited testing of each Firm's systems.

Secondly, we examined each Firm's audit methodology for compliance with auditing standards operative for financial reporting periods commencing prior to the date of our inspection.

Thirdly, we reviewed the conduct of aspects of a limited number of individual audit and review engagements for compliance with each Firm's stated audit methodology and applicable auditing standards as at the date of each audit or review. Each review focuses on the substance of work and on whether sufficient appropriate audit evidence is on file to support the conclusions reached in relation to key decisions and significant judgements on the audit.

Our work programmes are tailored to ensure that reviews are sufficiently focused on major risk areas for each audit. They are not designed to find minor instances of non-compliance. We challenge audit partners on the basis on which significant judgements were made. We do not seek to confirm the overall audit opinion.

The inspection process

The process was designed to gain an understanding of:

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

In conducting our inspections, we:

- reviewed material provided by the Firms under notice pursuant to the *Australian Securities and Investments Act 2001* (ASIC Act)
- reviewed the Firms' systems and processes for managing compliance with the audit independence requirements of the Corporations Act and for ensuring audit quality
- reviewed aspects of a selection of audit and review engagements at each Firm, weighted towards listed entities
- interviewed selected partners in the Firms holding leadership roles
- interviewed selected human resources representatives
- interviewed a number of the Firms' other partners and staff
- in the case of national Firms, visited other capital city offices and interviewed selected partners and staff.

Key terms

Term	Meaning in this document
AAC	Authorised audit company
APES	Australian Professional and Ethical Standards
ASA	Australian Auditing Standards applicable to financial reporting periods commencing 1 July 2006 that are legally enforceable
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
ASRE	Australian Auditing Standards on Review Engagements
ASX	Australian Securities Exchange
CLERP 9	Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004
Corporations Act	<i>Corporations Act 2001</i> (Cth) including regulations made for the purposes of that Act
Group A	Audit firms inspected for the first time in Year 3.
Group B	Audit firms inspected twice since the commencement of ASIC's audit inspection program
Group C	Audit firms inspected three times since the commencement of ASIC's audit inspection program
PCAOB	Public Company Accounting Oversight Board of the United States of America
RCA	Registered company auditor
Year 1	Audit firm inspections completed between 1 July 2004 and 30 June 2005
Year 2	Audit firm inspections completed between 1 July 2005 and 30 June 2006
Year 3	Audit firm inspections completed between 1 July 2006 and 31 December 2007