



INSPECTIONS DEPARTMENT

**PUBLIC REPORT ON THE INSPECTION PROGRAMME
2011 to 2012**

SEPTEMBER 2012

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Executive Summary

This report covers the principle findings arising from firm and engagement inspections performed by the Inspections Department of the Independent Regulatory Board for Auditors (IRBA) during the period April 2011 to March 2012.

The Inspections process, discussed in more detail below, has not seen significant change in approach from the previous period. The risk based approach continues to focus on the attention on public interest firms with the allocation of resources within IRBA aligned in accordance with this principle. The IFIAR principles for inspections were applied in the preparation and implementation of the inspection plan.

The findings identified from the firm and engagement inspection process identified deficiencies in the consideration of certain policies and the effective implementation of documented procedures. The lack of sufficient and appropriate documentation considered to be of particular concern relate to engagement quality control review and monitoring. The engagement inspection process also identified a lack of sufficient consideration of paragraphs within the accounting statements of relevance to asset valuation and impairment.

The overall response to quality control management has, however, generally been found to be sound with systems and processes put in place to manage the risk of non-compliance in this regard. The remediation processes within IRBA continue to see issues reported on being rectified with a positive and constructive attitude by firms and practitioners evident.

The changing regulatory environment continues to pose challenges to practitioners with the impact not fully integrated into the current regulatory environment. Indications are that the changes will be more significant for non-public interest firms and practitioners. The IRBA inspection approach to public interest inspections will therefore not be fundamentally influenced by these changes.

This report includes full firm wide inspections performed on thirty two (2) firms meeting the requirements for firm inspection. Additional monitoring and engagement inspections were performed at the Big Four firms where full firm wide inspections were performed during the previous two years. The thirty two firms operate throughout the country and their names are listed on Appendix A.

This report focuses primarily on areas identified in the inspections as requiring improvement. All the findings do not necessarily relate to each firm, and where they do apply to more than one firm, there will be differences in degrees of application. The recommendations set out in this report should be read in this context.

Framework

The inspections are performed under the authority of Section 47 of the Auditing Profession Act, 2005 (Act 26 of 2005) (APA). For firm inspections, the International Standard on Quality Control (ISQC1), *Quality Control for Firms that perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Engagements*, is applied when inspecting an audit firm's system of quality control. In addition, South African Auditing Practice Statement (SAAPS) 1 on Quality Control and the IFAC Code of Ethics for Professional Accountants are used on firm inspections. Compliance with IFAC International Standards on Auditing is inspected through engagement inspections.

Firm inspections

We have identified areas where we consider that improvements to these systems could be made in order to enhance audit quality. These were included in our detailed reports to the relevant firms listed in the appendix. The findings tend to be correlated with the size and maturity of the quality control systems in place. The prevalence and representative nature of the findings are detailed below.

The Inspections Department views the implementation of ISQC 1 as fundamental to issuing audit opinions that are appropriate in the circumstances. The “integrated” approach to inspections will continue to be implemented going forward to ensure the rating of firm adherence to auditing, accounting and legislative requirements depends on compliance, at firm level, and at practitioner level.

During the past year we inspected the policies and procedures relating to audit quality in 32 firms.

Engagement inspections

1. In interpreting the results of engagement inspections, it is important to note that, since inception in 1995, it has been the view of the Inspections Department that if audit work is not documented then it is presumed that it was not done. Auditing standards require sufficient and appropriate documentation of audit evidence obtained and for this reason we do not accept verbal explanations on inspection findings. The major reason for inspection results not being rated satisfactory relates to documented audit evidence either being insufficient and/or inappropriate. Non-documentation of audit evidence does not necessarily imply that an inappropriate audit opinion was expressed.
2. A total of 364 engagement inspections were performed at these 32 firms. While quality audit work was evident throughout our inspections, the Inspections Department continues to identify a number of instances where engagement files do not adequately comply with the professional standards in relation to documentation. The requirement for the auditor to document matters providing evidence to support the audit opinion has existed for many years and the lack of such documentation remains unacceptable.

Detailed Report

A: Introduction

Background

The IRBA is the statutory body controlling that part of the accountancy profession involved with public accountancy in the Republic of South Africa. Section 3 of the APA, effective from 1 April 2006, has provided for the establishment of the IRBA as a juristic person mandated to exercise its functions in accordance with the Act, relevant legislation and specifically the Public Finance Management Act.

IRBA's mission is to protect the financial interest of the South African public and international investors in South Africa through the effective regulation of audits conducted by registered auditors, in accordance with internationally recognised standards and processes. The overall objective is ultimately to ensure users and stakeholders of the financial statements can rely on the financial information and the audit reports providing assurance.

Following from this the legislative application of the APA and auditing and accounting standards serve to protect the South African public by regulating public interest audits performed by Registered Auditors. The functions of the IRBA include promoting the integrity of the auditing profession through conducting inspections.

Regulatory environment

South Africa has approximately 1400 audit firms and these comprise some 2800 attest practitioners. All these audit firms and practitioners have to annually meet the registration requirements of the IRBA in order to obtain a license to practice as a Registered Auditor.

Registration as a Registered Auditor ("RA") has associated with it a number of criteria for initial and on-going registration with IRBA. The task of ensuring RAs comply with the requirements for registration as defined by IRBA continues to pose a challenge for the RA. Compliance with auditing, accounting and legislative standards is fundamental to ensuring a profession that can compete internationally with a reputation that allows for reliance on professional auditors.

The integrated approach to regulation within IRBA allows for the Inspections department to play a key role to assist in providing effective regulation of the auditing profession. Compliance with auditing, accounting and legislative requirements is one of the pillars within IRBA

The legislative changes to the Companies Act have had significant implications for the profession. The introduction of the "independent review" rather than "audit assurance" will affect the profession going forward with the regulatory framework amended to cater for "reviewers" as well.

2011 inspection approach

Inspections are performed by the Inspections Department on a cyclical basis. Practitioners and firms must be found satisfactory in a cycle before proceeding to the next cycle. Inspections are performed by qualified professional staff employed on a full time basis by

the IRBA. In the period 1995 to 2005 Inspections Department ran two five-year engagement inspection cycles. In this period a total of 7250 engagement inspections were performed. In 2006 we commenced with the three year firm inspection cycle and will now perform engagement inspections on either a three or six year cycle depending on the classification of a practitioner's attest portfolio. Extensive research was conducted by the IRBA on global best practices relating to firm inspections prior to the implementation of this process in South Africa.

A confidential detailed report is sent to the firm and practitioner concerned setting out both the inspection findings and the comments received from the firm and practitioner on the inspection findings. These reports are presented, on an anonymous basis, to the Inspection Committee at their quarterly meeting for a decision on the outcome of the inspections.

An inspection decision will either be:

- Satisfactory, meaning inspection in the next cycle; or
- Not satisfactory, meaning a follow-up visit (maximum 2) is required to resolve and/or address issues raised, or
- Investigating Committee referral, meaning possible disciplinary action by the IRBA.

The remediation process continues to indicate positive intent on the part of firms to address findings raised by the Inspections process. The Investigations Committee effectively prosecutes significant non-compliance with professional standards. Non-compliance is disclosed when considered appropriate.

B: Objectives of IRBA Inspections

The objective of the Inspections Department is to inspect the work of registered auditors and their practices to monitor their compliance with the professional standards. The inspection process includes firm and engagement inspection:

Firm Inspection

The firm inspection process has the objective of inspecting the design and implementation of each firm's system of quality control, organised under the following principle elements:

- Leadership responsibilities;
- Ethical requirements;
- Client acceptance and continuance;
- Human resources;
- Engagement performance; and
- Monitoring.

Currently IRBA is in the fourth inspection cycle with firms meeting the cycle requirement included in the scope. This includes the big four firms, second tier firms as well as small to medium sized entities that meet the cycle criteria.

The firm inspection approach is risk based incorporating assessment of whether the quality control requirements of ISQC 1 are complied with as well as assessing whether the controls have been effectively implemented.

The approach is considered to be comprehensive with all principle elements detailed above included in the scope of a firm inspection.

Engagement Inspection

The engagement inspection process has the objective of inspecting practitioners' compliance with relevant professional standards, legislative and regulatory requirements in the performance of the audits of financial statements. The process includes inspection of compliance with ethical codes and standards.

The approach is risk based with the material misstatement the overriding principle that focuses inspection effort.

For both firm and engagement inspections performed Inspections Department considers it appropriate, where necessary, to provide guidance to firms and practitioners to assist in ensuring effective application of the professional standards.

C: Scope of IRBA Inspections

Firm inspections

The firm inspection process is applicable to audit firms whose client base includes audits of all public interest audit engagements (e.g. listed companies, medical aids, pension funds, public companies, trusts, NGOs). The scope is restrictive in that any firm that has public interest clients will be subject to firm inspection. This has resulted in a number of smaller to medium sized firms being included in the inspection plan. The coverage is considered to be appropriate for the current audit environment within South Africa.

Engagement inspections

The IRBA does not in all instances inspect every aspect of the engagements selected for inspection. A risk based approach is followed ensuring the inspection process focuses on compliance with the relevant quality control standards and the process is effective and efficient. Planning and completion sections are generally scoped in with high risk balance sheet, income statement and disclosure items inspected.

The IRBA inspects a sample of audit engagements that a practitioner has responsibility for. The absence of significant findings on an engagement inspection cannot, therefore, be an endorsement that the selected client's financial statements were necessarily fairly presented or that in general all audits performed by the practitioner are compliant with professional standards.

D: IRBA Inspection Approach

Firm inspections

The firm inspection process involves examination of evidence to understand the design of a firm's system of quality control and assesses the effectiveness of its implementation.

This evidence includes:

- a) Policy and procedure manuals;
- b) Quality related communications from a firm's leadership to its partners and staff;
- c) Independence confirmations;
- d) Client acceptance and continuance documentation;
- e) Personnel files;
- f) Engagement quality control reviews;
- g) Consultations that took place during audit engagements on difficult or contentious matters; and
- h) The results of the firm's own quality monitoring program.

As part of the firm inspection process, interviews are carried out with the senior executives in each firm who have management responsibilities relating to audit quality. Questionnaires are completed by a sample of professional staff to assess their experience and understanding of the application of the firms' system of quality control.

Engagement inspections

The engagement inspection process involves the examination of an audit engagement performed by attest practitioners registered with the IRBA. IRBA reviews the sufficiency and appropriateness of the evidence obtained and the appropriateness of the key audit judgements made. Our inspectors may question practitioners, where necessary, regarding the basis on which key audit judgements are made. Verbal representations on inspection findings are accepted only where the risk of an inappropriate audit opinion is regarded as minimal.

E: Findings arising from the Inspections

The firm inspection process has identified that there is a professional and positive attitude towards quality control and compliance with quality control standards. The quality control policies and procedures were generally found to be adequate supported by evidence of the use of quality control manuals and the documentation requirements of ISQC 1.

The findings are indicative of the weaknesses due to systems and processes that lack maturity. Weaknesses identified also relate to the implementation of the firms' policies and procedures. There have been no instances identified that indicate a lack of allocation of appropriate resources that has resulted in a significant deficiency in the management of audit quality. The firm inspection process has indicated that numerous firms have internal staff and/or external consultants assigned the task of focusing effort on audit quality.

We note below the principle findings of the inspections. We reiterate that not all findings apply to every firm and where they do apply to more than one firm there are inevitably differences in the degree of application.

1. Leadership

Requirement

The firms' leaderships significantly influences the internal culture of the firms and one way to do this is to issue mission statements, strategic plans, newsletters, etc.

Finding

Documented strategic plans have not always been prepared and we were therefore not always able to assess whether there is a fair balance between quality and commercial consideration.

(12 firms)

2. Client acceptance and continuance

Requirement

Firms have to policies and procedures in place to address client acceptance and to guard against engagements that could jeopardise the independence and reputation of the firms. For this to operate efficiently the firms need to be able to communicate to all its offices the existing client base of the firm.

Finding

At a number of firms a consolidated "Prohibited Entities" list does not exist and where such list do exist these are not updated regularly and not monitored for completeness and compliance.

(12 firms)

3. Human Resources

Requirement

In terms of the professional standards, firms should have reasonable assurance that they have sufficient personnel who are capable, competent and are committed to ethical principles.

Record keeping and formalised policies and procedures were found to be lacking for performance evaluation and career advancement. There was particularly evident for partner evaluation and indicative of firm size and human resource department staffing.

Finding

No or inadequate policies and procedures for partner admission, evaluation, performance, discipline, compensation and measurement of effective workload.
(20 firms)

4. Engagement Performance

Requirement

Firms are required by the professional standards to have reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements so that appropriate audit reports are issued. Engagement quality control reviews (EQCR) are required to be performed on certain engagements prior to the signing of the audit opinion.

Engagement inspection findings in planning and completion sections represented by a lack of sufficient and appropriate fraud considerations and ethical and independence considerations. The application of relevant provisions within the accounting standards for asset valuation and impairment were frequently lacking.

Finding

The areas identified on engagement inspections as not having sufficient and appropriate audit evidence documented are:

Engagement letters (23 engagements);

Ethical and independence considerations (23 engagements);

Fraud considerations (19 engagements);

Laws and regulations (17 engagements);

Information systems and internal controls (21 engagements);

Residual value, estimated useful life and componentization considerations of property, plant and equipment (38 engagements);

Income transaction testing (17 engagements);

Going concern considerations (31 engagements);

Management representation letters (47 engagements); and

Disclosure considerations for loans without repayment terms expressed (19 engagements).

Conclusion:

The overall focus of audit firms on audit quality remains sound. Established processes and systems in place evidence the resources being allocated to manage audit quality. We are encouraged by the generally positive attitude displayed by the firms and partners in undertaking to implement corrective action to address inspection findings.

The key areas where improvement is still required include consideration of ethics and confidentiality, consideration of the audit team capabilities and competence and improvement required in performance management processes, the lack of performance and adequacy of the performance of EQCRs, and lack of sufficient documentation relating to the performance of the monitoring function.

Going forward the IRBA encourages the leadership within audit firms to continue the focused and considered approach to managing audit quality.

F: Appreciation

We received full co-operation from the firms' leadership and personnel during the course of the inspections and all information requested by us was submitted to us for inspection. We thank the firms' leadership and personnel for their co-operation during the inspections.

BERNARD PETER AGULHAS
CHIEF EXECUTIVE OFFICER

PAUL VAN HELDEN
DIRECTOR: INSPECTIONS

APPENDIX A

Full firm wide inspections performed:

Advoca Auditing Incorporated
Aitken Lambert Elsworth Incorporated
AM Smith & Co Incorporated
Anderson Rochusson van der Bijl Incorporated
Boake Incorporated
C2M Chartered Accountants Incorporated
Charles Orbach & Company
Certified Master Auditors Incorporated
Enslins Bethlehem Ingelyf
Equifin Incorporated
G L Palmer and Company
Greenwoods CA's and Auditors
Harris Dowden and Fontaine
Khatieb Incorporated
Kwinana & Associates
Loubser du Plessis Incorporated
LDSW Ingelyf
Levendal & Associates Incorporated
Lloyd Viljoen
Mazars
MGI Bass Gordon GHF
Middel and Partners
Moore Stephens SA
Nolands Inc
Nwanda Inc
Rademeyer Wesson
Russel James and Co Inc
Smit Kruger
Tag Incorporated
Tuffias Sandberg KSI
Valentine Sargeant
Watermark Auditors Incorporated

Monitoring and/or engagement inspections only performed:

BDO South Africa
Deloitte & Touche
Ernst & Young
Geyser & du Plessis
Grant Thornton
Horwath Leveton Boner
KPMG Incorporated
Marais & Crowther Ingelyf
Nexia Levitt Kirson
PKF
PricewaterhouseCoopers Incorporated
RSM Betty Dickson
SAB & T Incorporated
SizweNtsalubaGobodo