REPORT 607

Audit inspection program report for 2017–18

January 2019

About this report

This report summarises the observations and findings identified by ASIC's audit inspection program in the 18 months to 30 June 2018.

We expect this report to be of 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 20 audit firms inspected. The absence of a reference in this report to any other aspect of a firm's systems, policies, procedures, practices or conduct is not an approval by ASIC of those aspects.

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 the audit work in a particular key audit area is, in our view, 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 exhibit deficiencies.

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 include 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.

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 the degree of application. 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 20 Australian audit firms undertaken in the 18 months to 30 June 2018, covering financial reports for years ended 31 March 2016 to 31 December 2017. Our inspections focus on audits of financial reports of public interest entities prepared under the *Corporations Act 2001* (Corporations Act).

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

3 We reviewed key audit areas in audit files at the largest six firms. In our view, in 20% of the key audit areas that we reviewed, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 23% in the previous 18-month period ended 31 December 2016 and represents a welcome reduction in the level of findings for the largest six firms.

4 However, in our view, in 24% of the total 347 key audit areas that we reviewed across 98 audit files at firms of all sizes covered by our inspections, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 25% of 390 key audit areas in the previous 18-month period ended 31 December 2016: see Section A.

5 Findings from our audit inspection program 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.

6 We recognise the efforts by firms to improve audit quality and the consistency of audit execution, which is reflected in some improvements in findings collectively for the largest six firms. However, the overall level of findings still suggest that further work and, in some cases, new or revised strategies are needed to improve quality.

7 In our report for the 18-month period ended 31 December 2016, we highlighted the following areas for improvement:

(a) *the audit of asset values, particularly impairment of non-financial assets*—including challenging the reasonableness of any forecasts and key assumptions, and the basis of valuation;

(b) *the audit of revenue*—including accounting policy choices, substantive analytical procedures and tests of detail; and

(c) *maintaining a strong culture of audit quality*—including strong messages from firm leadership, setting expectations, leading by example, coaching, robust review processes and effective accountability mechanisms.

8 We have seen some improvement in the level of findings in the audit of asset values and revenue. These areas continue to be the areas of the highest level of findings from our reviews and should continue to be a focus of the firms for sustainable improvement. For further information on findings related to asset values, revenue recognition and other areas, see Section D.

9 We consider that good auditors deliver professional, high quality audits by matters such as applying appropriate experience and expertise, effective internal supervision and review, and having robust accountability mechanisms. We encourage all auditors to work to this standard.

10 Our audit inspection work complements our separate risk-based surveillance of the financial reports of public interest entities. This surveillance led to material changes to 4% of these financial reports reviewed for financial reporting periods that ended 30 June 2010 to 31 December 2017.

11 We reviewed aspects of the audit of 98 financial reports in the 18 months to 30 June 2018. In 11 cases where we raised findings on audit work and financial reporting, we also raised financial reporting concerns with the company concerned or the auditor followed up financial reporting matters we identified with the company. In one additional case, a company independently identified the same financial reporting issue that ASIC identified during its audit file review. In nine of these 12 cases, the companies made material changes to the amounts of both the net assets and profits in the subsequent period, or restated amounts for the year reviewed by us, which we believe related to our concerns. Generally, these cases are included in the financial reporting findings referred to in paragraph 10.

Initiatives to improve and maintain audit quality

12 While there has been improvement in the level of findings, audit firms need to continue to work on improving audit quality and the consistency of audit execution. While firms continue to make good efforts to improve in this area, they should consider enhancing existing initiatives and focus on new and sustainable initiatives to improve audit quality, and maintain a culture focused on this.

13 Firms should undertake, or continue to undertake, comprehensive analysis to identify the underlying root causes of findings from their own quality reviews of audit files and our audit inspections. They should identify

effective solutions to address these root causes, and consider past initiatives of the firm that have been effective in improving audit quality, as well as the initiatives and approaches outlined in Section B and Information Sheet 222 *Improving and maintaining audit quality* (INFO 222).

14 While the largest six audit firms maintained efforts to improve audit quality, they need to continue to focus on their action plans and other initiatives. Some action plan initiatives, including focuses on impairment of non-financial assets, have led to improvements in our findings in particular areas. Firms should consider the need for enhanced, new and changed initiatives to build on these areas of improvement.

15 We outline the areas of focus for our future inspections in Section C.

16 Directors are primarily responsible for the quality of the financial report. Audit quality supports financial reporting quality, and it is in the interests of directors and audit committees to support the audit process. This includes ensuring that management produces quality financial information, that adequate resources, skills and expertise are applied in the reporting process, and that the audit is appropriately resourced. We strongly caution against selecting auditors on the basis of cost rather than to ensure a quality audit: see Information Sheet 196 *Audit quality: The role of directors and audit committees* (INFO 196).

17 Regulatory Guide 260 *Communicating findings from audit files to directors, audit committees or senior managers* (RG 260) explains when we will communicate findings to audit committees on an exception basis.

Areas for focus

18 We believe that sustainable improvements in audit quality require a focus on culture and talent by firms. In particular:

(a) all partners and staff should embrace the need to improve audit quality and the consistency of audit execution;

(b) partners and staff should understand and be accountable for their roles in conducting quality audits; and

(c) firm leadership should give strong, genuine and consistent messages to partners and staff that audit quality is not negotiable, and this should be supported by holding individuals to account for inadequate audit work.

19 Audit engagement partners should:

(a) spend significant time at the audited entities to understand the business and risks, engage with directors and management, and involve themselves in risk areas of the audit on a timely and comprehensive basis;

(b) work directly with the audit team on risk areas to ensure timely and quality audit work, apply their knowledge and experience throughout the audit process, and upskill staff; and

(c) undertake comprehensive reviews of the audit files at the premises of audited entities, focusing on possible risk areas.

20 Our findings suggest that audit firms should continue to focus on the areas outlined in paragraph 7.

21 It also remains important for auditors to focus on:

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

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

(c) the appropriate use of the work of experts and other auditors.

22 We undertook reviews of the largest six firms' approaches to root cause analysis of internal and external file review findings, as well as each firm's approach to engagement project management. Following these reviews, we provided feedback to each firm on opportunities to improve their practices in these two areas. Some audit firms inspected also need to further improve their quality control systems or adherence to existing quality control processes: see Section E.

23 In early 2018, we hosted a meeting with the heads of assurance of the largest six firms at which attendees shared the initiatives that they found most effective in improving audit quality. Some initiatives to improve audit quality are detailed in Section B.

Understanding our findings

24 The nature of our findings is consistent with the findings of audit regulators in other jurisdictions, as reflected in the inspection findings survey results published by the International Forum of Independent Audit Regulators (IFIAR) earlier this year. The level of findings may vary between jurisdictions.

Note: See IFIAR, *2017 Survey of inspection findings*, March 2018.

25 Our inspections focus on higher risk audit areas and so caution is needed in generalising the results across the entire market. We generally select some of the more complex, demanding and challenging audits, and some more significant or higher risk areas of the financial reports. We do not select areas of audit files for review in our inspections where known reporting or audit issues have already been identified in our financial reporting surveillance program, in our investigations, or by other means. Therefore,

purely random reviews could result in a different level of findings than indicated in paragraph 3.

26 Although audit firms may agree to take remedial actions based on our findings, firms do not necessarily agree with all of our findings. 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 paragraphs 3 and 4 do not include instances where we had reservations but considered that individuals could reasonably reach different judgements.

27 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. We recognise that very often auditors will cause material changes to draft financial reports in performing their role.

28 Matters relevant to understanding the percentage measures in paragraphs 3 and 4 are discussed in Information Sheet 224 *ASIC audit inspections* (INFO 224). ASIC was assisted by feedback from an external consultative panel on our method of measuring findings: see paragraphs 55–56.

A Overall findings

Key points

In our view, in 24% of the total 347 key audit areas reviewed across 98 audit files at 20 firms of different sizes, auditors did not obtain reasonable assurance that the overall financial report was free of material misstatement.

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

This section includes information on our approach to audit quality.

Audit quality

The importance of audit quality

29 The quality of financial reports is key to confident and informed markets and investors. The objective of the independent audit is to provide confidence in the quality of financial reports. Improving audit quality and the consistency of audit execution is essential to continued confidence in the independent assurance provided by auditors.

Our approach to audit quality

30 For our regulatory purposes, audit quality refers to matters that contribute to the likelihood that the auditor will:

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

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

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

Our findings

32 In our view, in 24% of the 347 key audit areas that we reviewed on a risk basis across 98 audit files in the 18 months to 30 June 2018, 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 31 December 2016 was 25% across 390 key audit areas.

33 The occurrence of the above findings at firms of different sizes is shown in Table 1.

Table 1: Findings by number and size of firms inspected

Type of firm	18 months to 30 June 2018	18 months to 31 December 2016
Largest six firms	20%	23%
Other national and network firms	29%	31%
All firms	**24%**	**25%**

Note: The percentages for the 'other national and network firms' are not directly comparable between periods, as we inspected different firms and numbers of files in the 18 months to 30 June 2018 and in the 18 months to 31 December 2016.

34 Many of our findings related to accounting estimates (such as impairment of assets) and accounting policy choices (such as revenue recognition). Further information appears in Table 4, Table 5, and Section D of this report.

35 We believe that sustainable improvements in audit quality require a focus on culture and talent by firms. In particular:

(a) all partners and staff should embrace the need to improve audit quality and the consistency of audit execution;

(b) partners and staff should understand and be accountable for their roles in conducting quality audits; and

(c) firm leadership should give strong, genuine and consistent messages to partners and staff that audit quality is not negotiable, and this should be supported by holding individuals to account for inadequate audit work.

36 Our findings suggest that audit firms should continue to focus on:

(a) *the audit of asset values, particularly impairment of non-financial assets*—especially challenging the reasonableness of any forecasts, key assumptions, and the basis of valuation; and

(b) *the audit of revenue*—with emphasis on accounting policy choices, substantive analytical procedures and tests of detail.

37 It also remains important for auditors to focus on:

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

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

(c) the appropriate use of the work of experts and other auditors.

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 Our audit inspection work complements our separate risk-based surveillance of the financial reports of public interest entities. That surveillance led to material changes to 4% of these financial reports reviewed for the financial reporting periods that ended between 30 June 2010 and 31 December 2017.

41 We reviewed aspects of the audit of 98 financial reports in the 18 months to 30 June 2018. In 11 cases (15 cases in the previous report) where we raised findings on audit work and financial reporting, we also raised financial reporting concerns with the company concerned, or the auditor followed up financial reporting matters we identified with the company. In one additional case, a company independently identified the same financial reporting issue that ASIC identified during its audit file review. In nine of these 12 cases (12 of the 15 cases in the previous report), the companies made material changes to the amounts of both the net assets and profits in the subsequent period or restated amounts for the year reviewed by us, which we believe related to our concerns. Generally, these cases are included in the 4% mentioned above.

42 Our findings show that auditors need to continue to improve audit quality and the consistency of audit execution.

Our coverage

43 We inspected 20 audit firms of different sizes in the 18 months to 30 June 2018, covering financial reports for years ended 31 March 2016 to 31 December 2017. These firms, in aggregate, audit 97% of listed entities by market capitalisation.

44 The number and size of firms we inspected is provided in Table 2.

Table 2: Number and size of firms inspected

Type of firm	18 months to 30 June 2018	18 months to 31 December 2016
Largest six firms	6	6
Other national and network firms	8	8
Smaller firms	6	9
Total	**20**	**23**

Note: Our findings for ‘other national and network firms’ and ‘smaller firms’ are not directly comparable as we inspected different firms in the 18 months to 30 June 2018 and in the 18 months to 31 December 2016.

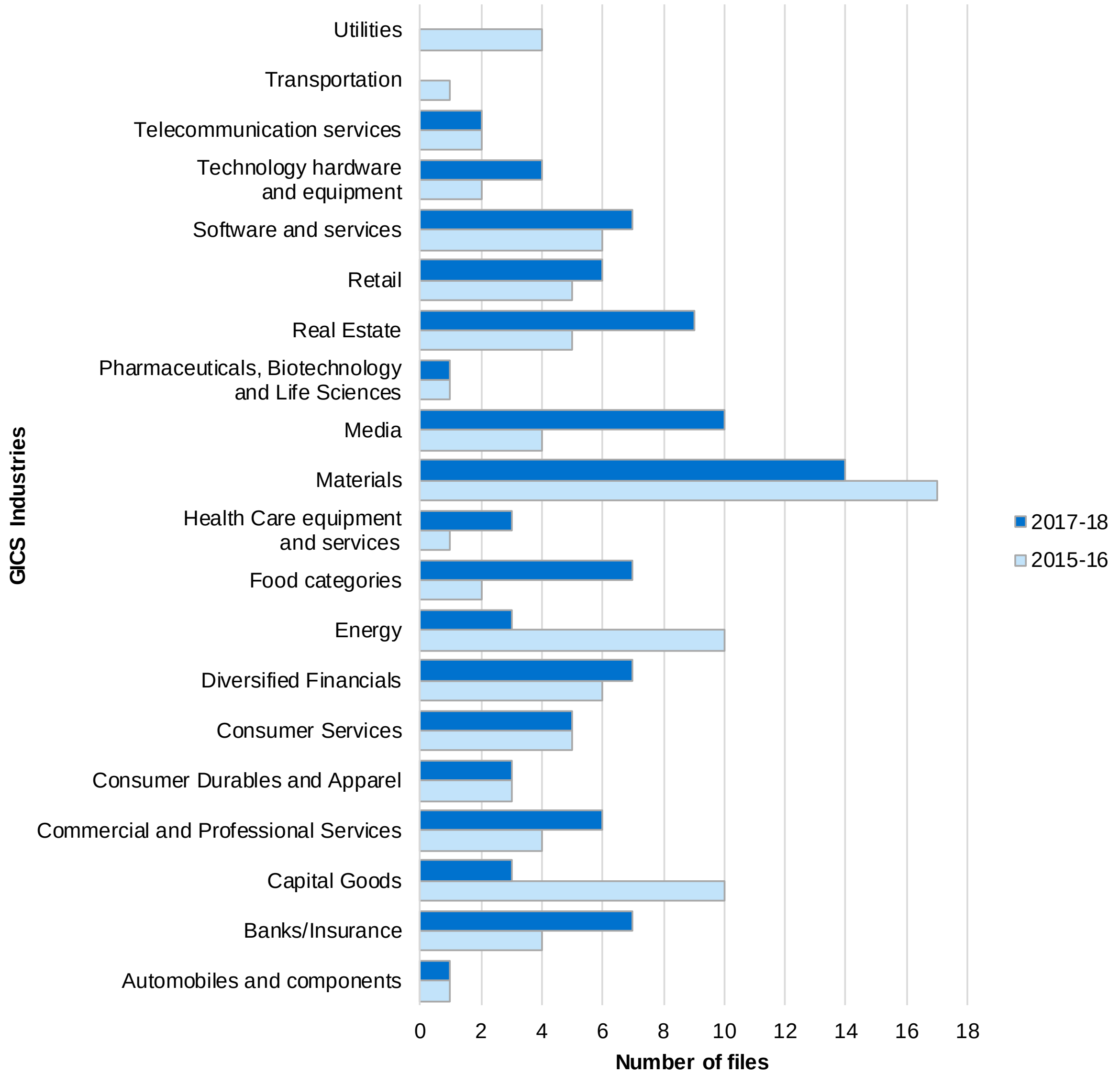
45 The numbers of audits subject to our reviews is shown in Table 3.

Table 3: Number of audits reviewed

Type of firm	18 months to 30 June 2018	18 months to 31 December 2016
Largest six firms	78	66
Other national and network firms	14	18
Smaller firms	6	9
Total	**98**	**93**

46 The industry groups covered by our reviews of audit files in inspections in the 18 months to 30 June 2018 compared to the 18 months to 31 December 2016 are detailed in Figure 1.

Figure 1: Industry groups for the audit files reviewed in the current and previous 18-month periods using Global Industry Classification Standard (GICS)



Note 1: There has been no overall change in the industry groups for the audit file reviewed that would be expected to cause a significant change in our inspection results.

Note 2: See Table 10 in the appendix for the data shown in this graph (accessible version).

47 Our findings were not affected by any significant change in our areas of focus. The audit areas covered in our reviews in the 18 months to 30 June 2018 and the 18 months to 31 December 2016 were similar, as shown in Table 4. The percentages of total key audit areas reviewed are shown in parentheses.

Table 4: Key audit areas selected for review in the current and previous 18-month periods

Key audit area	18 months to 30 June 2018	18 months to 31 December 2016
Impairment/asset valuation	78 (23%)	78 (20%)
Revenue/receivables	92 (27%)	90 (23%)
Taxation	40 (12%)	70 (18%)
Investments and financial instruments	29 (6%)	26 (7%)
Inventory/cost of sales	22 (6%)	18 (5%)
Expenses/payables	19 (6%)	16 (4%)
Loans/borrowings	18 (5%)	39 (10%)
Provisions	14 (4%)	13 (3%)
Acquisition accounting	13 (4%)	4 (1%)
Mining exploration and evaluation (excluding impairment)	9 (3%)	16 (4%)
Cash	7 (2%)	8 (2%)
Share-based payments	0 (0%)	4 (1%)
Other	6 (2%)	8 (2%)
Total	**347 (100%)**	**390 (100%)**

48 Table 5 shows that most of our findings in the 18 months to 30 June 2018 concerned the audit of revenue and asset values. While the level of findings in these areas have decreased compared to the 18 months to 31 December 2016, these areas continue to require further focus by auditors. The figures in parentheses represent the percentage of findings out of the number of times we reviewed the key audit area.

Table 5: Findings in each key audit area in the current and previous 18-month periods

Key audit area	18 months to 30 June 2018	18 months to 31 December 2016
Impairment/asset valuation	20 (26%)	29 (37%)
Revenue/receivables	27 (29%)	30 (34%)
Taxation	5 (13%)	5 (7%)

Key audit area	18 months to 30 June 2018	18 months to 31 December 2016
Investments and financial instruments	11 (38%)	14 (54%)
Inventory/cost of sales	6 (27%)	6 (29%)
Expenses/payables	5 (26%)	2 (14%)
Loans/borrowings	2 (11%)	1 (2%)
Provisions	3 (21%)	4 (30%)
Acquisition accounting	4 (31%)	1 (20%)
Mining exploration and evaluation (excluding impairment)	1 (11%)	3 (18%)
Cash	1 (14%)	0 (0%)
Share-based payments	0 (0%)	1 (33%)
Other	0 (0%)	1 (40%)
Total	**85 (24%)**	**97 (25%)**

49 The nature of our findings are consistent with those of audit regulators in other jurisdictions, as reflected in the inspection findings survey results published by IFIAR earlier this year. The level of findings may vary between jurisdictions.

Note: See IFIAR, *2017 Survey of inspection findings*, March 2018.

50 All of these findings are important because the auditor had not obtained reasonable assurance that the financial report was free of material misstatement and had not performed the work necessary to support their opinion on the financial report.

51 It is important that all of our findings are addressed by firms and that they perform sufficient work to support their opinions on financial reports. The probability of a misstatement existing in the financial report that was not detected as a result of not performing required audit work will vary. As outlined in paragraph 40, in our view, for at least nine of the 98 financial reports audited there were material misstatements that had not been identified or addressed.

52 For some of our other findings relating to audit sampling (e.g. not testing all items selected, and following up exceptions), the probability of a material misstatement in the overall financial report may have been lower.

53 Other matters relevant to understanding our findings and the percentages reported above are outlined in INFO 224—in particular, findings excluded from these percentages. The percentages reflect findings in the areas and industries discussed in Section D.

54 In executing key work, auditors should provide appropriate documentation in their working papers to enable an experienced auditor to understand their work and the basis for the conclusions reached, as required by auditing standards. Documentation also assists the auditor in executing their work, challenging judgements, supervision and review, and reaching their conclusions. It is not plausible to claim auditors have performed sufficient work but merely failed to document it. It is generally not possible to execute and review significant work and judgements without appropriate documentation.

Consultative panel

55 We used a panel to consult on the method of measuring and reporting aggregate findings from our inspections. The panel discussed the conclusions reached on a small number of our more challenging inspection findings where significant judgement was required and generally concurred with our findings. The panel also considered our measurement and reporting methodology, and agreed with our approach.

56 The panel consisted of Messrs Peter Day, Harley McHutchison and Des Pearson AO, who have extensive qualifications and experience in business, accounting and audit, and are considered independent of the audit firms and professional bodies. Overall, the panel concurred with our approach and the reporting of our findings.

B Improving and maintaining audit quality

Key points

Audit firms should undertake or enhance root cause analysis on quality review and inspection findings, and develop or revise action plans to improve audit quality.

In this section we discuss:

- what good looks like for audit firms;
- action plans to improve audit quality;
- initiatives that appear to have improved audit quality in specific areas;
- the role of directors, audit committees and others in supporting audit quality; and
- our work with international regulators.

What good looks like for audit firms

57 Auditors should deliver professional, high quality audits through:

(a) a strong internal culture focused on quality audits and professional scepticism;

(b) applying appropriate resources, experience and expertise to audits;

(c) effective internal supervision and review;

(d) robust accountability mechanisms;

(e) identifying and addressing audit risks and issues on a timely basis; and

(f) accepting and addressing key findings from audit inspections, including findings on asset values and revenue recognition.

Key initiatives to improve audit quality

58 Given the findings from our audit inspections, to improve audit quality, audit firms need to improve their focus on:

(a) a culture focused on conducting quality audits, supported by strong, genuine and consistent messages on the importance of audit quality, including holding partners and staff accountable for internal and external quality findings;

(b) conducting effective quality reviews of audits;

(c) remediating findings from firm quality reviews and our inspections by obtaining the audit evidence necessary to form an opinion on the financial report;

(d) identifying root causes of findings from their own quality reviews and our audit inspections;

(e) developing and implementing action plans to address findings; and

(f) monitoring and revising action plans to ensure that they are effective.

Action plans

59 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 the consistent execution of audits. This involves ongoing analysis of the underlying root causes of findings from quality reviews and audit inspections.

60 Auditors should refer to INFO 222, which outlines considerations for auditors to improve and maintain audit quality. In their action plans, firms should consider opportunities to improve their focus on:

(a) the culture of the firm, including messages from the firm's leadership on the importance of audit quality, setting expectations and leading by example;

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

(c) supervision and review, including greater partner involvement with audit teams when planning and executing audits, robust review processes during the engagement, robust post-completion reviews, and real-time quality reviews of engagements; and

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

61 For example, there may be opportunities to improve the overall direction and supervision of complex audits of entities such as large financial institutions, and to review audit approaches.

62 Firms that have not yet done so should develop action plans to improve the quality of the audits they conduct.

63 During 2013, the largest six audit firms responded to our requests to prepare action plans to improve audit quality and the consistency of audit execution. These plans continue to be updated and revised. We continue to discuss with these firms their progress in implementing these action plans, and assess the

impact of these plans on audit quality. Plans continue to develop and evolve. Firms should continue to explore the need for new and changed initiatives.

64 Plans that are too high level and general, without specific documented actions, responsibilities and timelines, are less likely to be effective.

65 Refer to INFO 222 for some examples of initiatives to improve and maintain audit quality that might appear in action plans.

Some initiatives that appear to have improved audit quality

66 Initiatives undertaken by some firms that appear to have a positive impact on aspects of audit quality at those firms include:

(a) forming specialist focus groups and risk panels on impairment of non-financial assets, substantive analytical procedures and other areas to develop the necessary expertise, support and coaching for audit teams;

(b) increasing partner time spent on engagements, in the audit files, at the audited entities and with the audit team;

(c) developing a strong culture focused on audit quality with accountability at all levels of partners and staff;

(d) conducting effective analysis to identify the root causes of individual and thematic findings from internal and external file reviews and implementing initiatives to address those findings;

(e) proper project management of audits, including monitoring—at audit team and firm level—of progress against key engagement-specific milestones, and addressing issues early to minimise deadline pressures at the conclusion of the audit;

(f) firm and peer quality reviews of completed audit files by independent reviewers that include a focus on difficult judgement areas; and

(g) greater education of directors and management of audited entities to improve financial reporting quality and support the audit process.

67 In early 2018, we hosted a meeting with the heads of assurance of the largest six firms at which attendees shared the initiatives that they found most effective in improving audit quality.

The role of others in supporting audit quality

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

(a) directors and audit committees—by supporting quality financial reporting and the external audit process;

(b) standard setters—by developing and maintaining quality auditing and ethical standards;

(c) international regulators—by cooperating to influence audit firms, directors and audit committees, and standard setters internationally; and

(d) professional accounting bodies—by educating members and ensuring the supply of qualified accountants.

69 Directors are primarily responsible for the quality of the financial report. Audit quality supports financial reporting quality, and it is in the interests of directors and audit committees to support the audit process. This includes ensuring that management produces quality financial information and that the audit is appropriately resourced. We strongly caution against selecting auditors on the basis of cost rather than to ensure a quality audit.

70 Audit committees should take an interest in our findings and discuss with their auditors whether the findings are relevant to the auditors and their firm, and how those findings are being addressed.

71 RG 260 explains when we will communicate findings to audit committees on an exception basis.

72 Directors and audit committees should consider the following ASIC information sheets:

(a) Information Sheet 196 *Audit quality: The role of directors and audit committees* (INFO 196);

(b) Information Sheet 183 *Directors and financial reporting* (INFO 183); and

(c) Information Sheet 203 *Impairment of non-financial assets: Materials for directors* (INFO 203).

73 The role of standard setters, accounting bodies and others is discussed in Information Sheet 223 *Audit quality: The role of others* (INFO 223).

International regulators

74 ASIC works with securities and audit regulators in other countries to promote audit quality. This is important because 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.

75 Through the International Organization of Securities Commissions, we have worked with other securities regulators on such matters as:

(a) seeking to enhance the standard-setting governance for the international auditing and ethical standards setting boards;

(b) seeking improvements to the international auditing and ethical standards; and

(c) preparing a guide on the role of audit committees in supporting audit quality.

76 Through IFIAR, we have worked with other major regulators in discussing actions to improve audit quality with the largest six firms internationally.

C Areas of future focus

Key points

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

The top areas of focus for our upcoming inspections are:

- all partners and staff should embrace the need to improve audit quality and the consistency of audit execution;
- partners and staff should understand and be accountable for their roles in conducting quality audits;
- firm leadership should give strong, genuine and consistent messages to partners and staff that audit quality is not negotiable, and this should be supported by holding individuals to account for inadequate audit work; and
- firm cultures focused on audit quality.

Other areas of focus for our upcoming inspections include:

- asset impairment;
- revenue;
- major new accounting standards;
- the other focus areas identified in our six-monthly financial reporting media releases, including asset values and revenue;
- firms having robust quality reviews and undertaking root cause analysis;
- firms developing, implementing and revising action plans to improve audit quality;
- partner involvement, project management, supervision and review, and accountability frameworks;
- audit evidence, professional scepticism, and the use of experts and other auditors;
- understanding of business models and risks;
- internal control reviews and taxation.

Our continuing general approach to inspections

77 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;

(c) files for audits of entities and industries that may be more vulnerable to risks arising from existing and emerging market conditions, or affected by new accounting standards or accounting requirements requiring significant judgement; and

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

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

79 We will also select a small number of audit files for review on a random basis.

80 From 1 July 2018, we received additional funding for the audit inspection program. This is being used to engage the services of recently retired, experienced former audit partners to conduct reviews of audit files.

Our areas of focus in upcoming inspections

81 Our upcoming reviews at the largest six firms will include matters relating to culture and talent. This includes:

(a) the means to establish and maintain a culture focused on audit quality and the consistency of audit execution—including strong, genuine and consistent messages from leaders, how the roles of all partners and staff are focused on quality, and accountability of leaders, partners and staff for audit quality; and

(b) internal quality reviews of audit engagement work so that the firms address issues before we inspect key areas of audit files—including involvement of the engagement control quality reviewers, real time reviews, coaching in areas of past inspection findings, and post completion reviews, as well as the independence of reviewers.

82 As part of our discussions with the six largest firms on their action plans, we will focus on the approaches of the firms to attracting, retaining and upskilling partners and staff.

83 Table 6 and Table 7 outline areas of focus for firms and which will also be covered appropriately through our upcoming inspections of audit firms.

Table 6: Top three areas of focus for firms

Focus area	Details
Recognition of need to improve	Whether all partners and staff embrace the need to improve audit quality and the consistency of audit execution.
Accountability	Whether partners and staff understand and are held accountable for their roles in conducting quality audits—through performance reviews and remuneration—for findings from firm quality reviews and external inspections. Credit should be given for accepting findings and acting to address those findings.
Leadership	Whether firm leadership gives strong, genuine and consistent messages to partners and staff that audit quality is not negotiable, and this should be supported by holding individuals to account for inadequate audit work.

Table 7: Other areas of focus for firms

Focus area	Details
Partner-led improvement	Whether audit engagement partners: • spend significant time at the audited entities to understand the business and risks, engage with directors and management, and involve themselves in risk areas of the audit on a timely and comprehensive basis; • work directly with the audit team on risk areas to ensure timely and quality audit work, apply their knowledge and experience throughout the audit process, and upskill staff; and • undertake comprehensive reviews of the audit files at the premises of audited entities, focusing on possible risk areas.
Asset impairment	Whether root causes of findings about the audit of impairment of non-financial assets have been identified and addressed. Auditors should also focus on asset values that may be affected by economic and other developments in the extractive industries and mining services, as well as entities that may be affected by digital disruption.
Revenue	Whether root causes of findings about the audit of revenue have been identified and addressed, including the adequacy of substantive analytical procedures and other audit techniques, appropriateness of accounting policy choices, consistency with the substance of commercial arrangements and cut-off.
Major new accounting standards	Firms should ensure that partners and staff are appropriately skilled to undertake audits under new accounting standards on: • revenue; • financial instruments, including loan loss provisioning under an expected loss model; • leases; and • new definition and recognition criteria for assets, liabilities, income and expenses. There is also a new standard on insurance activities. The operative dates of these new standards vary. Auditors should also encourage their clients to be adequately prepared for these new standards.

Focus area	Details
Other financial reporting focuses	Whether audits adequately address other focus areas identified in our six-monthly financial reporting surveillance program media releases.
Quality reviews	Effective quality reviews are key to maintaining and improving audit quality. Internal monitoring processes should be robust and effective. Firms should consider: • real time reviews during the audit process; • the quality, experience and independence of reviewers; • the scope and coverage of reviews; • how audit files and audit areas are selected for review; • the depth of reviews of individual audit files and audit areas; • whether reviews deal with difficult judgement areas; and • how findings are identified and addressed.
Root cause analysis and action plans	Whether firms have undertaken effective root cause analysis on findings from inspections, internal quality reviews, restatements and other sources. This includes using suitably qualified and experienced independent reviewers with sufficient authority to conduct the analysis, interviewing engagement team members, identifying themes, identifying underlying causes, and developing actions to address those underlying causes. Whether firms have developed action plans to improve audit quality and the consistency of execution, and whether they have continued to review and update those plans to ensure they are effective in improving and maintaining audit quality. Firms should consider which initiatives have been most effective in improving audit quality in their own firms, and at other firms in their local and international networks. Firms that do not have action plans should develop and implement such plans.
Supervision and review	Whether: • there is strong and effective supervision and review at all stages of the audit, including planning, performance and concluding procedures; • reviews by senior team members, the partner and the engagement quality control reviewer (EQCR) are timely, and comments raised are properly addressed and cleared by the reviewer; • firm quality reviews are frequent, timely, have depth and are undertaken by independent reviewers; and • firms have considered real-time quality reviews and coaching for key areas during execution of the audit.
Audit evidence	Whether auditors have obtained sufficient appropriate audit evidence to conclude that the financial report is free of material misstatement and to support their audit opinions.
Professional scepticism	Whether an appropriate level of professional scepticism is exercised by auditors, focusing on significant judgements about audit evidence, accounting estimates, going concern assumptions and accounting treatments.

Focus area	Details
Reliance on internal audit and experts engaged by management	Whether reliance has been placed on internal audit or experts engaged by management. The type of work performed by internal auditors as employees of an audited entity may be inconsistent with the fundamental requirement for an independent audit. Internal audit work may help inform audit risks and form part of the system of internal control, but should not be used as a substitute for work that should be undertaken by the external auditor. Similarly, reliance on management experts—rather than engaging the auditor's own expert—can result in the work of the expert forming the basis for both the financial report and the audit. This can undermine the ability of investors and other users of financial reports to rely on, and have confidence in, an independent audit.
Use of the auditor's experts and other auditors	Whether auditors have appropriately used and evaluated the work of: • their own experts; and • 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.
Risk ratings, materiality and sampling	Whether audit partners and teams sufficiently consider the risks, materiality and sample sizes for individual audits. We may consider whether methodologies that result in a small number of tests of details are reasonable and supportable.
Business models and risk assessment	Whether auditors have adequately understood the business model of the entity audited. We will also consider whether auditors have identified and appropriately responded to key areas of risk. Auditors need to: • understand the impact of technology on the businesses of their clients, such as any threats from competitors using new electronic product distribution channels; and • understand the impact of certain systems and processes occurring outside the entity and the need to use other auditors to gain assurance over the adequacy of these systems and processes, and perform substantive testing on relevant transactions and balances.
Internal controls	Whether: • consideration is given to assessing controls, which can give rise to a more effective audit and can add value; • internal control reviews are conducted and the impact of deficiencies are identified for institutions with large numbers of systematically processed transactions—where an effective audit may be difficult without relying on controls; and • auditors appropriately identify, understand and test the controls that they rely on.

Focus area	Details
Tax	Whether auditors have independently reviewed the tax calculations of the audited entity and used their own tax expert. This includes whether 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 and their impact on the financial report; and • differences between tax and accounting treatments are properly identified and appropriately accounted for.
Use of data analytics and new audit technologies	Whether using new technologies and techniques that can increase audit effectiveness and result in a higher level of assurance have been properly applied. These new technologies and techniques may include data analytics, robotics and cognitive learning. When using data analytics, auditors should consider whether applications have been properly implemented and whether the results can be relied on. Data analytics can lead to a more effective audit, but there are risks and limitations to the circumstances in which it can be used. For example: • the auditor must have a good understanding of business, risks and controls; • data used must be complete, accurate and reconciled to the financial report or appropriate independent sources; • controls around the data should be reviewed and tested for effective operation; • exceptions should be investigated on an appropriate basis; • models and techniques should be reviewed each reporting period to ensure that they remain relevant and effective, including taking into account changes in the business and controls of the audited entity; • appropriately qualified and experienced staff should design and perform the procedures; • substantive analytical procedures rely on the ability to predict a population from independent data, and there may be limited cases where this technique can be used; • significant judgement and business knowledge can be required to identify exceptions or unusual patterns in populations for audit focus; • data analytics will not assist with the most difficult judgements on accounting policies and estimates. These judgements will continue to require experience, expertise and professional scepticism; and • there must be sufficient documentation for an experienced auditor, having no previous connections with the audit, to understand the work performed and the reasons for the conclusions reached. The use of robotics and learning systems will also create challenges in understanding the business, considering limitations and exceptions, and obtaining and reconciling source information.

D Key findings: Audit file reviews

Key points

Our inspections suggest that, in addition to maintaining a strong culture of audit quality (see Section B), audit firms should continue to improve both the adequacy of their audits of asset values and revenue recognition.

In particular, auditors can improve in the areas of:

- impairment of non-financial assets;
- revenue and receivables;
- investments, financial assets and contract liabilities;
- inventory and cost of sales;
- expenses/payables;
- taxation;
- using the work of experts and other auditors; and
- journal entry testing.

84 This section contains examples of findings from file reviews in the 18 months to 30 June 2018 that may be useful to other auditors when considering audit quality improvement areas on individual engagements.

85 We reviewed 98 files in the 18 months to 30 June 2018. Table 4 (in Section A) shows the number and percentage of those files for which we reviewed particular key audit areas. Table 5 (also in Section A) shows the number and percentage of cases where we had findings in each key audit area.

86 This section includes some more common or important findings across key audit areas. In many cases when we had a finding in a particular area (e.g. impairment of non-financial assets and the audit of revenue), we identified a combination of the matters that led to a finding for that area. However, it should not be inferred that all of the examples that relate to a particular audit area below applied in all of the cases when we had a finding.

87 For example, at a financial institution, we might have findings in each key audit area reviewed. In each area there could be a number of findings on risk assessment, controls and substantive testing.

88 The largest numbers of findings in the 18 months to 30 June 2018 related to the audit of asset values and revenue/receivables.

89 This section also covers findings on journal entry testing. Because these findings are not associated with a specific key audit area, they are excluded from the findings percentages in paragraphs 3 and 4.

Impairment of non-financial assets

90 For impairment of non-financial assets, we continued to find instances when the auditor did not:

(a) appropriately assess impairment indicators or ask management to perform impairment testing where there were indicators of impairment;

(b) understand the nature of the impairment model used by management to support recoverable amounts and appropriately test the model;

(c) adequately consider the appropriateness and reasonableness of forecast cash flows and key assumptions used in discounted cash flow models, including:

  (i) revenue and expense forecasts and terminal value growth rates that were not consistent with past actual outcomes and where historical forecasts had not been met;

  (ii) discount rates, working capital, future capital expenditure, and forecast exchange rates and commodity prices; and

  (iii) not performing adequate sensitivity testing on significant assumptions;

(d) ensure that the carrying amount of all assets that were supported by the cash flows used in determining the recoverable amount were compared to the recoverable amount;

(e) engage an auditor’s expert, where the audit team did not have sufficient expertise in the entity’s business and markets;

(f) perform a valuation crosscheck to assess the reasonableness of the assumptions underpinning the recoverable amount calculation—or, when they did perform a valuation crosscheck:

  (i) comparable multiples did not support the asset’s carrying amount;

  (ii) comparable companies relied on were not appropriate or identified in the audit work papers; or

  (iii) the auditor did not challenge the appropriateness of comparable entities used by internal experts;

(g) test an asset’s fair value. They did not:

  (i) use a valuation technique for which sufficient data and/or observable inputs were available;

  (ii) consider whether management’s assumptions would be those used by market participants;

  (iii) consider the reliability of the model; and

  (iv) apply valuation techniques consistently;

(h) in relation to capitalised costs:

(i) evaluate whether the recognition criteria in Australian Accounting Standard AASB 138 *Intangible assets* were met;

(ii) test the reliability of data; and

(iii) test the reasonableness of useful lives for amortisation purposes.

91 We had concerns about some impairment assessments for mining assets when the auditor did not:

(a) adequately consider the appropriateness and reasonableness of forecast commodity prices and foreign exchange rates;

(b) assess whether the forecast assumptions, including mine plans and management-prepared resource estimates underpinning the impairment models were reasonable and supportable;

(c) assess impairment indicators in line with Australian Accounting Standard AASB 136 *Impairment of assets* and Australian Accounting Standard AASB 6 *Exploration for and evaluation of mineral resources*, including where market capitalisation was less than net assets or there was illiquidity in the company's shares;

(d) identify the appropriate provisions of AASB 6 and AASB 136 that apply to impairment assessments for exploration and evaluation assets versus development assets;

(e) consider whether fair value was determined using appropriate assumptions by reference to market participants; and

(f) confirm the rights to tenements and the existence of exploration licences.

92 Table 8 shows matters contributing to our findings in relation to impairment and asset values. Table 4 shows that we reviewed work on impairment and asset values in 78 audit files in both the 18 months to 30 June 2018 and the 18 months to 31 December 2016.

Table 8: Matters contributing to impairment of non-financial assets findings in the current and previous 18-month periods

Matters	18 months to 30 June 2018	18 months to 31 December 2016
Forecast cash flows or terminal value not reasonable	7	16
Discount rate, exchange rate, commodity price or other key assumptions not appropriate or reasonable	16	23

Matters	18 months to 30 June 2018	18 months to 31 December 2016
Fair value crosscheck not reliable or crosschecks not performed	6	13
Not testing reliability of data and testing of reasonableness of useful lives for capitalised costs	4	1
Impairment indicators not assessed	4	3
Issues with sensitivity testing or no sensitivity testing performed	3	5
Carrying amount and recoverable amount not calculated on a consistent basis	2	7
Issues with work performed by firm's expert or specialist	2	7
Unclear as to which impairment model was used by management to support recoverable amount (fair value or value in use)	2	1
Mathematical accuracy of the entity's impairment model not adequately tested	1	1
Fair value not reliable or use of market-based inputs not maximised	1	6
Other	1	7
Total contributing factors	**49**	**90**

Note: A combination of the factors listed in Table 8 may contribute to a finding on impairment of non-financial assets in the audit of a company's financial report. A single factor alone may or may not give rise to a risk of the auditor not detecting a material misstatement in the financial report. In order to focus firms on key issues, we may have reduced the number of factors that would be reported in individual file reviews over time.

Revenue and receivables

93 In relation to the audit of revenue and receivables, we found instances where the auditor:

(a) did not assess risks appropriately, and suitable audit procedures were not planned or performed;

(b) did not obtain an understanding of the company's systems and controls over the initiation, recording and processing of revenue;

(c) placed an inappropriate reliance on internal controls, including instances where the auditor did not:

  (i) identify all relevant key controls that prevent, detect and mitigate assessed risks;

  (ii) test the operating effectiveness of key controls for the entire period of reliance;

  (iii) respond appropriately to control deficiencies identified; and

  (iv) test more than one transaction for the entire financial year, and not adequately testing the IT general controls or understanding of the different revenue types and processes;

(d) did not consider the appropriateness of changes in revenue accounting policy and/or understanding key contract terms;

(e) did not test estimates relevant to the recognition of revenue;

(f) did not adjust substantive procedures to respond to the assessed risks and/or control deficiencies;

(g) used substantive analytical procedures without:

  (i) a plausible relationship;

  (ii) taking into account key factors likely to significantly affect the expectation;

  (iii) maximising independent inputs;

  (iv) testing the reliability of data used to develop the auditor's expectation;

  (v) disaggregating revenue by product type or geographical location;

  (vi) setting thresholds for investigation that were of an appropriate size (i.e. that were not too large);

  (vii) investigating, or adequately investigating, differences from expectations above the threshold; and

  (viii) considering the impact of significant changes in the business (e.g. a major acquisition during the year);

(h) used substantive tests of detail without:

  (i) establishing the completeness and accuracy of the population tested;

  (ii) using adequate sample sizes;

  (iii) investigating or evaluating errors identified through samples tested

  (iv) testing receivables for which there were no subsequent receipts by confirmation or other means; and

(i) that there were deficiencies in group audit strategy or instructions to component auditors, and the group auditor inadequately evaluated the work of component auditors.

94 In testing financial institution interest revenue and insurance company premium revenue, we found instances where the auditor did not:

(a) understand processes, identify or evaluate key controls when relying on controls, and did not consider or review controls responding to risks;

(b) include all significant revenue streams in the scope of testing;

(c) test system-generated information they relied upon;

(d) design and perform adequate substantive procedures, including substantive analytical procedures; and

(e) adequately test that the adopted earnings curve for unearned premium liability was consistent with recent history and changes in the business.

95 Table 9 shows the matters contributing to our findings in relation to revenue and receivables. Table 4 shows that we reviewed revenue and receivables in 92 audit files in the 18 months to 30 June 2018 and in 90 audit files in the 18 months to 31 December 2016.

Table 9: Matters contributing to revenue and receivables findings in the current and previous 18-month periods

Matters	18 months to 30 June 2018	18 months to 31 December 2016
Risks not assessed or substantive procedures did not respond to the assessed risks/assertions	14	19
The relationship used in a substantive analytical procedure was not plausible or did not take into account key factors affecting the expectation	8	4
Data used to develop the auditor’s expectation in a substantive analytical procedures was not reliable or tested	9	15
Thresholds for investigating differences in substantive analytical procedures too high and/or population not disaggregated	9	7
Inappropriate reliance on internal controls	8	17
Inadequate sample sizes for tests of detail	5	6
Errors from tests of detail not investigated or evaluated	5	1

Matters	18 months to 30 June 2018	18 months to 31 December 2016
Inappropriate accounting policy for revenue recognition, or not checking for consistency with key contract terms	6	5
Inadequate group audit strategy, instructions to component auditors and evaluation of work of component auditors	4	5
Not testing accounting estimates relevant to the recognition of revenue	3	5
Not investigating, or adequately investigating, differences between recorded amounts and the auditor's expectation of those amounts that exceed the tolerable threshold in substantive analytical procedures	1	6
Other	1	1
Total contributing factors	**73**	**91**

Note: A combination of the factors listed in Table 9 may contribute to a finding on revenue/ receivables in the audit of a company's financial report. A single factor alone may or may not give rise to a risk of the auditor not detecting a material misstatement in the financial report. In order to focus firms on key issues, we may have reduced the number of factors that would be reported in individual file reviews over time.

Investments and financial instruments

96 Regarding investments and financial instruments, we found instances where the auditor did not:

(a) when testing the values of financial instruments at financial institutions:

(i) adequately assess risk, evaluate the design and implementation or test the operating effectiveness of key controls;

(ii) test the reliability and accuracy of source information;

(iii) adequately evaluate the valuation expert's assumptions;

(iv) develop sufficiently precise thresholds for identifying differences in values to investigate, adequately investigate the reasons of differences, or evaluate differences as possible errors;

(v) use adequate sample sizes for tests of detail;

(vi) use a consistent valuation cut-off time; and

(vii) adequately evaluate the relevance and reasonableness of the auditor's expert's significant assumptions;

(b) for risk insurance contracts of insurers:

(i) understand actuarial systems and valuation processes, including data extraction and integrity; and

(ii) adequately evaluate the work performed by the auditor's actuarial expert on data, assumptions, model changes and the analysis of the profit report, and did not perform supplementary tests of controls and substantive audit procedures;

(c) for investment-linked product liabilities:

(i) understand products and unit price calculations;

(ii) review unit pricing policy, methodology and calculation; and

(iii) test controls and perform substantive tests over the unit prices used in the liability calculation at year end;

(d) adequately test the number of units used in the liability calculation;

(e) obtain sufficient appropriate audit evidence or adequately question the accounting basis for investment assets to support:

(i) the carrying amounts of equity accounted investments and share of net profits, based on unaudited management accounts, other unaudited information or outdated audited financial statements with only non-substantive analytical procedures; and

(ii) the recoverability of a joint venture loan receivable where security was held as a second ranking mortgage;

(f) obtain sufficient evidence over the fair values of investment properties when:

(i) the range of capitalisation rates was not sufficiently narrow;

(ii) the rental income from current leases was not considered; and

(iii) the work of a management expert was not tested; and

(g) in relation to business combinations, perform sufficient procedures to conclude that the purchase price allocation and accounting treatment adopted were appropriate and in accordance with the requirements of the accounting standards.

Inventory and cost of sales

97 For inventory and cost of sales, we found instances where auditors did not:

(a) test operating effectiveness of key controls when taking a controls-reliance approach;

(b) perform alternative procedures to address information technology system limitations impacting the ageing and provisioning of inventory;

(c) select a sample for tests of detail that was representative of the entire population;

(d) reconcile stock counts to final inventory quantities recorded;

(e) appropriately evaluate and extrapolate errors identified;

(f) substantively test cost of sales, relying on a non-substantive analytical procedure that relied on prior year gross margins;

(g) test that all relevant costs were included in inventory;

(h) test cash flow models and underlying assumptions supporting net realisable value; and

(i) consider the appropriate classification of inventory between current and non-current assets.

Expenses and payables

98 For expenses and payables, we found instances where auditors did not:

(a) understand the design and implementation of systems and processes or consider risks;

(b) test payroll expenses processed by a service organisation;

(c) identify a plausible relationship for a substantive analytical procedure;

(d) assess risks and design tests of detail to respond to risks, test the completeness of data, test transactions for the entire period, perform suitable roll-forward procedures, and/or base a sampling approach on appropriate methodology or inputs;

(e) evaluate the work performed by the auditor's expert, and/or test assumptions or data relied on by the expert; and

(f) test an expense reversal.

Taxation

99 In many instances, auditors should use their own tax experts when auditing tax calculations. The auditor should work closely with any tax specialist to ensure that the level and scope of the specialist's work is suitable for audit purposes, and that issues raised are resolved. The auditor should ensure that the tax expert has a good understanding of the business and nature of the financial reporting balances, and that the auditor understands the differences between tax and accounting treatments that give rise to deferred tax balances.

100 Findings in the audit of taxation balances included instances where the auditor did not:

(a) plan or perform audit procedures in relation to tax balances;

(b) assess the appropriateness of the recognition of unused tax losses as deferred tax assets, and/or the probability that taxable profits will be available to utilise tax losses in the future;

(c) review an agreement with a subsidiary that was critical to a tax treatment affecting the group;

(d) understand and evaluate the work performed by management's tax expert;

(e) evaluate their own tax expert's work and conclusions, including performing procedures to support key assumptions; and

(f) adequately instruct the component auditor or review the component auditor's working papers in key risk areas.

Using the work of experts and other auditors

101 Auditors often need to rely on their own experts, particularly for impairment assessments. In particular, auditors should consider the need to use experts reviewing valuations of the reserves and other assets of extractive industry companies. Auditors may also need to rely on the work of other auditors for the audits of group components and service organisations, or for other purposes.

102 When experts were used, we found instances where auditors did not:

(a) evaluate or test the work of management's experts (e.g. they did not review the calculation of the provision for rehabilitation costs by management's expert in an extractive industry client);

(b) use their own experts where members of the audit team had insufficient knowledge, skill and experience, including in testing and evaluating the information, estimates and opinions of management's expert;

(c) sufficiently involve their own expert (e.g. the expert only reviewed the aspects of the discount rate calculation for impairment assessments);

(d) appropriately scope, review and evaluate the work and reports of their own expert, consider the appropriateness of the work, and/or resolve issues raised by the expert;

(e) assess the completeness and accuracy of the source data used by experts;

(f) obtain sufficient evidence to support the reasonableness of assumptions used by management's expert; and

(g) evaluate the competence and independence of experts.

103 Regarding the work of other auditors, we found instances where auditors did not:

(a) scope the work for components based on their risk profile and materiality;

(b) ascertain the work performed by the component auditor on a major area where significant risks were identified;

(c) review, or adequately review, the work of other auditors that they relied on, including where risks were identified;

(d) adequately review and evaluate reports from component auditors, or resolve matters raised in those reports; and

(e) evaluate the competence and independence of component auditors.

Journal entry testing

104 We identified deficiencies in journal entry testing in 10% of files reviewed. These findings are not associated with a specific key audit area and are therefore excluded from the findings in paragraphs 3 and 4.

105 Findings included instances where auditors did not:

(a) adequately identify the relevant controls or perform audit procedures over journals to address the risk of fraud arising from management override of controls;

(b) demonstrate an understanding of the journal population or whether the selection of journals for examination adequately covered the population;

(c) perform planned audit procedures on journal entries;

(d) ensure completeness and accuracy of the journal listing obtained for testing;

(e) test a sample of the journals to supporting documents;

(f) test journal entries throughout the reporting period; and

(g) report identified internal control deficiencies over journal entry processing to those charged with governance.

106 Auditors should test the appropriateness of journal entries, particularly those made close to year end when preparing the financial report. There may be a greater risk of errors or irregularities with journal entries because they are generally not systematically processed and may not be well controlled.

Enhanced audit reports

107 Enhanced audit reports, including descriptions of key audit matters requiring the most attention in an audit, were required for audits of listed entities for years ending on or after 15 December 2016. Overall, the quality of the enhanced audit reports was good, and this is partly attributable to ‘dry runs’ where drafts were provided to audit committees and directors in the year before the standard was operative.

108 Our reviews indicated cases where:

(a) key audit matters were described in general terms rather than being specific to the circumstances of the entity;

(b) the audit procedures for the key audit matters were not clearly described;

(c) the work performed by the auditor was not consistent with that described for the key audit matters in the audit report; and

(d) matters described in the key audit matters should have been disclosed in the financial report.

E Key findings: Quality control systems

Key points

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

- comply with the auditor independence requirements;
- identify root causes of findings from internal and external reviews of the audit file; and
- appropriately monitor audit quality.

Auditor independence

109 Most firms have established policies and processes to facilitate compliance with the auditor independence requirements of the Corporations Act and professional standards. Nevertheless, the following matters noted from our inspections could undermine the actual or apparent independence and objectivity of auditors.

110 We found three instances in the largest six firms where, in our view, the provision of non-audit services to clients raised concerns about the appearance of independence being compromised.

111 In one case, the firm provided co-sourced internal audit work and, after consultation with the firm's independence experts, risk advisory services. In another case, the fees for non-audit services were double the audit fee and there was no consultation with the firm's independence experts. In the third case, the firm provided actuarial services to the company (not including final valuation figures) and that work was also used as audit evidence.

112 Auditors need to robustly evaluate the appropriateness of providing non-audit services to audit clients, having regard to the nature of the services and the size relative to total audit fees. They should carefully consider the appropriateness of any proposed safeguards intended to address threats to independence. While in some cases the firm's internal independence teams were consulted to advise on the acceptability of these services, in other cases no consultation occurred.

113 One small firm did not send partners and staff an annual independence questionnaire to confirm compliance with independence policies and procedures during the period.

Quality control

114 Effective firm quality review processes are key to maintaining and improving audit quality.

115 During the 18-month inspection period ended 30 June 2018, we reviewed the largest six firms' approach to project management of audit engagements and root cause analysis of internal and external inspection findings.

116 Firms have shown progress on project management and root cause analysis. All firms plan to introduce new or improved initiatives in these areas. Our suggested good practices in these areas are outlined below.

Project management

117 Some of the largest six firms have established project management milestones for timely completion of each stage of audit engagements, such as planning, audit execution and concluding procedures. The objective is to improve audit quality by ensuring that risks are addressed on a timely basis and that deadline pressures are minimised.

118 Some firms monitor progress against these milestones outside the engagement teams. In other firms, engagement partners and teams are responsible for project managing their own audit engagements.

119 Firms that haven't already done so should consider:

(a) establishing project management with monitoring outside the engagement team by a suitably senior person with authority to act where milestones are not achieved;

(b) introducing milestones for audit engagements covering each stage of the audit, particularly for public interest entities;

(c) establishing engagement-specific milestones that have regard to the risks, nature and circumstances of each engagement; and

(d) reporting milestone information to the wider partner group.

Root cause analysis

120 The largest six firms undertake root cause analysis on findings from inspections, internal quality reviews, restatements and other sources. The extent and maturity of the root cause analysis systems and processes differ between firms.

121 Some firms should consider enhancing their root cause analysis of internal and external quality review findings by:

(a) establishing a process to oversee the root cause analysis;

(b) establishing a timetable for performing and reporting on root cause analysis findings from external reviews and ensuring that the root cause analysis process is independent from the firm's internal quality monitoring processes;

(c) enhancing the root cause analysis framework and providing guidance and training on the root cause analysis methodology and processes to personnel responsible for conducting the analysis;

(d) ensuring that interviews with engagement team members identify the real, underlying root causes;

(e) considering whether audits with no findings from internal or external reviews show good practices that can be applied elsewhere;

(f) better linking the root cause analysis to remedial actions on individual audits and the firm's audit quality action plan to address audit quality; and

(g) undertaking a post-implementation review at an appropriate time to evaluate the effectiveness of the root cause analysis program and identify possible areas for improvement.

Appendix: Accessible version of figures

This appendix is for people with visual or other impairments. It provides the underlying data for Figure 1 in this report.

Table 1: Industry groups for the audit files reviewed in the current and previous 18 months using Global Industry Classification Standard (GICS)

Industry	18 months to 30 June 2018	18 months to 31 December 2016
Automobiles and components	1	1
Banks/Insurance	7	4
Capital goods	3	10
Commercial and professional services	6	4
Consumer durables and apparel	3	3
Consumer services	5	5
Diversified financials	7	6
Energy	3	10
Food categories	7	2
Health care equipment and services	3	1
Materials	14	17
Media	10	4
Pharmaceuticals, biotechnology and life sciences	1	1
Real estate	9	5
Retail	6	5
Software and services	7	6
Technology hardware and equipment	4	2
Telecommunication services	2	2
Transportation	0	1
Utilities	0	4

Note: This table sets out the data contained in Figure 1.

Key terms

Term	Meaning in this document
AASB 136 (for example)	An accounting standard issued by the Australian Accounting Standards Board (in this example numbered 136)
accounting standards	Standards issued by the Australian Accounting Standards Board under s334 of the Corporations Act
ASIC	Australian Securities and Investments Commission
auditing standards	Standards issued by the Auditing and Assurance Standards Board under s336 of the Corporations Act
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 made in the audit and conclusions reached in formulating the auditor's report
EQCR	Engagement quality control reviewer
GICS	Global Industry Classification Standard
IFIAR	International Forum of Independent Audit Regulators
INFO 203 (for example)	An ASIC information sheet (in this example numbered 203)
key audit area	An area of an audit engagement selected for review in our inspections on a risk basis that generally relates to a financial statement line
largest six firms	Large firms that audit listed entities with the largest aggregate market capitalisation, which may operate through national partnerships, an authorised audit company or a national network of firms
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
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
smaller firms	Firms that audit a limited number of listed entities and have a small number of audit partners

Related information

Regulatory guides

RG 260 *Communicating findings from audit files to directors, audit committees or senior managers*

Information sheets

INFO 183 *Directors and financial reporting*

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

INFO 203 *Impairment of non-financial assets: Materials for directors*

INFO 222 *Improving and maintaining audit quality*

INFO 223 *Audit quality: The role of others*

INFO 224 *ASIC audit inspections*

Standards

AASB 6 *Exploration for and evaluation of mineral resources*

AASB 13 *Fair value measurement*

AASB 136 *Impairment of assets*

AASB 138 *Intangible assets*

Note: You can access these standards at the AASB website.

Other documents

IFIAR, *2017 Survey of inspection findings*