ASIC
Australian Securities & Investments Commission

Ernst & Young Australia

Audit inspection report 18 months to 30 June 2018

May 2019

About this report

This report summarises findings from our reviews at Ernst & Young Australia (EY) including:

- key areas in audits where our reviews were substantially completed in the 18 months to 30 June 2018; and
- firm processes to identify and address root causes of audit deficiencies and project management of audits.

This report also lists findings from our reviews of financial reports audited by the firm in the 18 months to 30 June 2018.

Although this report may describe deficiencies identified, this should not be taken to provide assurance that the firm's audits and systems, or audited financial reports, are free of other deficiencies.

This report is intended to communicate our findings in a clear and concise manner to leadership of the firm who are informed auditing and accounting professionals. While there are no restrictions on the firm providing this report to third parties or releasing the report to the public, other readers of this report may not have the full context of this report and the findings summarised herein.

ASIC Information Sheet 224 *ASIC Audit Inspections* and ASIC Report 607 *Audit inspection report for 2017-18* provide further information on our audit firm inspection process.

Background

1 The objective of ASIC's audit inspection program is to work cooperatively with audit firms to promote improved audit quality. We focus primarily on the review of key areas in the audits of listed entities and other public interest entities.

2 This report summarises our findings from substantially completed reviews of audits, good practice recommendations on root cause analysis and project management, and financial reporting surveillances, relating to EY and the entities it audited in the 18 months to 30 June 2018. If it has not already done so, the firm should identify underlying root causes for the matters reported, and for findings from internal and peer reviews, and consider new and improved actions to achieve sustainable improvements in audit quality.

3 For more information refer to the detailed comment forms provided separately to the firm (matters in Tables 1 and 2) or in a media release available from the ASIC website (www.asic.gov.au) (matters in Table 4). The comment forms include the firm's response to our findings.

Audit review findings

4 In our view the auditor did not obtain reasonable assurance that the financial report was free of material misstatement in 14 of the 63 key areas reviewed in total across 20 audits (22% of the key areas reviewed). Audits and audit areas were selected for review on a risk basis.

5 Table 1 summarises these findings. The firm did not necessarily agree with all of our findings. The findings should not be taken to infer that the financial report was materially misstated, but rather that the auditor did not obtain sufficient evidence to support their opinion.

Table 1: Audit file review findings – risk of material misstatement

Entity	Areas with findings	Findings
Entity A	3 of the 3 key areas reviewed	• *Sales revenue* – for substantive testing, the auditor used a combination of a substantive analytical procedure (SAP) and tests of details. Sales were predicted in the SAP by applying the average percentage declines in sales for the last three years rather than extrapolating a trend of accelerating declines in sales. The auditor did not consider disaggregating by product or customer category. Tests of details were not sufficient in areas such as the accuracy of prices and cut-off.

Entity	Areas with findings	Findings
		• *Rebates* - for substantive testing, the auditor used a combination of a SAP and tests of details. Rebates were predicted in the SAP by applying the prior year ratio of rebates to sales to current year sales. The auditor did not disaggregate by product, type of rebate, and promotional activities in performing substantive analytical procedures. The threshold for identifying differences for investigation was too large. Test of details did not cover volumes, settlement or rebate calculation. The classification of promotion rebates against revenue rather than as an expense was not adequately assessed. • *Receivables* – the auditor tested receivables to subsequent receipts but where there was no subsequent receipt only obtained evidence of delivery. Credit notes were not reviewed for a sufficient period after balance date. The auditor did not adequately test the provision for doubtful debts. • *Impairment of intangible assets* – the auditor did not review the allocation of assets to cash generating units, test key assumptions, challenge the reliability of using 15 year cash flow forecasts, or consider that the entity had not met forecasts historically. The auditor did not challenge forecast revenue growth in excess of historical growth, assess operating cost and capital expenditure assumptions, or test the discount rate used. The auditor did not identify disclosure errors.
Entity B	2 of the 3 key areas reviewed	• *Property revenue* – the auditor used total prior year actual revenue to predict current year revenue in a substantive analytical procedure. Information was not disaggregated by property, and key drivers of revenue were not taken into account by property (e.g. changes in tenants, rental rates and lettable space, as well as redevelopment or expansion of a property). • *Recovery of outgoings from tenants* - the auditor applied the ratio of recovery outgoings revenue to recoverable expense for the two prior years to the current year recoverable expense to predict expected revenue. Our concerns are similar to those for the testing of property revenue. • *Fair values of investment properties* – the auditor's review of capitalisation rates for valuing more than 90% of properties consisted of a brief explanation of the reasonableness of the rate. The auditor did not visit sites or obtain evidence on matters such as the condition of the property, the ongoing tenancy situation, and the market in which each property is located. While rate ranges were obtained from an expert, rates for a third of properties were outside these ranges. For other properties, values were increased significantly but the ranges also generally supported no change in values.
Entity C	1 of the 2 key areas reviewed	• *Revenue recognition* – the auditor did not obtain sufficient evidence to support the immediate recognition of revenue from customer support, maintenance services, upgrading of licensed material and licences contingent on significant implementation and configuration services.
Entity D	1 of the 1 key area reviewed	• *Exploration and evaluation asset* – the auditor did not have sufficient evidence that the carrying value did not exceed recoverable amount. The auditor did not sufficiently assess the movement in the commodity price, discount rate, exchange rate, net assets exceeding market capitalisation, reasonableness of management's plans and an offer to purchase the asset at less than 10% of carrying value.

Entity	Areas with findings	Findings
Entity E	2 of the 3 key areas reviewed	• *Revenue and receivables* – the auditor did not obtain sufficient evidence that the entity's insurance claims and claims against a customer would be accepted and paid. The income statement classification for claims on loss making contracts was not adequately evaluated. • *Development property* – the auditor' work on the value of development properties was insufficient. This included work on the feasibility of development such as the effects of significantly extended development timeframes, failure to achieve past forecast sales, poor economic conditions, the time value of money and the reasonableness of management's plans. The auditor did not adequately consider whether parcels of land that were not yet acquired for one development should be included in the valuation. • *Cost of sales* - the auditor did not consider the appropriateness of excluding finance costs relating to properties sold from cost of sales.
Entity F	1 of the 2 key areas reviewed	• *Deferred management fees (DMF)* – the auditor did not obtain sufficient evidence on the completeness, accuracy and value of DMF. Revenue recognised was not sufficiently tested for completeness and accuracy or allocation to the correct period. The auditor did not adequately assess key assumptions on estimated tenure. The auditor's work on controls relied upon was not adequate.
Entity G	1 of the 4 key areas reviewed	• *Taxation* – the auditor did not obtain sufficient evidence that non-portfolio dividends and income of foreign subsidiaries were not taxable. This included whether the subsidiaries operated active businesses for tax purposes when one subsidiary had no staff or occupancy costs. The auditor did not test the completeness and accuracy of tainted income from a number of countries.
Entity H	1 of the 3 key areas reviewed	• *Impairment of intangible assets* – the auditor did not corroborate key assumptions made by management for the items comprising the intangible asset.
Entity I	1 of the 2 key areas reviewed	• *Impairment of goodwill and other intangibles* – the auditor did not obtain sufficient evidence for assumptions supporting the recoverable amounts for cash generating units, including forecast revenue, market share, revenue per customer and expenditure. There was no work on the comparability of companies used in a cross check using revenue multiples.
Entity J	1 of the 4 key areas reviewed	• *Investment in associate* – the auditor relied solely on unaudited management account for a different year end to support the value of an investment in an associate and the recognition of the share of the associate's profit.

Note: There were two findings relating to journal entry testing where, in our view, the auditor did not obtain reasonable assurance that the financial report was free of material misstatement. As journal entry testing is not a key area reviewed, the findings were not included in the percentage in paragraph 5 above.

6 Our audit file review findings which were reported to the firm in comment forms but not classified as involving a risk of material misstatement are summarised in Table 2.

Table 2: Audit review findings – other

Entity	Findings
Entity E	• *Going concern* – the financial report included a note on going concern and the auditor's report only included going concern as a key audit matter.

Entity	Findings
Entity K	• *Depreciation expense* – the auditor did not obtain sufficient evidence on an increase in management's estimate of the useful life of plant from changing to a units of use basis for depreciation.
Entity L	• *Provision for rehabilitation and restoration* – the auditor did not obtain sufficient evidence on the work of an auditor of a group component concerning the provision. The audit file did not include evidence of the estimated area of disturbance to date or an assessment of the competence, capability and objectivity of management's expert.
Entity M	• *Distributions payable and tax* - the auditor did not test the year end distribution calculation or whether all taxable income was distributed by the scheme. Procedures were not documented, including checking distribution rate, total distribution payable, and the completeness and accuracy of information. The audit file did not contain an assessment of the tax specialist's involvement. There was no disclosure of tax payable by unitholders in the future on unrealised investment gains. Some audit working papers were not legible. • *Management fees* - the auditor did not have work on management fees paid on the audit file, including work on completeness. Nor did the file refer to work performed by another audit team. Controls relied upon to support measurement and completeness were not identified. • *Value of investments* – the auditor did not evidence in the audit file work performed on inputs used in valuing investments.
Entity G	• *Capitalised software development costs* - the auditor did not test the indirect costs capitalised or the reasonableness of the allocation of those costs to the asset.

Root cause analysis and project management

7 We reviewed the firm's approach to root cause analysis of internal review and external inspection findings, and its approach to project management of audit engagements and monitoring progress against milestones. Table 3 summarises our good practice recommendations.

Table 3: Root cause analysis and project management – Good practice recommendations

Area	Good practice recommendations
Root cause analysis	• A governance body could be established with appropriate terms of reference to oversight the root cause analysis program, internal monitoring, and project management initiatives. • A post implementation review could be conducted on the effectiveness of the root cause analysis work.
Project management	• The robustness and integrity of milestone data could be tested through the internal monitoring processes.

Financial report findings

8 We completed risk-based reviews of aspects of 68 financial reports of listed and other public interest entities audited by the firm in the 18 months to 30 June 2018. Following our inquiries, five entities made material changes to net assets or profits in the instances outlined in Table 4. More information

can be found in media releases available from the ASIC website (www.asic.gov.au).

9 The review of the audit of one of these company's financial reports and the relevant key audit area were substantially completed in the 18 month period to 30 June 2018.

Table 4: Financial report findings – media releases issued

Entity	Year end	Findings
Nine Entertainment Co. Holdings Limited	30 June 2017	The company impaired goodwill by $260 million in the subsequent half-year financial report.
Spotless Group Holdings Limited	30 June 2017	The company impaired goodwill by $50 million in the subsequent half-year financial report.
Shine Corporate Limited	30 June 2017	The company impaired goodwill by $5 million in the subsequent half-year financial report.
Santos Limited	31 December 2017	The company impaired oil and gas assets by $764 million in the subsequent half-year financial report.
Intrepid Mines Limited	31 December 2017	The company impaired mining properties by $16 million in the subsequent half-year financial report.