REPORT 648

Audit inspection report for 2018–19

December 2019

About this report

This report summarises ASIC's findings and observations from proactive reviews of audit files in the 12 months to 30 June 2019.

We expect this report to be of interest both to the audit firms inspected and those audit 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

This report describes deficiencies and areas for improvement in audits and quality controls of the audit firms inspected. The absence of a comment in this report on any other aspect of an audit firm's audits, systems, policies, procedures, practices or conduct does not mean there are no deficiencies in these areas.

We reviewed selected areas of selected audit files. This report may not include all deficiencies identified when reviewing an audit file.

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 surveillances, and our separate surveillances of audits of concern.

Unless stated otherwise, not all matters in this report apply to every audit firm and, where they do apply to more than one firm, there will often be differences in the degree of application.

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Executive summary

Our inspections

1 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.

2 Audit inspections are one of our activities directed at promoting financial reports that provide useful and meaningful information—so that users of those reports can make informed decisions about the allocation of scarce resources. The quality of the financial report is supported by the quality of the independent audit. Our other activities include our separate financial report surveillances.

3 The objective of our audit firm inspections is to promote the improvement and maintenance of audit quality. Our inspections focus on audits of financial reports of listed entities and other public interest entities prepared under the *Corporations Act 2001* (Corporations Act).

4 This report outlines the findings from our inspections of 19 Australian audit firms undertaken in the 12 months to 30 June 2019, covering financial reports for years ended 30 June 2017 to 31 December 2018. It focuses on findings from our reviews of selected key audit areas in selected audit files at individual audit firms. The findings and areas for improvement identified may also be relevant for other audits of an inspected firm, other firms inspected and firms not inspected.

5 We ask audit firms to remediate findings from our audit file reviews, including developing actions to address thematic findings across a firm.

Overall findings

6 In our view, in 26% of the total 207 key audit areas that we reviewed across 58 audit files at audit firms of all sizes, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 24% of 347 key audit areas in the previous 18-month period ended 30 June 2018: see Section A.

7 The level of findings from our file reviews across audit firms of all sizes beginning with the 18 months to 30 June 2012 is shown in Table 1.

Table 1: Adverse audit file review findings on key audit areas for all audit firms inspected

Period	Adverse findings for all audit firms inspected	Key audit areas reviewed
18 months to 30 June 2012	18%	602
18 months to 31 December 2013	20%	454
18 months to 30 June 2015	19%	463
18 months to 31 December 2016	25%	390
18 months to 30 June 2018	24%	347
12 months to 30 June 2019	26%	207

Regulatory initiatives

8 The continuing overall level of findings needs to be addressed and ASIC will adopt a more intensive supervisory and regulatory approach in this regard.

9 During 2013, the largest six audit firms responded to ASIC's requests to prepare comprehensive action plans to improve audit quality. While audit firm action plans remain important in improving audit quality, these have not been sufficient alone to reduce the level of adverse inspection findings from our reviews of key audit areas on audit files over time.

10 Although our reviews are risk based and the number of key audit areas and files reviewed is limited, it is clear that the level of findings remains too high. This indicates that other regulatory initiatives should be pursued.

11 Our new regulatory initiatives include those outlined in Table 2. See also Section B.

Table 2: New ASIC regulatory initiatives

Initiative	Details
Enforcement	We have implemented our 'why not litigate?' approach and the new Office of Enforcement. We will review each adverse file review finding and consider whether more matters should be referred to the Courts, the Companies Auditors Disciplinary Board (CADB) or other action taken. This may mean taking more enforcement actions against auditors for defective audits and auditor independence issues. Enforcement of auditor matters is a priority for ASIC.

Initiative	Details
Transparency	This report includes individual percentage adverse findings from reviewing key audit areas on audit files for each of the largest four audit firms.
Conflicts of interest, culture, talent, governance and accountability at audit firms	We have commenced a review of conflicts of interest, culture, talent, governance and accountability for audit quality at the largest six audit firms. We will review firm policy, processes and procedures, interview firm leadership and review other relevant records and evidence. This work will be completed in the current financial year. Partly as a result of our change to reporting over a 12-month period rather than an 18-month period, we intend to publish our findings from this work in our inspection report for the 12 months to 30 June 2020 or in a separate report.
Root causes of financial reporting and audit findings	We will review the effectiveness of the root cause analysis conducted by audit firms on selected adverse findings from our financial reporting surveillances where net assets and profits were materially misstated. Our work will extend to how audit committees fulfilled their role in ensuring the quality of the financial reporting and supporting the audit in relation to the matter. We will consider whether the results of this review indicate a need to improve governance at the company and/or audit firm. This work has commenced and we anticipate completing this work by the end of 2020.
Reporting findings to audit committees	Recognising the responsibility of directors and audit committees to contribute to audit quality, we will consult on whether to revise Regulatory Guide 260 *Communicating findings from audit files to directors, audit committees or senior managers* (RG 260) to provide that ASIC would routinely report findings from its audit inspection file reviews directly to the directors or audit committee of the entity audited. Presently this occurs on an exception basis. We will consult on this possible change in the first half of 2020.
Audit quality measures, indicators and other information	At the same time as publishing this report, we have published a report with a broader range of audit quality measures and indicators to supplement our audit firm inspection findings: see Report 649 *Audit quality measures, indicators and other information: 2018–19* (REP 649).

Further information on findings

12 Table 3 compares the overall findings rates from reviews of key audit areas in audit files at each of the largest four Australian audit firms for the 12 months to 30 June 2019 and the 18 months to 30 June 2018. These firms audit 95% of ASX listed entities based on market capitalisation.

Table 3: Adverse findings from reviews of key audit areas in audit files at the largest four audit firms

Audit firm	12 months to 30 June 2019	18 months to 30 June 2018
Deloitte Touche Tohmatsu	32%	32%
Ernst & Young	22%	22%
KPMG	33%	21%
PricewaterhouseCoopers	18%	12%

Note: Table 3 does not show findings for Grant Thornton or the BDO firms because we only reviewed two to four files at those firms.

13 The number of audit files inspected and key audit areas selected at the largest four Australian audit firms for the 12 months to 30 June 2019 are set out in Table 4.

Table 4: Numbers of files and key audit areas reviewed at the largest four audit firms in the 12 months to 30 June 2019

Audit firm	Number of files	Key audit areas
Deloitte Touche Tohmatsu	6	19
Ernst & Young	12	45
KPMG	10	36
PricewaterhouseCoopers	10	34

14 Adverse findings from our audit inspections 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.

15 Across the firms inspected overall, the largest numbers of our adverse findings were in the following areas:

(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*—including accounting policy choices, substantive analytical procedures and tests of detail.

16 For further information on findings related to asset values, revenue recognition and other areas, see Section F.

17 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% to 5% of these financial reports reviewed.

18 We reviewed aspects of the audit of 58 financial reports in the 12 months to 30 June 2019. In two cases we raised financial reporting concerns with the company, and in one case the company made material changes to net assets and profits in a subsequent period, which we believe related to our concerns. Generally, these cases are included in the financial reporting findings referred to in paragraph 17.

The role of audit firms in improving audit quality

19 Audit firms need to continue to work on improving audit quality and significantly reducing the number of instances where auditors did not obtain reasonable assurance that a financial report is free of material misstatement. Firms should enhance existing initiatives and focus on new and sustainable initiatives to improve audit quality.

20 Audit firms should maintain 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.

21 Audit firms should undertake, or continue to undertake, comprehensive analysis to identify the underlying causes of adverse 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 C and Information Sheet 222 *Improving and maintaining audit quality* (INFO 222).

22 The largest six audit firms need to continue to focus on their action plans and other initiatives to improve audit quality. All audit firms should consider the need for enhanced, new and changed initiatives to improve audit quality.

23 We discuss the role of audit firms in improving audit quality in Section C and outline the areas of focus for audit firms in Section E.

24 We believe that sustainable improvements in audit quality require a focus on governance, accountability, culture and talent by audit 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 engagement partners and other individuals to account for inadequate audit work.

25 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.

26 Our adverse findings suggest that audit firms should continue to focus on the areas outlined in paragraph 15.

27 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.

The role of directors and audit committees

28 Directors are responsible for the financial report. Directors should ensure that financial reports provide timely, useful and meaningful information for investors and other users of the report. Company directors, audit committees and management also have key roles in supporting quality audits.

29 Audit quality supports financial reporting quality, which in turn enhances market confidence in a company’s reported financial position and results. It is therefore in the interests of directors and audit committees to support the audit process. Among other matters, directors and audit committees should consider non-executive directors recommending audit firm appointments and setting audit fees; reviewing the resources devoted to the audit, including the amount of partner time; assessing the level of professional scepticism exhibited by the auditor in challenging estimates and accounting policy choices; and ensuring independence of the auditor.

30 See Section D for further information on the role of directors, audit committees, management and others.

Understanding our findings

31 The nature of our adverse 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, *Survey of inspection findings 2019*, 16 May 2019.

32 Our inspections focus on higher risk audit areas and so great 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 surveillances, in our investigations, or by other means. Therefore, purely random reviews could result in a different level of findings than indicated in paragraph 6 and Table 3.

33 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. However, the percentages in paragraph 6 and Table 3 do not include instances where we considered that individuals could reasonably reach different judgements.

34 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. In this regard, our report does not represent a ‘balanced scorecard’ for audit quality.

35 Matters relevant to understanding our audit firm inspection process and the percentage measures in paragraph 6 and Table 3 are discussed in Information Sheet 224 *ASIC audit inspections* (INFO 224). We were assisted by feedback from an external consultative panel on our method of measuring findings: see paragraphs 64–65.

A Overall findings

Key points

In our view, in 26% of the total 207 key audit areas reviewed across 58 audit files at 19 audit firms of different sizes, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement.

While financial reports may not have been materially misstated, in our view the auditors 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

36 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

37 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.

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

Our findings

39 In our view, in 26% of the 207 key audit areas that we reviewed on a risk basis across 58 audit files in the 12 months to 30 June 2019, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. The corresponding figure for the 18 months to 30 June 2018 was 24% across 347 key audit areas.

40 Our findings, classified by size of firm, are shown in Table 5.

Table 5: Adverse findings by size of audit firms inspected

Type of audit firm	12 months to 30 June 2019	18 months to 30 June 2018
Largest six audit firms	26%	20%
Other audit firms that audit more than one or two listed entities	34%	29%
All audit firms	**26%**	**24%**

Note: The percentages for the 'Other audit firms that audit more than one or two listed entities' are not directly comparable between periods, as we inspected different firms and numbers of files in the 12 months to 30 June 2019 and in the 18 months to 30 June 2018. The above table does not show findings for the firms that only audit one or two listed entities due to the small number of files reviewed and because we review different firms each period.

41 Table 6 compares the overall findings rates from reviews of key audit areas in audit files at each of the largest four Australian audit firms for the 12 months to 30 June 2019 and the 18 months to 30 June 2018. These firms audit 95% of ASX listed entities based on market capitalisation.

Table 6: Adverse findings from reviews of key audit areas in audit files at each of the largest four audit firms

Audit firm	12 months to 30 June 2019	18 months to 30 June 2018
Deloitte Touche Tohmatsu	32%	32%
Ernst & Young	22%	22%
KPMG	33%	21%
PricewaterhouseCoopers	18%	12%

Note: Table 6 does not show findings for Grant Thornton or the BDO firms because we only reviewed two to four files at those firms.

42 The number of audit files inspected and key audit areas selected at the largest four Australian audit firms for the 12 months to 30 June 2019 are set out in Table 7.

Table 7: Numbers of files and key audit areas reviewed at the largest four audit firms in the 12 months to 30 June 2019

Audit firm	Number of files	Key audit areas
Deloitte Touche Tohmatsu	6	19
Ernst & Young	12	45
KPMG	10	36
PricewaterhouseCoopers	10	34

43 Many of our adverse findings related to accounting estimates (such as impairment of assets) and accounting policy choices (such as revenue recognition). Further information appears in Table 16, Table 17 and Section F of this report.

44 Our adverse 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.

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

46 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% to 5% of the financial reports reviewed.

47 We reviewed aspects of the audit of 58 financial reports in the 12 months to 30 June 2019. In two cases we raised financial reporting concerns with the company, and in one case the company made material changes to net assets and profits in a subsequent period, which we believe related to our concerns. Generally, these cases are included in the financial reporting findings referred to above. The decrease is due to a change in ASIC's approach. We now raise questions on a financial report with the audited entity before reviewing the audit file. We continue to exclude areas from audit file reviews where an entity has made material changes to net assets and profit. We still ask audit firms to perform root cause analysis and identify actions to address such matters for future audits.

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

Our coverage

49 We inspected 19 audit firms of different sizes in the 12 months to 30 June 2019, covering financial reports for years ended 30 June 2017 to 31 December 2018. These firms, in aggregate, audit 99% of listed entities by market capitalisation.

50 The number and size of audit firms we inspected is provided in Table 8.

Table 8: Number of audit firms inspected by size of firm

Type of audit firm	12 months to 30 June 2019	18 months to 30 June 2018
Largest six audit firms	6	6
Other audit firms that audit more than one or two listed entities	8	8
Audit firms that audit one or two listed entities	5	6
Total	**19**	**20**

51 The number of audits subject to our reviews is shown in Table 9.

Table 9: Number of audit files reviewed by size of firm

Type of audit firm	12 months to 30 June 2019	18 months to 30 June 2018
Largest six audit firms	44	78
Other audit firms that audit more than one or two listed entities	9	14
Audit firms that audit one or two listed entities	5	6
Total	**58**	**98**

52 Of the 58 audit files inspected in the 12 months to 30 June 2019, 38 were inspected by ASIC for the first time. Of the 20 audit files that were previously inspected, seven of the entities concerned had changed their auditor since the file was last reviewed. Table 10 outlines the number of files reviewed in the 12 months to 30 June 2019 that were subject to a previous review by ASIC and when they were reviewed. How recently we last reviewed the audit of a company could affect the level of adverse findings from our current reviews.

Table 10: Audit files reviewed in the 12 months to 30 June 2019 that were previously reviewed by ASIC

Number of years since last file review by ASIC	Number of audits	Audit firm changed
1–3 years	0	0
4–6 years	6	2
7–9 years	10	4
10–12 years	4	1

Note: The remaining 38 audits subject to review in the 12 months to 30 June 2019 had not been reviewed by ASIC in earlier financial years.

53 We reviewed similar proportions of audit files across the ASX listed entity population by size in the 12 months to 30 June 2019 compared to the 18 months to 30 June 2018. The numbers of files reviewed, key audit areas reviewed and key audit areas with adverse findings is shown by entity size in Table 11 for the 12 months to 30 June 2019 and in Table 12 for the 18 months to 30 June 2018.

Table 11: Audit files reviewed and adverse findings by size of audited entity (12 months to 30 June 2019)

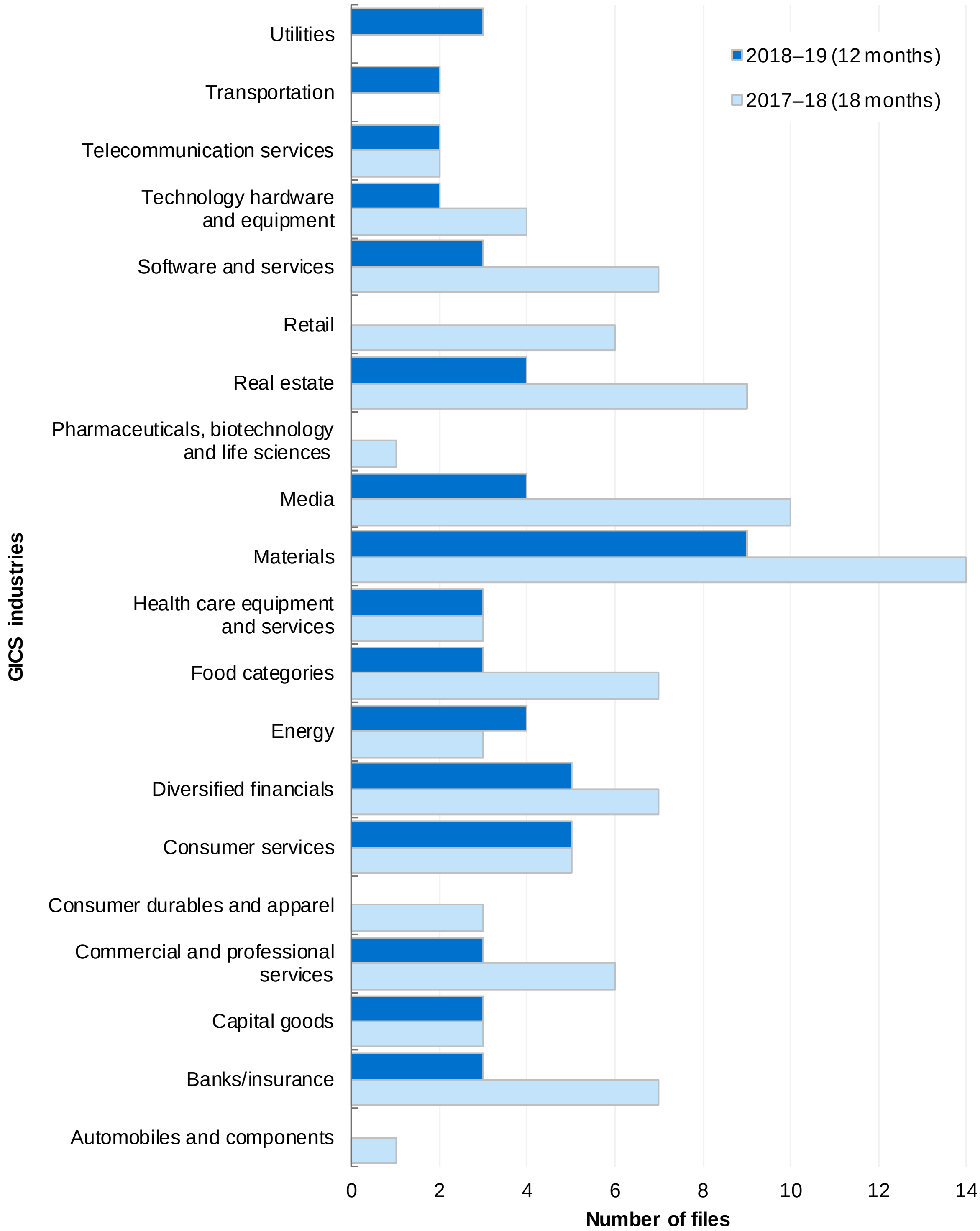
ASX listed entity	Number of files reviewed	Number of key audit areas reviewed	Number of key audit areas with findings	Percentage of key audit areas with findings
ASX 100	10	33	10	30%
ASX 101–200	8	28	7	25%
ASX 201–300	8	30	5	17%
ASX—Other	32	114	32	28%

Table 12: Audit files reviewed and adverse findings by size of audited entity (18 months to 30 June 2018)

ASX listed entity	Number of files reviewed	Number of key audit areas reviewed	Number of key audit areas with findings	Percentage of key audit areas with findings
ASX 100	9	31	13	42%
ASX 101–200	11	39	3	8%
ASX 201–300	9	35	5	14%
ASX—Other	69	243	64	26%

54 The audit files reviewed in the 12 months to 30 June 2019 and the 18 months to 30 June 2018 by industry, using the Global Industry Classification Standard (GICS) code for the audited entity, are detailed in Figure 1.

Figure 1: Audit files reviewed in the 12 months to 30 June 2019 and the 18 months to 30 June 2018 by industry of the audited entities



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

Note 2: See Table 20 in the appendix for the data shown in this graph (accessible version).

55 The audit areas covered in our reviews in the 12 months to 30 June 2019 and the 18 months to 30 June 2018 were similar, as shown in Table 13. The percentages of total key audit areas reviewed are shown in parentheses.

Table 13: Key audit areas reviewed in the 12 months to 30 June 2019 and the 18 months to 30 June 2018

Key audit area	12 months to 30 June 2019	18 months to 30 June 2018
Revenue/receivables	53 (25%)	92 (27%)
Impairment/asset valuation	47 (23%)	78 (23%)
Investments and financial instruments	21 (10%)	29 (6%)
Inventory/cost of sales	16 (8%)	22 (6%)
Loans/borrowings	15 (7%)	18 (5%)
Acquisition accounting	14 (7%)	13 (4%)
Expenses/payables	13 (6%)	19 (6%)
Taxation	12 (6%)	40 (12%)
Provisions	6 (3%)	14 (4%)
Mining exploration and evaluation (excluding impairment)	6 (3%)	9 (3%)
Other	4 (2%)	13 (4%)
Total	**207 (100%)**	**347 (100%)**

56 Table 14 shows that most of our findings in the 12 months to 30 June 2019 concerned the audit of revenue and asset values, as was the case in our last report. These areas require increased 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 14: Adverse findings in each key audit area for the 12 months to 30 June 2019 and 18 months to 30 June 2018

Key audit area	12 months to 30 June 2019	18 months to 30 June 2018
Impairment/asset valuation	13 (28%)	20 (26%)
Revenue/receivables	14 (26%)	27 (29%)

Key audit area	12 months to 30 June 2019	18 months to 30 June 2018
Investments and financial instruments	10 (48%)	11 (38%)
Inventory/cost of sales	5 (31%)	6 (27%)
Expenses/payables	5 (38%)	5 (26%)
Taxation	3 (25%)	5 (13%)
Share-based payments	1 (50%)	0 (0%)
Provisions	1 (17%)	3 (21%)
Mining exploration and evaluation (excluding impairment)	1 (17%)	1 (11%)
Acquisition accounting	1 (8%)	4 (31%)
Loans/borrowings	0 (0%)	2 (11%)
Cash	0 (0%)	1 (14%)
Total	**54 (26%)**	**85 (24%)**

57 The nature of our adverse findings is 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, *Survey of inspection findings 2019*, 16 May 2019.

58 All of our findings are important and should be addressed because in our view the auditors had not performed the work necessary to support their opinion on the financial report. 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. In our view, for at least one of the 58 financial reports audited there were material misstatements that had not been identified or addressed by the auditor.

59 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.

60 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 F.

61 Auditors must appropriately document their work to enable an experienced auditor to understand that 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 for auditors to claim they have performed sufficient work but merely failed to document it. Further, it is generally not possible to execute and review significant work and judgements without appropriate documentation.

ASIC staff and process

62 ASIC's Financial Reporting and Audit team (FR&A) conduct our audit inspection work. We also continue to use experienced retired audit partners from the largest audit firms to conduct audit file reviews.

63 Information on our inspection process, including the processes to ensure the quality of our findings, appear in INFO 224.

Consultative panel

64 We used an external 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 agreed with our findings. The panel also considered our measurement and reporting methodology, and agreed with our approach.

65 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. The panel agreed with our approach and the reporting of our findings.

B New ASIC initiatives to improve audit quality

Key points

Given the continuing level of findings from our audit firm inspections, new regulatory initiatives will be undertaken to promote improvements in audit quality.

In this section, we discuss the new ASIC initiatives to improve audit quality. In the 12 months to 30 June 2020, we will conduct:

- reviews at the largest six audit firms on conflicts of interest, culture, talent, governance and accountability related to audit quality; and
- reviews at the largest four audit firms of the effectiveness of the root cause analysis conducted by the firms on selected adverse findings from our financial reporting surveillances and related governance processes at the firms.

We also discuss the role of international regulators.

Response to continuing adverse findings

66 The continuing overall level of findings needs to be addressed.

67 During 2013, the largest six audit firms responded to ASIC's requests to prepare comprehensive action plans to improve audit quality. While audit firms' action plans remain important in improving audit quality, these alone have not been sufficient to reduce the level of adverse inspection findings from our reviews of key audit areas on audit files over time.

68 Although our reviews are risk based and the number of key audit areas and files reviewed is limited, it is clear that the level of findings remains too high. This indicates that other regulatory initiatives should be pursued.

69 Table 15 outlines new ASIC initiatives to promote improvements in audit quality.

Table 15: New ASIC initiatives

Initiatives	Details
Enforcement	We have implemented our 'why not litigate?' approach and new Office of Enforcement. We will review each file adverse review finding and consider whether more matters should be referred to the Courts, the CADB or other action taken. This may mean taking more enforcement actions against auditors for defective audits and auditor independence issues. We have reviewed our criteria for taking auditor enforcement actions, and the types of outcomes we may seek, including the use of enforceable undertakings and referrals of matters to the Courts and the CADB, as part of our implementation of the new Office of Enforcement. Enforcement of auditor matters is a priority for ASIC. The CADB has developed streamlined procedures for referring auditor conduct matters to the CADB.
Transparency	This report includes individual percentage adverse findings from reviewing key audit areas on audit files for each of the Big 4 audit firms.
Conflicts of interest, culture, talent, governance and accountability at audit firms	We have commenced a review of conflicts of interest, culture, talent, governance and accountability for audit quality at the largest six audit firms. We will review firm policy, processes and procedures, interview firm leadership and review other relevant records and evidence. These reviews will cover: • 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, and how the roles of all partners and staff are focused on quality; • ensuring that firms have the right talent for complex audits—including the approaches of the firms to attracting, retaining and upskilling partners and staff; • ensuring firm governance arrangements focus on audit quality—including structures and agendas focused on audit quality and the quality of other service lines supporting the audit process; • possible conflicts of interest—including the nature and extent of non-audit services to audited entities, any incentives for cross-selling through partner remuneration or other means, whether audit is a loss leader or is less profitable than other service lines, and any cross-subsidisation between service lines; and • accountability of leaders, partners and staff for audit quality. This work will be completed in the current financial year. We intend to publish our findings from this work in our inspection report for the 12 months to 30 June 2020 or in a separate report.

Initiatives	Details
Root causes of financial reporting findings	We will review the effectiveness of the root cause analysis conducted by audit firms on selected adverse findings from our financial reporting surveillances where net assets and profits were materially misstated. We will review the identification and effectiveness of actions by firms to address these root causes. Our work will extend to how audit committees fulfilled their role in ensuring the quality of the financial reporting and supporting the audit in relation to the matter. We will consider whether the results of this review indicate a need to improve governance at the company and/or audit firm. This work has commenced and we anticipate completing this work by the end of 2020.
Reporting findings to audit committees	Recognising the responsibility of directors and audit committees to contribute to audit quality, we will consult on whether to revise Regulatory Guide 260 *Communicating findings from audit files to directors, audit committees or senior managers* (RG 260) to provide that ASIC would routinely report findings from its audit inspection file reviews directly to the directors or audit committee of the entity audited. Presently this occurs on an exception basis. We will consult on this possible change in the first half of 2020. While we inform directors and audit committees that we are reviewing an audit to enable directors to ask questions of the auditor about any ASIC findings and how they were addressed, direct communication of the findings will ensure that the findings are fully and accurately communicated.
Audit quality measures, indicators and other information	ASIC's inspection findings are a significant output measure and an important indicator of audit quality. However, we only review a limited number of audits and focus on higher risk areas in each audit. At the same time as publishing this report, we have published a report with a broader range of audit quality measures and indicators to supplement our audit firm inspection findings: see REP 649. The measures and indicators that we report will evolve over time as more information becomes available.
Compliance audits	We will proactively review some Australian financial services licensee audits in early 2020.

International regulators

70 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.

71 Through the International Organization of Securities Commissions, we have worked with other securities regulators on matters such 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.

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

C The role of audit firms in improving 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:

- action plans to improve audit quality; and
- initiatives that appear to have improved audit quality in specific areas.

Areas for improvement by auditors

73 We believe that sustainable improvements in audit quality require a greater focus on culture and talent by audit firms. All audit firms need to develop a strong 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.

74 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.

75 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.

76 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.

Audit firm initiatives to improve audit quality

Action plans

77 We consider that developing, maintaining and updating action plans to address the underlying causes of audit deficiencies is an important part of improving audit quality and the consistent execution of audits. This involves ongoing analysis of the root causes of findings from quality reviews and audit inspections.

78 Given the adverse findings from our audit inspections, to improve audit quality, audit firms need to:

(a) conduct effective quality reviews of audits;

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

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

(d) develop and implement action plans to address findings; and

(e) monitor and revise action plans to ensure they are effective.

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

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

80 Audit firms that have not yet done so should develop action plans to improve the quality of the audits they conduct.

81 The largest six audit firms continue to respond to our request to prepare and update action plans to improve audit quality and the consistency of audit execution. 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.

82 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 aspects of audit quality

83 Initiatives undertaken by some audit firms that appear to have had 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) identifying the root causes of individual and thematic findings from internal and external file reviews and implementing initiatives to address those findings;

(e) 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.

D The role of directors, management and others in improving audit quality

Key points

Directors and management have key roles in supporting audit quality.

In this section we discuss:

- the role of directors and audit committees, and ASIC information sheets that assist directors in this regard;
- how company management can support audit quality through appropriate analysis and documentation for audit; and
- the role of standard setters, professional accounting bodies and others.

The role of directors and audit committees

84 Directors are responsible for the financial report. Directors should ensure that financial reports provide timely, useful and meaningful information for investors and other users of the report. Company directors, audit committees and management also have key roles in supporting quality audits.

85 Audit quality supports financial reporting quality, which in turn enhances market confidence in a company's reported financial position and results. It is therefore in the interests of directors and audit committees to support the audit process. ASIC has published or contributed to several documents which set out the roles of key stakeholders in contributing to financial reporting and audit quality.

86 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).

87 Among other matters, directors and audit committees should consider:

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

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

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

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

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

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

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

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

(i) ensuring independence of the auditor;

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

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

88 Further, directors and audit committees should ensure the company's internal governance and risk frameworks are robust and support the preparation of financial statements free of material misstatements.

The role of company management in supporting audit quality

89 Management should produce information on a timely basis that is supported by appropriate analysis and documentation for audit. Company management should:

(a) ensure appropriate processes and records to support the information in their financial report; and

(b) apply appropriate experience and expertise to produce quality financial information and financial reports, and appropriate analysis and documentation on a timely basis for audit.

The role of others in supporting audit quality

90 While auditors have the primary responsibility for audit quality and directors also have a key role, there are actions that others can take to promote and support audit quality, including:

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

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

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

E Focus areas for audit firms

Key points

In this section, we outline our areas of focus for audit firms to improve audit quality.

These focus areas include:

- whether all partners and staff embrace the need to improve audit quality and the consistency of audit execution;
- whether partners and staff understand their roles in conducting quality audits and are held accountable for findings from firm quality reviews and external inspections; and
- whether firm leadership gives strong, genuine and consistent messages to partners and staff that audit quality is not negotiable.

Areas of focus for audit firms

92 Table 16 and Table 17 outline areas of focus for audit firms, which will also be covered appropriately through our upcoming inspections of audit firms.

Table 16: Top three areas of focus for audit 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 their roles in conducting quality audits and are held accountable for findings from firm quality reviews and external inspections.
Leadership	Whether firm leadership gives strong, genuine and consistent messages to partners and staff that audit quality is not negotiable.

Table 17: Other areas of focus for audit firms

Focus area	Details
Partner-led improvement	Whether audit partners spend significant time in planning, risk assessment and reviewing audit files.
Asset impairment, revenue	Whether areas for improvement in audits identified through ASIC inspections and internal firm quality reviews in relation to impairment of non-financial assets and revenue have been identified and addressed.

Focus area	Details
Major newer accounting standards	Whether partners and staff are appropriately skilled to undertake audits under newer accounting standards. The newer standards cover revenue, financial instruments (including loan loss provisioning under an expected loss model), leases, insurance, and new definition and recognition criteria for assets, liabilities, income and expenses.
Professional scepticism	Whether appropriate professional scepticism is exercised about the sufficiency and appropriateness of audit evidence, accounting treatments and accounting estimates.
Conflicts of interest	Whether the general principles of auditor independence have been applied having regard to a reasonable person test, not just specific provisions. Auditors should consider both actual independence and any perceptions. Any safeguards must properly address any threats to independence.
Use of experts	Whether the auditor has used their own experts in areas where the audit team does not have sufficient expertise. Consistent with the fundamental requirement for an independent audit, auditors cannot use or rely on the work of management experts and need to obtain sufficient appropriate audit evidence.
Risk assessment, materiality and sampling	Whether audit partners and teams sufficiently consider the risks, materiality and sample sizes for individual audits.
Internal controls	Whether internal control reviews are conducted, and controls relied on are identified and tested by the auditor.
Quality reviews, root causes and action plans	Whether audit firms have undertaken effective root cause analysis on findings from ASIC inspections, internal quality reviews, restatements and other sources. Whether action plans to improve audit quality and the consistency of execution have been reviewed and updated to ensure they are effective in improving and maintaining audit quality.
Use of new audit technologies	Whether new technologies and techniques that can increase audit effectiveness have been properly applied. When using data analytics, robotics or machine learning systems, auditors should consider whether applications have been properly implemented and whether the results can be relied on, including whether the business and contracts are properly understood.

F 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 need to improve both the adequacy of their audits of asset values and revenue recognition.

In particular, auditors should improve in the areas of:

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

93 This section contains examples of findings from file reviews in the 12 months to 30 June 2019 that may be useful to auditors when considering audit quality improvement areas on individual engagements.

94 We reviewed 58 files in the 12 months to 30 June 2019. Table 13 (in Section A) shows the number and percentage of those files in which we reviewed particular key audit areas. Table 14 (also in Section A) shows the number and percentage of cases where we had findings in each key audit area.

95 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.

96 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.

97 The largest numbers of findings in the 12 months to 30 June 2019 related to the audit of asset values and revenue/receivables.

98 Our findings do not include cases where two professionals could reasonably reach different judgements on an accounting treatment, an accounting estimate or audit work to be performed. A statement that the auditor did not perform 'adequate' or 'sufficient' work should not be taken to imply otherwise.

Impairment of non-financial assets

99 For impairment of non-financial assets, we continued to find instances where 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) assess the appropriate identification of cash generating units (CGUs);

(d) obtain the entity's impairment calculation for each CGU with goodwill or other indefinite life intangibles;

(e) adequately consider the appropriateness and reasonableness of forecast cash flows and key assumptions used in discounted cash flow models. These include revenue and expense forecasts, terminal value growth rates, discount rates, working capital, future capital expenditure (including asset life cycles and capital maintenance program impacts), and forecast exchange rates and commodity prices. In particular, consideration was not given to:

  (i) management bias, where assumptions are inconsistent with past actual outcomes, historical forecasts were not met, and probability of outcomes was not taken into account; or

  (ii) the adequacy of sensitivity testing on significant assumptions;

(f) use an auditor's expert where the audit team did not have sufficient expertise;

(g) perform a valuation cross-check to assess the reasonableness of the assumptions used—or, when they did perform a valuation cross-check, comparable companies relied on were not appropriate;

(h) adequately test an asset's fair value, including:

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

  (ii) considering whether management's assumptions would be those used by market participants;

  (iii) adequately assessing the basis and assumptions used to estimate the fair value of each CGU;

  (iv) assessing the reasonableness of the ranges of fair values used to support the valuation cross-check of the recoverable amounts; and

  (v) considering the reliability of the model; and

(i) adequately test the reasonableness of the amortisation rate for capitalised costs.

100 We had concerns about some impairment assessments for mining assets where the auditor did not:

(a) adequately consider the relevance and reasonableness of key inputs used in valuing exploration projects, including commodity prices, ore reserves and mineral resources, production costs, employee cost allocations and discount rates; and

(b) test goodwill acquired in a business combination during the period, including where there were indicators of impairment.

101 Table 18 shows matters contributing to our findings in relation to impairment and asset values. Table 13 shows that we reviewed work on impairment and asset values in 47 audit files in the 12 months to 30 June 2019 and 78 audit files in the 18 months to 30 June 2018.

Table 18: Matters contributing to impairment of non-financial assets findings in the 12 months to 30 June 2019 and the 18 months to 30 June 2018

Matters	12 months to 30 June 2019	18 months to 30 June 2018
Forecast cash flows or terminal value not reasonable	4	7
Fair value not reliable or use of market-based inputs not maximised	3	1
Discount rate, exchange rate, commodity price or other key assumptions not appropriate or reasonable	2	16
Impairment indicators not assessed	2	4
Fair value cross-check not reliable or cross-checks not performed	1	6
Not testing reliability of data	1	4
Issues with sensitivity testing or no sensitivity testing performed	1	3
Issues with work performed by audit firm's expert or specialist	1	2
Unclear as to which impairment model was used by management to support recoverable amount (fair value or value in use)	1	2
Mathematical accuracy of the entity's impairment model not adequately tested	1	1

Matters	12 months to 30 June 2019	18 months to 30 June 2018
Carrying amount and recoverable amount not calculated on a consistent basis	0	2
Other	1	1
Total contributing factors	**18**	**49**

Note: A combination of factors in Table 18 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

102 For 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 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) understand and assess processes involving third-party organisations before data was transferred into the entity's accounting system or the IT control environment;

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

  (iv) obtain sufficient evidence over the operating effectiveness of controls that were relied on;

  (v) adopt an appropriate internal control sampling strategy across business units; and

  (vi) respond appropriately to control deficiencies identified;

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

(e) did not test estimates relevant to the recognition of revenue, such as in applying the percentage of completion method of recognition;

(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, customer or geographical location;

 (vi) setting thresholds for investigation that were not too large;

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

 (viii) obtaining evidence to appropriately challenge or substantiate explanations provided by management for differences above the threshold;

(h) used substantive tests of detail without:

 (i) assessing the characteristics of the population to consider stratification;

 (ii) using adequate sample sizes; and

 (iii) investigating or evaluating errors identified through items tested.

103 Table 19 shows the matters contributing to our findings in relation to revenue and receivables. Table 13 shows that we reviewed revenue and receivables in 53 audit files in the 12 months to 30 June 2019 and in 92 audit files in the 18 months to 30 June 2018.

Table 19: Matters contributing to revenue and receivables findings in the 12 months to 30 June 2019 and the 18 months to 30 June 2018

Matters	12 months to 30 June 2019	18 months to 30 June 2018
Risks not assessed or substantive procedures did not respond to the assessed risks/assertions	6	14
Thresholds for investigating differences in substantive analytical procedures too high and/or population not disaggregated	6	9

Matters	12 months to 30 June 2019	18 months to 30 June 2018
Inappropriate reliance on internal controls	6	8
Inadequate sample sizes	5	5
Not testing accounting estimates relevant to the recognition of revenue	5	3
Inappropriate accounting policy for revenue recognition, or not checking for consistency with key contract terms	4	6
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	4	1
Data used to develop the auditor's expectation in a substantive analytical procedure was not reliable or tested	3	9
The relationship used in a substantive analytical procedure was not plausible or did not take into account key factors affecting the expectation	1	8
Errors from tests of detail not investigated or evaluated	0	5
Inadequate group audit strategy, instructions to component auditors and evaluation of work of component auditors	1	4
Other	1	1
Total contributing factors	**42**	**73**

Note: A combination of the factors listed in Table 19 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

104 For investments and financial instruments, we found instances where the auditor did not:

(a) in testing the valuation and accounting for financial instruments:

(i) evaluate the design and implementation and test the operating effectiveness of key controls relied upon;

(ii) use an adequate sample size for the assessed risk in substantive tests of details;

(iii) test the relevance, reliability, completeness and accuracy of source data, assumptions and forecasts, and source inputs, including reperforming calculations, examining data and making comparisons with reputable authoritative sources or comparisons with other third-party experts;

(iv) evaluate and investigate variances between valuations by the audited entity and the auditor that are over a threshold and corroborate management’s explanation for the variances; and

(v) identify that the methodology used to calculate fair value did not comply with accounting standards;

(b) in testing the fair values of investment properties:

(i) perform property-specific audit procedures to conclude on the reasonableness of capitalisation rates;

(ii) obtain sufficient corroborating information from sources independent of the entity for management representations and to conclude that capitalisation rates reflect observable marketplace information; and

(iii) assess the appropriateness of relying on prior year valuations, and the continuing relevance and reasonableness of assumptions;

(c) in testing equity accounted investments:

(i) conclude on the accounting treatment for the entity’s interest and the substance of the arrangements;

(ii) identify that the share of joint venture profit was calculated incorrectly, and variances were not investigated to resolve the error in the calculation;

(iii) for impairment, assess the reasonableness of the growth rate in the context of industry forecasts, substantiate forecast capital expenditures or report an estimated impairment to those charged with governance; and

(iv) assess the financial condition, guarantees and support pledged to the investment, and consider the need for any potential provision;

(d) in testing the values of financial instruments at a financial institution:

  (i) adequately assess and verify the objectivity of the entity's internal defence control assurance team, whose work was relied on to support high controls reliance;

  (ii) adequately identify, understand and evaluate the design and implementation, and test the operating effectiveness of relevant controls related to the accuracy and reasonableness of rates used;

  (iii) understand and investigate the reasons for differences between the auditor's expert valuation and the entity's values;

  (iv) analyse and challenge the precision of valuation thresholds; and

  (v) assess and quantify the impact of the reasons for differences on the relevant population; and

(e) for business combinations, perform sufficient procedures on the purchase price allocation and accounting treatment adopted.

Inventory and cost of sales

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

(a) perform adequate procedures on the existence and value of work-in-progress and finished goods inventories;

(b) test that the subsidiary system reconciled to the general ledger or that the sampled cost transactions agreed to the cost reports from the subsidiary system;

(c) assess the characteristics of the populations or consider stratifying the populations in testing controls and substantive tests of details;

(d) adopt an appropriate sampling approach and test sufficient sample sizes;

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

(f) appropriately evaluate and extrapolate errors identified;

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

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

(i) test the allocation of overhead and labour costs, or the allocation of items between different inventory categories; and

(j) perform procedures to obtain evidence to support the existence and accuracy of inventory in the custody of third parties.

Expenses and payables

106 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 key controls or perform tests of detail using a representative sample;

(c) perform adequate substantive procedures over the completeness and accuracy of expenses, or identify and investigate variances in procedures performed;

(d) test the relevance and reliability of data used in testing; and

(e) perform substantive procedures on all samples selected for testing.

Taxation

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

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

(b) assess the reasonableness of the approved budget used to support recognition of deferred tax assets;

(c) test the reliability of data used and underlying facts;

(d) evaluate the work of management experts; and

(e) adequately assess the basis for the entity's position with reference to relevant tax legislation, case law, ATO rulings and determinations.

Experts and other auditors

108 The auditor should use their own expert where members of the audit team have insufficient knowledge, skills and experience, including auditing the information and estimates prepared by a management expert. Auditors often use their own experts and specialists, particularly for impairment assessments of mining reserves and other assets, and when auditing tax balances. We found cases where the auditor did not:

(a) sufficiently involve their own expert (e.g. the expert only reviewed the aspects of the discount rate calculation for impairment assessments or relied on an expert's review performed a number of years earlier);

(b) 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;

(c) assess the relevance, completeness and accuracy of the source data used by experts;

(d) obtain sufficient evidence to support the reasonableness or challenge assumptions and forecasts used by management’s expert; and

(e) perform procedures to corroborate the expert’s price inputs, including reperforming calculations, examining data and making comparisons with reputable authoritative sources or other experts.

109 We also found instances where auditors had insufficient evidence of review and involvement in the work of component auditors.

Journal entries

110 We identified deficiencies in journal entry testing in 9% of audit files reviewed in the 12 months to 30 June 2019, compared to 10% of files in the 18 months to 30 June 2018. These findings are not associated with a specific key audit area and are not included in the findings in paragraph 6 and Table 3.

111 Findings included instances where auditors did not:

(a) perform planned audit procedures on all journal entries or applied a threshold for testing journals that led to the population not being adequately covered;

(b) check completeness and accuracy of the journal listing obtained for testing; and

(c) test journal entries throughout and at the end of the reporting period.

Enhanced audit reports

112 Our reviews identified cases where:

(a) the audit procedures for the key audit matters were not clearly described in the audit report; and

(b) the work performed by the auditor was not consistent with that described for the key audit matters in the audit report.

Appendix: Accessible version of Figure 1

113 This appendix is for people with visual or other impairments. Table 20 provides the underlying data for Figure 1 in this report.

Table 20: Audit files reviewed in the 12 months to 30 June 2019 and the 18 months to 30 June 2018 by industry of the audited entities

Industry	12 months to 30 June 2019	18 months to 30 June 2018
Automobiles and components	0	1
Banks/insurance	3	7
Capital goods	3	3
Commercial and professional services	3	6
Consumer durables and apparel	0	3
Consumer services	5	5
Diversified financials	5	7
Energy	4	3
Food categories	3	7
Health care equipment and services	3	3
Materials	9	14
Media	4	10
Pharmaceuticals, biotechnology and life sciences	0	1
Real estate	4	9
Retail	0	6
Software and services	3	7
Technology hardware and equipment	2	4
Telecommunication services	2	2
Transportation	2	0
Utilities	3	0

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

Key terms

Term	Meaning in this document
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
CADB	Companies Auditors Disciplinary Board
CGU	Cash generating unit
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
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. These firms may operate through national partnerships, an authorised audit company or a national network of firms
professional bodies	Means Chartered Accountants Australia and New Zealand, CPA Australia and the Institute of Public Accountants
public interest entities	Listed entities and other entities of public interest with a large number of investors and other stakeholders
RG 260 (for example)	An ASIC regulatory guide (in this example numbered 260)

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*

Reports

REP 649 *Audit quality measures, indicators and other information: 2018–19*

Accounting and auditing standards

You can access Australian Accounting Standards at the AASB website and Australian Auditing Standards at the AUASB website.

Other documents

IFIAR, *Survey of inspection findings 2019*