Audit inspection report

1 July 2019 to 30 June 2020

Report 677 | December 2020

About this report

This report sets out findings from our review of audit files for the period 1 July 2019 to 30 June 2020, and recommendations from reviews of conflicts of interest, governance and accountability at the larger audit firms. We also detail our regulatory actions and our focus areas for audit firms to improve audit quality.

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 directors, audit committees, investors and other stakeholders interested in financial reporting and audits.

Contents

Executive summary

This report summarises the findings from our review of audit files of firms that audit the financial reports of listed entities and other public interest entities for the period 1 July 2019 to 30 June 2020. This report also outlines recommendations from reviews of conflicts of interest, firm governance and accountability for audit quality at the larger audit firms. We also detail our further regulatory initiatives and our focus areas for audit firms to improve audit quality.

The quality of financial reports is key to confident and informed markets and investors. The quality of a financial report is supported by the quality of the independent audit. The objective of our audit inspections is to promote improved audit quality.

Our findings

This report covers findings from reviews substantially completed in the 12 months to 30 June 2020 of key areas in audits of financial reports prepared under the *Corporations Act 2001* (Corporations Act). In our view, in 27% of the 179 key audit areas we reviewed on a risk basis across 53 audit files in the 12 months to 30 June 2020, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 26% for the 12 months to 30 June 2019.

These reviews mainly related to audits of 31 December 2018, 30 June 2019 and 31 December 2019 year-end financial reports. These financial reports and audits were not significantly affected by COVID-19 conditions. Further, it was too early for the level of findings to be affected by the regulatory initiatives we adopted in 2019.

The largest number of adverse findings continued to relate to the audit of asset values and impairment of non-financial assets and the audit of revenue.

Adverse findings from our reviews of audits 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.

Our separate risk-based reviews of the financial reports of listed and other public interest entities led to material changes to net assets and profits for 4% to 5% of financial reports reviewed in recent years.

Our findings are discussed further in 'Overview of audit file reviews' and 'Findings: Audit file reviews' below.

Better practice recommendations from our reviews of aspects of approaches to audit quality at the largest firms are outlined below in 'Recommendations: Conflicts of interest, governance, accountability and root cause analysis'. Among other matters, we found that the largest four audit firms were generally not performing root cause analysis where audited entities had made material changes to reported net assets and profit following ASIC inquiries.

We have released our second report of audit quality measures and indicators to supplement our audit inspection findings: see Report 678 *Audit quality measures, indicators and other information 2019–20*.

Our regulatory initiatives to improve audit quality

Although our reviews are risk based and the number of key audit areas and files reviewed is limited, the continuing overall level of findings needs to be addressed.

In 2019, ASIC adopted regulatory initiatives to promote audit quality relating to:

- enforcement actions involving auditor misconduct
- transparency of audit inspection results
- conflicts of interest, firm governance, accountability for quality, culture, talent and root cause analysis focused on audit quality
- reporting our findings directly to audit committees.

These initiatives are discussed further below in 'Improving audit quality' (in particular in Table 8) and 'Recommendations: Conflicts of interest, governance, accountability and root cause analysis'.

Focuses for audit firms in improving audit quality

Audit firms need to work on improving audit quality and significantly reducing the number of instances where auditors do not obtain reasonable assurance that a financial report is free of material misstatement. Overall, firm action plans have not sufficiently improved audit quality to date. Firms should enhance existing initiatives and implement further new initiatives to improve audit quality. This includes a strong culture focused on conducting quality audits, the experience and expertise of partners and others, supervision and review of audits, and accountability of partners and others for audit quality.

Audit quality and the need to properly inform the market and investors through financial reports is even more important in the context of COVID-19 conditions. There can be more difficult judgements on asset values, liabilities, solvency, going concern and disclosures, as well as challenges from remote work arrangements. Auditors need to respond to these conditions in their audits.

These matters are discussed further below in 'Improving audit quality'.

Overview of audit file reviews

Our findings

In our view, in 27% of the 179 key audit areas that we reviewed on a risk basis across 53 audit files in the 12 months to 30 June 2020, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. Table 1 shows the level of these findings for the 12 months to 30 June 2020 and the preceding two review periods, classified by size of firm.

Table 1: Adverse findings by size of audit firms inspected

Type of audit firm	12 months to 30 June 2020	12 months to 30 June 2019	18 months to 30 June 2018
Largest six audit firms	24%	26%	20%
Other audit firms inspected	48%	34%	29%
All audit firms inspected	**27%**	**26%**	**24%**
Key audit areas reviewed	179	207	347

Note: The percentages for 'Other audit firms inspected' are not directly comparable between periods, as we inspected different firms and numbers of files in each period. We reviewed more audit files across the largest six audit firms than at the other audit firms inspected, so the level of findings at the largest six audit firms has a greater impact on the findings level for 'All audit firms inspected'.

There were no material changes to the way in which we conducted our reviews that would affect the level of findings shown in Table 1.

The largest number of adverse findings continues to be in the following audit areas:

- *asset values and impairment of non-financial assets*—including challenging models, forecasts and key assumptions
- *revenue*—including accounting policy choices, substantive analytical procedures and tests of detail.

The findings in Table 1 do not include matters arising from our separate surveillances of audits of concern.

Table 2 compares findings levels at each of the largest six audit firms for the 12 months to 30 June 2020 and the 12 months to 30 June 2019. These firms audit 96% of ASX listed entities based on market capitalisation.

Table 2: Adverse findings from reviews of key audit areas in audit files at each of the largest six audit firms

Audit firm	12 months to 30 June 2020	12 months to 30 June 2019
BDO	20%	29%
Deloitte Touche Tohmatsu	35%	32%
Ernst & Young	14%	22%
Grant Thornton	27%	31%
KPMG	26%	33%
PricewaterhouseCoopers	23%	18%

The individual ASIC inspection reports on each of the largest six firms are available on our website.

Our coverage

The number of audit firms and audit files we inspected by size of firm in the 12 months to 30 June 2020 and the 12 months to 30 June 2019 is provided in Table 3. Our reviews in the 12 months to 30 June 2020 covered financial reports for years ended 30 June 2018 to 31 December 2019.

Table 3: Number of firms and audit files inspected by size of firm

	Number of audit firms		Number of audit files	
Audit firms inspected	12 months to 30 June 2020	12 months to 30 June 2019	12 months to 30 June 2020	12 months to 30 June 2019
Largest six audit firms	6	6	46	44
Other audit firms	7	13	7	14
Total	**13**	**19**	**53**	**58**

The number of audit files and key audit areas reviewed at the largest six audit firms for the 12 months to 30 June 2020 and the 12 months to 30 June 2019 is set out in Table 4.

Table 4: Number of files and key audit areas reviewed at the largest six audit firms

	Number of audit files		Number of key audit areas	
Audit firm	12 months to 30 June 2020	12 months to 30 June 2019	12 months to 30 June 2020	12 months to 30 June 2019
BDO	3	2	10	7
Deloitte Touche Tohmatsu	7	6	26	19
Ernst & Young	11	12	35	45

	Number of audit files		Number of key audit areas	
Audit firm	**12 months to 30 June 2020**	**12 months to 30 June 2019**	**12 months to 30 June 2020**	**12 months to 30 June 2019**
Grant Thornton	3	4	11	13
KPMG	11	10	39	36
PricewaterhouseCoopers	11	10	35	34

Comparability of findings levels between periods

There has been no overall change in the industry groups for the audit files reviewed in the 12 months to 30 June 2020 compared with the 12 months to 30 June 2019. For example, there were 10 companies in materials in the 12 months to 30 June 2020 and nine in the 12 months to 30 June 2019. There were seven companies in consumer services in the 12 months to 30 June 2020 and five in the 12 months to 30 June 2019. Had there been an overall change, the level of findings might not have been comparable between periods.

Table 5 shows, for the 12 months to 30 June 2020 and the previous 12 months:

› the number of key audit areas in which we had findings. The largest number of findings in both years concerned the audit of asset values and revenue

› the number of key audit areas that we reviewed. The areas reviewed were similar in the two years.

Table 5: Key audit areas with adverse findings, and key audit areas reviewed in the 12 months to 30 June 2020 and the 12 months to 30 June 2019

	12 months to 30 June 2020		12 months to 30 June 2019	
Key audit area	**Key audit areas with findings**	**Key audit areas reviewed**	**Key audit areas with findings**	**Key audit areas reviewed**
Impairment/asset valuation	14	53	13	47
Revenue/receivables	13	50	14	53
Inventory/cost of sales	5	18	5	16
Acquisition accounting	1	12	1	14
Investments and financial instruments	7	11	10	21
Taxation	1	10	3	12
Provisions	4	8	1	6
Expenses/payables	2	7	5	13

	12 months to 30 June 2020		12 months to 30 June 2019	
Key audit area	**Key audit areas with findings**	**Key audit areas reviewed**	**Key audit areas with findings**	**Key audit areas reviewed**
Loans/borrowings	1	5	0	15
Leases	0	3	0	0
Mining, exploration and evaluation (excluding impairment)	0	1	1	6
Other	0	1	1	4
Total	**48**	**179**	**54**	**207**

Understanding our findings

Matters relevant to understanding our audit firm inspection process and the percentage measures in Table 1 are discussed in Information Sheet 224 *ASIC audit inspections* (INFO 224).

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. However, 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.

While we reviewed a limited number of audit files and focused on higher risk audit areas, we did not review areas where there were known financial reporting issues. Purely random reviews could result in a higher or lower level of findings than indicated in Table 1.

Our separate risk-based reviews of the financial reports of listed and other public interest entities led to material changes to net assets and profits for 4% to 5% of financial reports reviewed in recent years. We generally excluded these cases from our audit file reviews.

Where an audited entity made material changes to net assets and profit following our inquiries, we asked the audit firm to perform root cause analysis and identify actions to address such matters for future audits. We found, following earlier reviews, that audit firms did not perform this root cause analysis, so from 1 July 2020 we will consider including the relevant areas in our audit file reviews.

We raised financial reporting concerns with audited entities following our review of three audit files in the 12 months to 30 June 2020. In all three cases the audited entity made material changes to net assets and profits for the relevant reporting period or a subsequent period, which we believe related to our concerns. These cases are included in the financial reporting findings referred to above.

Although audit firms may take remedial actions based on our audit file review findings, firms do not necessarily agree with all of our findings. Audits involve the application of professional judgement, and the percentages in Table 1 do not include instances where we considered that individuals could reasonably reach different judgements.

Auditors are required to appropriately document their work to enable an experienced auditor to understand that work and the basis for the conclusions reached. 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. It is generally not possible to execute and review significant work and judgements without appropriate documentation.

The nature of our adverse findings is generally consistent with those 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.

Note: See IFIAR, *2019 Inspection Findings Survey*, 17 February 2020.

ASIC staff and process

ASIC's Financial Reporting and Audit team conducts our audit inspection work. During 2019–20, we also engaged experienced retired audit partners from the largest audit firms to conduct 11 audit file reviews at three of the largest four firms.

Information on our processes to ensure the quality of our findings appears in INFO 224.

External panel

We consulted an external panel on the method of measuring and reporting aggregate findings from our audit file reviews. The panel discussed the conclusions reached on a small number of our more challenging audit file review findings where significant judgement was required, and generally agreed with our findings. The panel agreed with our approach to measuring and reporting our findings.

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 accounting bodies.

Findings: Audit file reviews

This section contains the more common or important findings from our audit file reviews in the 12 months to 30 June 2020 that may be useful to auditors when considering areas to improve audit quality. Not all findings related to all of the firms inspected.

In many cases when we had a finding in an audit area (e.g. impairment of non-financial assets), 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.

Impairment of non-financial assets

For impairment of non-financial assets, we found instances where the auditor did not:

- appropriately assess impairment indicators
- ask management to perform impairment testing where there were indicators of impairment or where impairment testing was mandatory
- obtain the entity's impairment calculation for each cash generating unit (CGU) with goodwill or other indefinite life intangibles
- understand the nature of the impairment model used by management and appropriately test the model
- assess the impact of the change in accounting for leases on impairment of assets
- assess the appropriate identification of CGUs and allocation of goodwill to CGUs
- adequately consider the reasonableness and/or reliability of forecast cash flows and key assumptions used in discounted cash flow models. These include revenue and expense forecasts and margins, terminal value growth rates, discount rates, working capital adjustments, future capital expenditure (including asset life cycles and capital maintenance impacts), and forecast exchange rates and commodity prices. In particular, consideration was not given to:
    - assumptions being inconsistent with past actual outcomes, historical forecasts were not met, and the probability of outcomes, or
    - the adequacy of sensitivity testing on significant assumptions
- perform a valuation cross-check, or use comparable companies for a valuation cross-check
- adequately test an asset's fair value, including:
    - using a valuation technique for which sufficient data and/or observable inputs were available

- considering whether management's assumptions would be those used by market participants
- considering the reliability of the model
- using a recoverable amount other than the entity's own market capitalisation
- considering whether the impact of reasonably possible changes in key assumptions should have been disclosed.

Table 6 shows matters contributing to our findings in relation to impairment and asset values. We reviewed work on impairment and asset values in 53 audit files in the 12 months to 30 June 2020 and in 47 audit files in the 12 months to 30 June 2019.

Table 6: Matters contributing to impairment of non-financial assets findings in the 12 months to 30 June 2020 and the 12 months to 30 June 2019

Matters	12 months to 30 June 2020	12 months to 30 June 2019
Forecast cash flows or terminal value not reasonable	5	4
Discount rate, exchange rate, commodity price or other key assumptions not appropriate or reasonable	4	2
Issues with work performed by audit firm's expert or specialist	3	1
Mathematical accuracy of the entity's impairment model not adequately tested	2	1
Fair value not reliable or not using sufficient market-based inputs	2	3
Impairment indicators not assessed	2	2
Fair value cross-check not reliable or cross-checks not performed	2	1
Not testing reliability of data	1	1
Issues with sensitivity testing or no sensitivity testing performed	1	1
Carrying amount and recoverable amount not calculated on a consistent basis	1	0
Other, including disclosure deficiencies	3	2
Total contributing factors	**26**	**18**

Revenue and receivables

For revenue and receivables, we found instances where the auditor:

- did not assess risks appropriately, and suitable audit procedures were not planned or performed
- did not obtain an understanding of the company's systems and controls over the initiation, recording and processing of revenue
- did not test or sufficiently challenge management's assumptions or calculations for expected credit losses
- did not consider the appropriateness of changes or inconsistencies in group revenue or receivables accounting policies and/or understand the terms and conditions of key contracts including variable consideration
- did not test estimates relevant to the recognition of revenue and receivables, such as in applying the percentage of completion method of recognition
- did not adjust substantive procedures to respond to the assessed risks, and/or control deficiencies
- used substantive analytical procedures without:
  - a plausible relationship
  - taking into account key factors likely to significantly affect the expectation
  - adequately testing the reliability of data used to develop the auditor's expectation
  - setting thresholds for investigation that were sufficiently precise
  - adequately identifying and investigating differences from expectations above the threshold
  - disaggregating revenue by product type or geographical location
- used tests of detail without:
  - establishing the completeness and accuracy of source data and not testing the value of collateral for receivables
  - using adequate sample sizes or sampling techniques
  - obtaining independent evidence in relation to the sample items selected
  - investigating or evaluating errors identified through items tested.

Table 7 shows the matters contributing to our findings in relation to revenue and receivables. We reviewed revenue and receivables in 50 audit files in the 12 months to 30 June 2020 and in 53 audit files in the 12 months to 30 June 2019.

Table 7: Matters contributing to revenue and receivables findings in the 12 months to 30 June 2020 and the 12 months to 30 June 2019

Matters	12 months to 30 June 2020	12 months to 30 June 2019
Inappropriate accounting policy for revenue recognition, or not checking for consistency with key contract terms	7	4
Risks not assessed adequately, or substantive procedures did not respond to the assessed risks/assertions	5	6
Inadequate group audit strategy, instructions to component auditors and evaluation of work of component auditors	3	1
Data used to develop the auditor's expectation in a substantive analytical procedure was not reliable or tested	3	3
Inadequate sample sizes and sampling techniques used	3	5
Not testing accounting estimates relevant to the recognition of revenue	3	5
Thresholds for investigating differences in substantive analytical procedures too high and/or population not disaggregated	2	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	1	4
The relationship used in a substantive analytical procedure was not plausible or did not take into account key factors affecting the expectation	1	1
Errors from tests of detail not investigated or evaluated	1	0
Inappropriate reliance on internal controls	0	6
Other	1	1
Total contributing factors	**30**	**42**

Investments and financial instruments

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

- in testing the valuation, classification and accounting for financial instruments:
  - evaluate the design and implementation and test the operating effectiveness of key controls

- perform sufficient or appropriate substantive tests of underlying assets or use an adequate sample size for the assessed risk in substantive tests of details
- test the reliability and reasonableness of source data, assumptions and forecasts, including reperforming calculations, examining data, obtaining support and making comparisons with reputable authoritative sources or comparisons with other third-party experts
- consider the requirements of a service organisation and whether reporting was appropriate in the circumstances

- in testing the fair values of investment properties:
  - perform property-specific audit procedures to conclude on the reasonableness of capitalisation rates
  - obtain sufficient corroborating information from sources independent of the entity for management representations and to conclude that capitalisation rates reflect observable marketplace information
  - test properties outside the auditor's estimated ranges of capitalisation rates
  - assess the appropriateness of relying on prior year valuations, and the continuing relevance and reasonableness of assumptions
- in testing investments:
  - consider whether the company had significant influence and should have equity accounted the investment
  - consider whether a loan to a joint venture was part of the net investment and should have been written down for significant losses of the joint venture
- in testing the values of financial instruments at a financial institution:
  - adequately evaluate the design and implementation of the entity's policy, process and controls, and test the operating effectiveness of key controls
  - sufficiently test discount rates used in asset valuation
- consider whether contingent consideration in a business combination should have been accounted for as remuneration rather than goodwill.

Inventory and cost of sales

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

- perform adequate procedures on the existence and value of work-in-progress and finished goods inventories
- properly scope the audit of a material inventory balance
- determine the quantitative impact of accounting treatment difference between the group and acquired entity
- reconcile stock counts to final inventory quantities recorded
- adequately test that items included in stock-in-transit are not recorded as revenue and that inventory sold during the year has been recorded in cost of goods sold
- corroborate management's decision regarding provisions for slow-moving and one-off inventories.

Expenses and payables

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

- evaluate the design and implementation of systems, processes and controls
- test key controls or perform tests of detail using a representative sample
- perform adequate substantive procedures over the completeness and accuracy of expenses, or identify and investigate variances
- test the relevance and reliability of data used in testing.

Taxation

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

- use their own expert where the audit team did not have sufficient expertise
- recognise deferred tax in the transitional adjustments on adopting a newer revenue accounting standard.

Provisions

Findings in the audit of provisions included instances where the auditor did not:

- evaluate whether the recognition criteria for a provision had in fact been met under the accounting standards instead of a contingent liability note disclosure
- evaluate the reasonableness of key assumptions and the reliability of source data underlying provisions
- confirm continuing relevance of evidence obtained in previous audits and perform further procedures, aside from discussions with management, to support the estimates and assumptions
- analyse movements and quantify changes arising from matters identified during the audit against the provision.

Experts and other auditors

Auditors often use their own experts and specialists, particularly for impairment assessments of non-financial assets, values of investment properties and other assets, and when auditing tax balances. We found cases where the auditor did not:

- use their own expert where the audit team did not have sufficient knowledge, experience or expertise
- perform audit work, relying solely on the work of management's expert
- 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)
- assess the competence, capabilities and objectivity of experts

- 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
- assess the relevance, completeness and accuracy of the methods and source data used by experts
- obtain sufficient evidence to support the reasonableness or challenge assumptions and/or forecasts used by management's expert, such as reperforming calculations, examining data and making comparisons with reputable authoritative sources or other experts.

We also found instances where there were deficiencies in group audit strategies and instructions to component auditors. Auditors were also not sufficiently involved in the work of component auditors and did not sufficiently evaluate and review that work.

Journal entries

We identified deficiencies in journal entry testing in 4% of audit files reviewed in the 12 months to 30 June 2020, compared to 9% of files in the 12 months to 30 June 2019. Findings included instances where auditors did not plan or perform journal entry testing or did not test journal entries at the end of the reporting period. These findings are not included in the percentage measures in Table 1 because they do not relate to a specific key audit area.

Other findings on financial report audits

Other findings that were not included in the percentage measures in Table 1 include:

- where confirmations were not obtained for loan facilities recognised and disclosed in the company's financial report
- where materiality could have been set at a lower level, which may have led to an increase in the extent of testing
- not considering whether a contingent liability should be disclosed for litigation against the audited entity
- where segment disclosures were not in accordance with the accounting standards.

AFS licensees

We also reviewed work on client monies in the audit of one Australian financial services (AFS) licensee at each of the largest four audit firms.

Our findings at a number of these firms were that the auditors did not:

- adequately test controls over segregating client moneys and depositing into designated bank accounts, and controls to ensure withdrawals were for permitted purposes
- adequately test controls over daily and monthly reconciliations of client money liability ledgers to designated bank accounts
- test the completeness and accuracy of breach registers and breach reporting, and the timely resolution of complaints.

The adverse findings from these reviews are not included in the percentage measures in Table 1.

Recommendations: Conflicts of interest, governance, accountability and root cause analysis

During the six months to 31 December 2019, we reviewed:

- approaches to possible conflicts of interest at the largest four audit firms
- approaches to firm governance and accountability for audit quality at the largest six audit firms
- whether root cause analysis was performed by each of the largest four audit firms where there were material changes to financial reporting by an entity audited by a firm as a result of ASIC inquiries.

This section outlines our better practice recommendations from these reviews. Not all matters listed apply to all firms reviewed.

Conflicts of interest

Our review of the approaches of the largest four audit firms to possible conflicts of interest included the nature and extent of non-audit services to audited entities, and any incentives for cross-selling through partner remuneration or other means. Our better practice recommendations for firms include:

- considering the general requirement to be independent not just the specific independence requirements when considering the provision of non-audit services to audited entities
- partners making rigorous evaluations of the threats from providing specific non-audit services to audited entities
- consulting more with the firm's independence experts on non-audit services to audited entities and the consultation being clearly documented
- performing quality control reviews of evaluations of non-audit service for compliance with the independence requirements
- assessing whether the level of total fees earned from non-audit services compared to audit fees for an audited entity as well as the nature of those services causes an actual or perceived conflict.

During our reviews of audit files at the largest four firms, we found three instances where there could be the appearance that the auditor's independence was compromised. These instances were:

- the firm was the largest trade debtor of the audited entity. This matter was identified during the firm's independence compliance testing
- the auditor did not adequately assess threats to independence where the firm continued to compile information to lenders relating to debt covenant compliance for an investee in which the entity had a significant investment and where there was a likely takeover of the investee
- the auditor's fees for non-audit services were over nine times the audit fees and included tax advisory work that supported figures in the financial report.

Governance

Our better practice recommendations for firms from our review of the focus of firm governance bodies on audit quality at the largest six firms include:

- having at least one experienced independent external person on internal governing boards or forming an advisory board with experienced independent persons to advise on audit quality initiatives at a high level
- ensuring partners and staff are fully aware of processes for escalating audit quality concerns with appropriate protections. This may include establishing an independent group to receive matters and investigate, assess and act on those matters
- clearly articulating the remit of internal governing boards for audit quality, including the authority they have to hold partners and staff accountable for audit quality deficiencies.

Firm and assurance division strategic plans should include a strong focus on audit quality, including compared to other objectives.

Accountability

Our better practice recommendations for firms from our reviews of how the largest six firms hold audit partners accountable for audit quality include:

- having clear measures in partner performance goals and plans
- ensuring sanctions imposed on engagement partners for adverse findings in internal and external quality reviews are sufficient
- ensuring that the consequences for engagement partners for deficient audits are transparent to the partner group
- holding engagement quality control reviewers and firm experts/specialists involved on audit engagements accountable for adverse findings identified in internal and external quality reviews
- firm leadership seeking feedback on audit quality from the audit committees and directors of audited entities on matters such as expertise, knowledge of the business and industry, and demonstrating professional scepticism
- not remunerating audit partners for selling non-audit services to audited entities.

Root cause analysis

Contrary to ASIC's prior suggestion, we found that the largest four audit firms were generally not performing root cause analysis where audited entities had made material changes to reported net assets and profit following ASIC inquiries. In our view, firms should conduct root cause analysis to identify actions needed to improve audit quality in all instances where there are material changes to an audited entity's financial reporting, whether following ASIC inquiries or otherwise.

Improving audit quality

ASIC's regulatory response to the continuing adverse findings

Table 8 outlines new ASIC initiatives to promote improvements in audit quality.

Table 8: ASIC initiatives

Initiatives	Details
Enforcement	We have implemented a 'why not litigate?' approach. We review each file adverse audit review finding and consider whether a matter should be referred to the courts, the Companies Auditors Disciplinary Board 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 and a number of matters are currently being considered for possible action.
Transparency	Transparency can promote improved audit quality. This report includes individual percentage adverse findings from our audit file reviews for each of the largest six audit firms. ASIC inspection reports on each of the six largest audit firms are available on our website.
Culture and talent	We intend to complete reviews in the first half of 2021 of how the largest six audit firms: • establish and maintain a culture focused on audit quality • have the right talent for complex audits, including how they attract, retain and upskill partners, staff and experts • monitor actions to improve audit quality.
Reporting findings to audit committees	We are considering consulting on whether to revise Regulatory Guide 260 *Communicating findings from audit files to directors, audit committees or senior managers* such that ASIC would routinely report findings from its audit file reviews directly to the directors or audit committee of the entity audited. This matter has been deferred due to COVID-19 conditions.

ASIC's work with international regulators

ASIC works with 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, Australia's auditing and ethical standards are based on international standards, and our markets are affected by international economic, regulatory and other developments.

Through IOSCO, we have worked with other securities regulators on matters such as:

› seeking to enhance the standard-setting governance for the international auditing and ethical standards-setting boards

› seeking improvements to the international auditing and ethical standards

- meeting with the largest six audit firms internationally to understand their approach to auditing and financial reporting under COVID-19 conditions.

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

Focus areas for audits under COVID-19 conditions

Audit quality is even more important in the context of COVID-19 conditions. There can be more difficult judgements on asset values, liabilities, solvency, going concern and disclosures, as well as challenges from remote work arrangements.

Under COVID-19 conditions it is particularly important that audit engagement partners:

- spend significant time 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
- undertake comprehensive reviews of the audit files of audited entities, focusing on possible risk areas.

Table 9 outlines our focus areas for audits of financial reports under COVID-19 conditions. The table includes a number of areas that would also be focus areas for audits in the absence of COVID-19 conditions or impacts.

Table 9: Focus for audits of financial reports under COVID-19 conditions

Focus area	Details
Financial reporting	Whether the auditor has addressed the key focus areas for financial reporting under COVID-19 conditions, including asset values, liabilities, solvency, going concern and disclosures. In particular, the auditor should have considered the areas, factors and disclosures outlined in *COVID-19 implications for financial reporting and audit: Frequently asked questions (FAQs)*, FAQs 1, 2 and 3 and the matters outlined in Media Release (20-157MR) *Focuses for financial reporting under COVID-19 conditions* (7 July 2020).
Understanding the business	Whether the auditor has gained an understanding of how the businesses of the entity being audited have been, and are likely to be, affected by factors such as those listed in FAQ 2 (including the impact of such factors on suppliers, customers, investees and others).
Non-COVID-19 impacts	Whether the auditor has identified the impact of non-COVID-19 changes affecting the businesses of the audited entity, such as new competitors and changes in technology. Financial reports should attribute declining performance and impairment to all relevant causes, not just COVID-19 conditions.
Risk assessment	Whether the auditor has identified and responded to fraud and other risks, including uncertainties and difficult judgements on assets, provisions, solvency, going concern and disclosures.

Focus area	Details
Remote work	Whether the auditor has addressed the impact of remote work arrangements during and since the year end on: • the ability to effectively conduct audits remotely, including limitations on interactions with officers of the audited entity and accessing records • the design and effective operation of key company internal controls, and the impact on the nature, timing and extent of audit procedures • the audit work on stock counts, fixed asset counts and system walk throughs, and the ability to conduct procedures effectively using virtual technology • the impact on component audits and restrictions on access to records.
Materiality	Whether the auditor has considered reduced performance materiality due to assessed risks and reduced asset values, revenue and/or profit affecting the nature, timing and extent of audit procedures.
Professional scepticism	Whether appropriate professional scepticism is exercised by the auditor and whether estimates, assumptions, assessments, accounting treatments and the sufficiency and appropriateness of audit evidence are appropriately challenged.
Applying required experience	Whether the required experience and expertise has been applied to the audit given the challenges and judgements involved, including increased partner involvement, appropriate supervision and review, and the use of the auditor's own experts.
Data and assumptions	Whether the auditor has assessed the adequacy of data, assumptions and past approaches in supporting asset values and other estimates, as well as the auditor's own analytical procedures.
Financial report disclosures	Whether the auditor has considered the adequacy of disclosures about matters such as estimation uncertainties, key assumptions and government support, which are likely to be material for investors and other users in the context of the overall financial report (including half-year reports). Material misstatements in disclosure have not been included in the percentage measures in Table 1 but may be included in the equivalent measures in our audit firm inspection report for the 12 months to 30 June 2021 given the increased importance of disclosures under COVID-19 conditions.
Operating and financial review or review of operations	Whether the auditor has read the operating and financial review or review of operations for material inconsistencies with the financial report and the auditor's knowledge, including the matters outlined in FAQ 4, and reported any suspected contraventions to ASIC in accordance with section 311 of the Corporations Act.
Deadline pressures	Whether audits are adequately planned and managed to minimise deadline pressures.
Documentation	Whether audit work and the reasons for judgements made have been adequately documented.

Firm-wide focus areas

More generally, Table 10 outlines firm-wide and non-engagement-specific focus areas for audit firms to improve and maintain audit quality.

Table 10: Other areas of focus for audit firms

Focus area	Details
Firm culture	Whether the firm has a strong culture focused on conducting quality audits. In particular: • whether all partners and staff embrace the need to improve audit quality and the consistency of audit execution • whether partners and staff understand and are accountable for their roles in conducting quality audits • whether firm leadership gives strong, genuine and consistent messages to partners and staff that audit quality is not negotiable, and supports this by holding partners and others to account for inadequate audit work.
Asset impairment, revenue, lessee accounting	Whether areas for improvement identified through ASIC inspections on impairment of non-financial assets and revenue have been addressed firm-wide.
Conflicts of interest	Whether the general principles of auditor independence have been applied, not just the specific provisions. Any safeguards must properly address any threats to independence.
Use of new audit technologies	Whether new technologies and techniques such as data analytics, robotics or machine learning systems have been properly implemented across the firm and whether the results can be relied on.

Audit firm action plans

To improve audit quality, we expect audit firms to:

› conduct effective quality reviews of audits

› remediate findings from internal reviews and ASIC audit inspections by performing additional work necessary to form an opinion on the financial report

› identify root causes of adverse findings from their own quality reviews, our audit inspections and material changes to audited financial reports

› develop and implement action plans to address findings

› monitor and revise action plans to ensure they are effective.

Firms should refer to Information Sheet 222 *Improving and maintaining audit quality*, which outlines considerations and examples of initiatives for auditors to improve and maintain audit quality. Audit firm action plans should focus on improving:

› the culture of the firm

› the experience and expertise of partners, staff and experts

› supervision and review

› accountability of partners, review partners and firm leadership for audit quality.

We will continue to discuss with the largest six audit firms their progress in implementing their action plans, and how they assess the impact of these plans on audit quality.

The role of directors, management and others

As directors are responsible for the financial report, they should ensure the company's internal governance and risk frameworks are robust and support the preparation of financial reports that are free of material misstatements.

Quality audits support financial reporting quality and market confidence in a company's reported financial position and results. It is in the interests of directors to support the audit process. ASIC has published the following documents to assist directors in their roles for financial reporting and audit quality:

- Information Sheet 196 *Audit quality: The role of directors and audit committees*
- Information Sheet 183 *Directors and financial reporting*
- Information Sheet 203 *Impairment of non-financial assets: Materials for directors*.

Company management should support the audit process by:

- ensuring appropriate processes and records to support the information in the financial report
- applying 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 standard setters, accounting bodies and others in supporting audit quality is discussed in Information Sheet 223 *Audit quality: The role of others*.

Key terms

accounting standards	Standards issued by the Australian Accounting Standards Board under section 334 of the Corporations Act
AFS licensee	Australian financial services licensee
ASIC	Australian Securities and Investments Commission
auditing standards	Standards issued by the Auditing and Assurance Standards Board under section 336 of the Corporations Act
CGU	Cash generating unit
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
finding	An instance where in a key area of an audit ASIC concluded that an auditor did not obtain reasonable assurance that the financial report as a whole was free of material misstatement
IFIAR	International Forum of Independent Audit Regulators
INFO 224 (for example)	An ASIC information sheet (in this example numbered 224)
IOSCO	International Organization of Securities Commissions
key audit area	An area of an audit selected for review by ASIC 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. They are the BDO firms in Australia, Deloitte Touche Tohmatsu Australia, Ernst & Young Australia, Grant Thornton Audit Pty Ltd, KPMG Australia and PricewaterhouseCoopers Australia.
professional accounting 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)