CPA Australia Podcast, Episode 13 - Transcript

ASIC'S AUDIT INSPECTION PROGRAM FINDINGS FOR 18 MONTHS ENDED 31 DECEMBER 2016

CLAIRE: Welcome to this Podcast on the Australian Securities and Investment Commission's audit inspection findings. For the 18-month period to December 2016. I'm Claire Grayston, CPA Australia's policy adviser on Audit and Assurance and with me is Doug Niven ASIC senior executive leader for Financial Reporting and Audit to take us through ASIC's inspection findings. Welcome Doug and thank you for coming to speak with us.

DOUG: Thank you Claire.

CLAIRE: Firstly, Doug, could you clarify which audits your report covers in terms of the companies audited and the audit firms and reporting periods.

DOUG: Definitely, our audit and inspection program focuses on auditors of listed entities and public interest entities. We're really concentrated on where financial reports are most important because they have the largest number of users and therefore if there are issues with the financial report it can have the most impact on the market. So therefore there are about 120 auditors of listed entities. We clearly have a situation where there's a concentration of listed entities particularly in terms of market capitalization amongst the larger firms. So clearly our inspections cover those larger firms but we also do cover the next tier of firms. And a number of smaller firms as well that might audit just one or two listed entities as part of our inspection program. You're right. The program does cover the 18 months to 31 December 2016 which means inspections of files particularly that were completed during that period. There might still be some reporting bits to be tied up with the individual firm but the reviews are done and the issues are out and being discussed where there are issues. And that does mean because it covers up to 18 months. It does cover a range of balanced dates through from 31 December 2014 through to 30 June 2016. Probably the majority will be 30 June 2015. But there would also be quite a number for 30 June 16 in there as well. So quite a range of entities. Our inspection program of course is about visiting firms and having all those files quality controls as well and other matters.

But the key part in terms of the inspection process is the final reviews and over the 18 months we did look at 93 files across those various firms.

CLAIRE: And do the firms change between the inspection periods the firms that you inspect.

DOUG: They do so certainly probably not a surprise we visit the Big Four firms every 18 months. Given my comment about market capitalization and so forth. So that part doesn't change. And with the other national firms and network firms in sort of the mid-tier we visit different firms in each 18 months it would be some that we would visit each 18 months but quite a number that we'll visit one 18 months and not the other. In terms of for those smaller firms that might audit one or two listed entities. You'll gather that quite a number of those. We actually visit about nine or so nine, ten in each 18-month period which probably gives a clear view if you do the maths. And I'm doing it in my head at the moment it probably takes about 12 years to visit the whole population of those smaller firms. So clearly they're not ones we visit every 18 months but they're a very important part of the capital markets as well.

CLAIRE: So let's jump straight to the question that everyone would be most curious about and that is have you found any improvement or have you found a deterioration in those inspection findings for this 18-month period?

DOUG: Yes. Well given that firms have been making a substantial investment in order quality in a lot of cases and we're pleased with that. I should preface my comments by saying we are seeing some areas where the efforts of the firms appear to be paying off. But if you were to look at our overall results it is true that the level of findings is not where I would like it to be. So in the previous 18 months' period you know simple overall percentage we looked at 463 key audit areas in files and in 19 percent of those cases in our view the auditors have not obtained reasonable assurance that the financial report is free of material misstatement. In the more recent 18 months 31 December 2016, we looked at 390 key audit areas across files and the corresponding percentage was 25 percent. So good efforts by the firms but it's an indicator that more does need to be done in terms of audit quality and getting the consistency of execution of audits. Certainly big things have been done but it's an opportunity to think about new strategies and focuses and ways to improve audit quality as well.

CLAIRE: So before we come on to what those ways that that audit quality can be addressed perhaps you can just explain how we should interpret those results So does that mean that 25 percent of audits there is a material misstatement or how would we interpret that?

DOUG: Yes. And you're quite right. We need to be careful in how we read those findings. Firstly, it doesn't it's about whether the auditor has obtained that reasonable assurance required under the auditing standards. And that doesn't necessarily mean that the financial reports themselves are misstated. So companies need to have good reporting processes controls and everything else. I won't go into all that detail at the moment. So it's about what everyone does in the reporting chain. Certainly through our financial reporting surveillance program, we're consistently seeing in companies' financial reports we look at of those reports and follow up a number of matters. 4 percent of cases where there are material misstatements net assets and profits. So it is important to have that context around it as well. Our inspection program is risk based so we are targeting particular audits on you know, risk criteria. And so therefore the results may not be the same as what you would get from a random sample. We are looking at some of the more complex and higher risk audits. There are audits where firms will be putting of course good resources and attention as well. But it's not necessarily representative you couldn't necessarily extrapolate it across the whole population. So I think those are important facts to bear in mind when looking at this and we do recognize by the way that auditors do play a key role as part of the audit process in looking at numbers and they will suggest changes quite often in terms of the financial reports which none of us see before those financial reports get to the market. So you know no one is suggesting that audit is not playing an incredibly important role in this process as well.

CLAIRE: Right. So in terms of the industry groups that you inspected this period has that changed much from previous periods. And were there any particular groups that have sort of more are experiencing more of those inspection findings than others.

DOUG: Yes. Largely speaking we do have a graph in the public report which by the way I should say is available for our website. We do have a graph which shows the breakdown of the files that we've looked at by the industry codes for companies that have been subject to audit and it largely does show that the split of the industry is very similar. Certainly the largest industry in terms of our file reviews was it's called the materials sector but largely speaking it means the extractives. Interestingly enough we did look at fewer files in that area that didn't necessarily need to lead to a smaller number of findings. By the way because a lot of that's around impairment of non-financial assets as well. But broadly speaking consistent impairment does continue to be an area where we do have a large number of findings. And so we continue to focus on that in terms of industries. We talked about extractives. Obviously we have a focus on particular industries and we'll target on bases on risk of digital disruption but also we do ensure that we have a consistent spread of major financial institutions in our Audit inspections as well. That doesn't mean we're looking at the same financial institutions at each firm and each period it will be different firms but we do try to get the spread there consistent as well.

CLAIRE: So you mentioned impairment. What other key areas were prevalent amongst your findings.

DOUG: Yes. And you're right the top one was the impairment of non-financial assets and asset values and that's consistent with previous periods. And there are some consistent themes in that area as well which we can perhaps come back to or just basically cover the themes. The second most common area pretty much equivalent level of findings very close to it was the area of revenue and receivables. So there are a few bits in that by the way. Some of it is revenue recognition, some of it's recoverability of debtors, some of it's around the quality of the substantive testing substantive procedures, tests of detail cut off as a range of matters in that but they'd be the two key areas or the largest areas where we do actually have findings.

And so when you look at our report we have actually highlighted three key focus areas and themes for this report. The themes are not surprisingly asset impairment.

The revenue side of things and the third one might think doesn't fit exactly with those two themes but it's around the culture of the firms and ensuring that firms continue have cultures where there is a very strong focus on audit quality, the consistency of execution. Those sorts of matters we talked about before but also genuine backup for those messages and processes around quality reviews and addressing findings from those and so on. So you can see a bit of consistency in terms of those sorts of matters.

CLAIRE: So now Doug perhaps you could talk us through each of the key finding areas and explain what you found.

DOUG: Yes. Happy to do that. And I think that is worthwhile in the report. We do actually highlight some of the findings that we've found as examples for firms are expected but also the ones that haven't been expected to look at those examples and to what they can learn from them. Are they similar things that they need to consider in terms of the audits that they're conducting. So these examples I won't go through everything that's in the report of course but we do find that a number of them are common across a number of files not saying every file. And of course it can be files where there's a combination of matters as well. So pretty much in the impairments space the key findings really haven't changed that much. And in broad terms perhaps before I go into more specifics the overall themes that we've had in the past and we continue to have are around audit evidence, professional skepticism and also we had the use of experts which is very relevant for impairment and to some degree in some cases also the use of other auditors. So very much in the impairment space it is about how much the auditor is challenging the numbers that particularly go into this kind of cash flow calculations but can also be particular types of fair value calculations as well and how appropriate the cash flows are. Are they questioning well if management has forecast amounts before they haven't been met this year, what's changed this year? If something has changed how realistic that is it supportable? But it's also round a range of assumptions it can be the discount rate or always have factors.

We do understand that judgment is involved in these areas but it's also important that the auditor does challenge in these areas. And so I won't go through enormous detail on that one. But certainly we continue to have areas where we see on audit files the auditor not recognizing that in those sort of discounted cash flow analyses, the cash flows that are used in a model don't necessarily match up with the assets and liabilities that are being tested. And unfortunately on the carrying and outside if it, it tends to be assets that haven't been included in the calculation. So it looks like there's headroom when potentially there isn't headroom. So we still do find instances of that. It's about challenging the choice of cash generating units. It's even things like valuation cross-checks. So there are a range of matters in the impairment space and it is worthwhile firms and auditors thinking further about that and what can be done perhaps to partly education, partly focus, perhaps internal quality reviews, a range of matters that can be thought about, coaching and so forth to perhaps get better results in that area. And I should say that area and perhaps the next one too that I'm about to talk about, it's fair to say if you look at global inspection findings, there is a public report out by the international form of independent audit regulator the nature of the findings at a high level that we have actually aren't that dissimilar to what is being seen globally as well and also these areas impairment non-financial assets and the one about to come to around revenue are actually common areas in our financial reporting surveillance findings as well.

So those themes are very important from that perspective. In terms of revenue I have already touched on the types of testing. But we do also find not so much underlying these particular percentages I mentioned before, but it is important to think about where the risks are in the organization. If you align controls, is it appropriate to do so. Have they been properly tested. But a lot of it does come down to particularly around substantial lack of procedures the quality of those procedures and perhaps I'll just mention a few things. Is a relationship that's being used to project what the population should be. Is that actually an appropriate relationship Do you have appropriate data and in some cases is that reliable. When you're projecting amounts and you find differences, you need to set thresholds to identify differences that should be investigated. Are those thresholds appropriate particularly when you desegregate a population. When you identify the differences, are they being investigated so we have seen instances where those procedures do need to be improved. But again it also touches on revenue recognition policies whether Auditors are appropriately challenging those. And as I mentioned before and even an element in that is around the receivables including recoverability questions. Other areas those were obviously two areas where we are having the largest number of findings. Best probably worthwhile mentioning a few other common areas as well.

So tax calculations, that has been an area of focus for us and a little bit for some similar reasons to impairment which I didn't touch on in detail which is often the auditor needs to rely on experts, they should be relying on the management's experts but they should be using their own experts if they don't have the appropriate skills within the audit team in the case of impairment by the way is just about you've got a valuation specialist. Are they properly instructed. Do they understand the audit process you know, matters that they identify being properly followed through all of those elements. And similarly when you think about the tax side there are questions about how well the audit and the tax specialist really communicate with each other. Drawing the two sides together so that's why we had that as an area we've been focusing on and we do have a number of findings in that area but we haven't been particularly focusing on tax payable itself but we do have questions around that. A lot of it's around deferred tax balances, recoverability of deferred tax balances for losses but even just fundamental questions about testing even issues around source information it goes into the tax calculations and has it actually been tied in and tested as well. I could probably spend more time on that but I won't. Perhaps what I should do is just briefly mention some of the other common areas. And I'm saying these are the only areas where we had findings but certainly around audits of investment assets, financial assets and contract liabilities around a range of assumptions and assertions there. Inventory and cost of sales, I touched on before. But yes the use of experts and other auditors and also a continuing area of findings is around journal entry testing.

CLAIRE: Thank you Doug. So that was the main findings you had in relation to the audit files themselves. And how about in relation to firm's quality control with aspects that you could highlight that you found in your inspections.

DOUG: There were, yes. We've probably taken a little bit of a different approach to quality controls over time by background they're incredibly important in the early years of inspections, we would have spent more time looking at the systems. Obviously as we revisit firms and they've improved systems, you know, not necessarily because of us it may be their own process as well I should say. They've got their own processes but it's become a bit less of a focus. But we do look at changes from time to time and particular risk areas. We do always have some focus on auditor independence. There were some findings in that area and there were actually some cases where firms have just come to us and said look sorry about this but there were some problems with our compliance with the auditor independence requirements whether it's in legislation or (inaudible). So certainly there's some matters we've identified there, including rotation of audit partners but other matters as well. In terms of the quality control system, we did do something a little bit different from what we've done in some of the previous inspections. We wanted to particularly focus on the firm's own processes for quality reviews so reviews of audit files internally and it is pleasing as well to see that in a sense it turned out our timing perhaps wasn't perfect for those reviews.

I'll be honest because a good thing happening that a number of the firms were actually in the process of changing how they go about the quality reviews and so they were moving to models where the reviews involved more time in the reviews more in-depth reviews looking at judgment areas using more independent reviewers and those sorts of things. So that's very positive and that was in process. There were still some findings that we had around the process even to some extent how well it was linked into. Now you found something. What's the process from there in terms of how it's addressed and remediation and how you can improve processes and quality going forward. So worthwhile looking at some of the matters we've identified there because again what we've seen might be relevant for other firms to to think about.

CLAIRE: So in doing your inspections how do you ensure that your methodology is sound. Do you have a review process yourselves?

DOUG: Yes, we do. I'm not sure how exciting this will be for our listeners today but I'll perhaps go through it very briefly. You're quite right. We need to have pretty much the same sorts of processes that we've been talking about in terms of what and not only what auditors should have but companies in terms of their internal financial reporting by the way. So it's a whole range of things. We've just been talking about quality control systems. And I won't go into everything but obviously we want to recruit the right people in the first place training but also when it comes down to the actual inspections we obviously want to allocate the right people to the right engagement so obviously trying to match up industry experience and skill levels. That's not just an industry experience, we've got people who are particularly focused on impairment and asset valuation as you can probably understand and find out you know financial instrument valuation. So it's that sort of matching up. But it's also in terms of the process itself and I said I'd keep this brief so I'd better be quick. We do obviously have quality reviews. It's not just one person who looks at the matter and you can be assured that the firms themselves, we have good interactions with the firms and we have to be mindful that what we see or what we think we've got as a finding on a file might not actually be a finding for a range of reasons it might be we haven't seen something else on the file that addresses a point whatever it may be or you know we're concerned about a particular judgment and you know we can resolve that. So the interactions with the firms in this (inaudible) apart from our internal processes are very key to this as well because I can assure you the firms aren't going to be shy to tell us where we haven't quite got it right or we've missed something, so that's a very key part of it and because we're working cooperatively with the firms to improve audit quality there is good dialogue in that regard and even once we've been through our own quality reviews and those processes we then have other processes to go through all the findings make sure we are consistent that there are appropriate findings and so forth before we actually issue anything to the firm in terms of (inaudible) or feed something through into our public report.

CLAIRE: And you also have a panel that reviews the report.

DOUG: Yes. Their role is a little bit different. Their role we've used them now for this is a third 18-month period.

So their role, they're independent people. They're also independent of their profession by the way. So we've got a former big 4 Chairman head of Audit. We've got a prominent well they're all company directors but we've got a prominent company director who has also been once upon a time chair of the Australian Accounting Standards board it probably doesn't matter if I name them. The third one is a former auditor general. So we have got a range of experience there. The reason we've been using that panel is more to test our methodology. And so as a part of that they look at how we rate matters, what we include in the percentage, what we exclude and those sort of methodology questions but also we have been using them in this period in the previous period to look at a number of our inspection findings one of which are included in case of where we think the audit obtained reasonable assurance of the financial report is pre-material misstatement and ones that were excluded from that as well just to in a sense to test out a bit of that methodology around the classification. Their feedback and they are very good group by the way. They will challenge us as well and be professionally skeptical which is very healthy. Obviously it's more about our methodology and so forth. But I think that's a key element as well as just testing the process.

CLAIRE: So earlier on you mentioned that the firms have been very proactive in seeking to improve audit quality. So what initiatives have you observed in the firms?

DOUG: There are a range of initiatives and particularly with the larger six firms back in 2013 we suggested they develop action plans to improve audit quality, it's not to say they didn't have any initiative prior to that but that was a good process. They obviously take ownership of those action plans and we are suggesting that others may want to look at doing this as well so that in itself has been helpful in terms of the process. But there have been some particular areas that perhaps I should highlight, I won't go through everything obviously, where we think that some of the things that have been done have been effective are sometimes hard to draw a direct correlation but certainly some of the initiatives around firstly the culture of the firms I sort of targeted that earlier as a particular focus area. And so I think that has been quite helpful. But when you go back also to the carers of finding it we talked about before particularly asset impairment but other areas as well. Some of the initiatives to form within the firm are focused teams which develop a particular expertise in the area they can be then used to coach people do the training provide important areas that should be focused on guidance. And so that's been quite effective. Obviously involved in potentially quality reviews so we've seen when that's being well done that that has made a difference. It's not just focused teams in those areas around asset impairment but there can be other areas. Tax for example where a firm identifies that there's an opportunity to do more in that space.

Also ones which were quite interesting spending more partner time on engagements might sound obvious but that can help you in terms of quality of experience and expertise and (inaudible) to default judgment areas. Also project management to make sure that you audit it is planned ahead so you don't end up running into issues right at the deadline and under pressure they're being addressed early so that's sort of some of the areas I could probably go on. But that gives you a little bit of a flavour of some of these things and we do try to draw those out in the report so that other firms can perhaps learn from some of those experiences as well.

CLAIRE: You mentioned earlier that ASIC's inspection findings were had quite a lot of similarities with other jurisdictions. Could you explain how ASIC's findings feed into the inspections finding survey conducted by IFIAR?

DOUG: Yes, definitely. It's actually quite a good process. The International form of independent audit regulators runs this survey annually. And each regulator within that there are I'll get my numbers wrong it's fifty-one or fifty-two members I should know the number, but there's quite a number of members in there. They're all audit oversight regulators are not at the moment. All of them contribute cause some of them are perhaps smaller and developing their inspection programs but memberships are important from that point of view. There is obviously a survey questionnaire to ensure consistency in (inaudible) definitions around how you classify matters in that survey. For what it's worth the overall key classification criteria is the same as the that one we are using which is the fundamental objective of the audit. Has the audit obtained reasonable assurance that the financial report or financial report is free from material misstatement So that fits nicely with our process as well. But yes the information is collated in talks in a survey questionnaire the various areas that are thought to be common then collected across all of the regulators and and published so I mean that's not all of it because obviously one on one. But also to some extent collectively we do have dialogue with other regulators to ensure consistency. We've in fact had you know, won't say which organization but we've had people from another (inaudible) Audit (inaudible) regulator here to work with us. We've seconded people to another country as well. So there's sort of a cross fertilisation if you like as a part of the process as well. But I think it is worthwhile having a look at that particular survey.

Yes. There probably are a couple of areas where there's some difference in terms of survey result. I didn't highlight internal controls and obviously we focused on that. To some extent as well. But there are quite a number of findings there but that's because in particular countries there are different requirements and special requirements for auditors in terms of separate sign offs in relation to internal controls. But I guess also it may just be worthwhile briefly touching on the fact that based on that survey, a target has actually been set and agreed to by the six largest firm networks to reduce inspection findings by 25 percent over four years. Now I need to be careful. I'm about to quote a percentage which I should put a qualifier on. The first year the percentage overall was 43 percent. Now to qualifiers, one that's actually cross every final survey. This target is actually across nine jurisdictions which includes Australia. But if you recall the percentage I mentioned earlier it was a low percentage for Australia.

Now the reason is that in part they calculate on a different basis it is about reasonable assurance and so on. But ours is on key audit areas within a file. The IFIAR is on findings on a file so that's why you get a sort of a different calculation. So that's an interesting process and the firms have obviously got a particular focus on achieving that target as well.

CLAIRE: So going forward what will be your areas of focus for future inspections?

DOUG: Well yes. First we are probably going to be pretty obvious obviously around asset impairment. The revenue side of things and what we're talking about around culture there are a range of other focus areas and perhaps I won't touch on all of them now. But just a few that are perhaps new or relatively new you probably gathered we've got to focus around the quality review process within the firms and following on from that root cause analysis to understand what caused the finding and how to address that. Certainly we do talk about partner involvement engagements and the project management that we've touched on before. We do not surprisingly include a focus around the new enhanced audit reports which wouldn't come as a surprise. We do also mention some other issues around some of the new technologies and how they're being used in audits which is very positive by the way. But also just making sure they're implemented in an appropriate way and taking account of appropriately the risks in that area. We do also highlight that the fact that there are new accounting standards coming and the need to think about those particular matters. And one more specific one that's new is around the audit of client monies. And we have seen some issues in that area and that's why we've got a focus there. In simple terms some auditors on some occasions might think for client monies particularly in AFS licensees although it can be held elsewhere if you're holding client monies as long as on the balance sheet the asset and the liability are the same, that's ok. Unfortunately, in some cases they might look the same but they're not actually the same.

So obviously auditors need to think about audit work in terms of the assets making sure they're there and liabilities are properly recorded and all the reconciliation questions and so forth. So that's some of the themes is a little bit of a list there but we thought it was important to draw out some of the areas which we thought would be helpful to firms. And again I should reiterate that's not to suggest firms aren't doing a lot themselves and we do give them credit for all of the efforts that's going in and it's very easy to focus on the negatives and the areas for improvement which is obviously very important but you know a lot of good things are being done as well.

CLAIRE: So I can see there's a lot to learn from the report and listeners can read more detail in ASIC's Audit inspection program report for 2015 - 2016 if they would like that extra detail. So thank you very much for sharing your insights into the inspection findings today.

DOUG: Thank you Claire.

CLAIRE: For a transcript and more information on today's podcast please visit www.cpaaustralia.com.au/podcast. Thank you for listening.