

Report
of the
Auditor Oversight Commission
on the results of the
inspections
according to § 62b WPO
for the years
2007-2010

Table of Contents

I.	Overview.....	3
II.	Introduction.....	4
III.	Results of the inspections	6
	1. Findings on the system of quality control.....	6
	2. Findings on the performance of audit engagements	8
	2.1 Findings in the context of the financial market and economic crisis.....	8
	2.2 Other findings	10
	3. Consequences resulting from the findings.....	11
IV.	Evaluation of the inspection results	13
V.	Outlook	15

I. Overview

Since 2005 the Auditor Oversight Commission (AOC) has been carrying out public oversight on the Chamber of Public Accountants and the associated auditors independently from the profession and not subject to any instructions. A core area of the AOC's oversight activities refers to the regular inspections according to § 62b WPO (Public Accountant Act) of the auditors of listed entities. The procedure was introduced at the end of 2007 and is subject to the supervision of the AOC. By the end of 2010 at least one inspection had been carried out with all auditors and audit firms ("firms") subject to the procedure. The AOC report on the results of the inspections for the years 2007-2010 is now issued on the occasion of the end of the first three-years inspection cycle.

In general the inspection findings in this period show that there is still room for improvement in terms of the audit quality, according to the AOC.

This particularly applies in view of the auditor's indispensable professional scepticism towards statements made by the audit client. In this respect the inspections showed indications in some cases that the audits had not been conducted with the necessary professional scepticism, especially in the audit fields which were exposed to increased risks in the context of the financial market and economic crisis and consequently required particular professional scepticism on the part of the auditor.

Many findings also occurred in the field of auditing the measurement of the goodwill and other assets as well as auditing accounting estimates. In this respect the inspectors determined in many cases that the auditor had not carried out a sufficient assessment of the applied measurement methods and the underlying assumptions or at least had not comprehensively documented their evaluation. When examining the recoverable amount of the goodwill, objections could frequently be made that the business plans had not recognizably been assessed in terms of their plausibility.

Irrespective of the quality defects revealed by the inspectors, it can be positively determined that the majority of firms act on the findings made by the inspectors and derive quality improving measures from them. The AOC will observe the effectiveness of the initiated quality control measures in subsequent inspections.

In light of the AOC's experience, the inspections performed by an independent public body decisively contribute towards strengthening the credibility and independence and consequently towards the quality of audits.

II. Introduction

Since 2005 the AOC has been carrying out public oversight on the Chamber of Public Accountants and the associated auditors independently from the profession and not subject to any instructions. A focal point of the related oversight work comprises the field of disciplinary oversight and there in particular the procedure of inspections according to § 62b WPO. The AOC report on the results of the inspections for the years 2007-2010 is now issued on the occasion of the end of the first three-year inspection cycle.¹

The procedure of inspections was introduced in Germany upon the Disciplinary Oversight Reform Act coming into force on 6th September 2007. Since then, all auditors of public interest entities (i.e. listed entities in terms of § 264d HGB (German Commercial Code)) have been subject to random inspections without indication for professional misconduct. The predominantly preventative inspections are intended to guarantee a high quality audit of public interest entities and contribute towards strengthening the public's trust in the audit.

The rules of procedure for the inspections are based on the international customary practice for independent inspections in view of the design and methodology of the procedure. For this purpose, the experience acquired while working with the European Group of Auditors' Oversight Bodies (EGAOB) and the International Forum of Independent Audit Regulators (IFIAR) was applied.

In compliance with the European Audit Directive 2006/43/EU, the rules of procedure for inspections provides for auditors of public interest entities that at least one inspection within a period of three years has to be conducted. In the case of firms that have conducted such audits with over 25 relevant clients in a calendar year, the rules of procedure provide for an annual inspection cycle.

¹ In addition the AOC publishes an activity report annually (www.apak-aoc.de).

The total number of inspections prescribed in the reporting period 2007 to 2010 is distributed over the size categories of the firms as follows:

Inspections ordered at:	2007	2008	2009	2010
- large firms (with over 25 public interest clients)	0	2	5	5
- mid-tier firms (with 6 to 25 public interest clients)	1	7	4	4
- small firms (with up to 5 public interest clients)	1	23	37	36
Total number of inspections ordered	2	32	46	45
Total number of firms	148	143	128	119

At the end of the year 2010 the first three-years inspection cycle was concluded, i.e. all firms that had conducted statutory audits of public interest entities had been subject to at least one inspection. Along with the large firms that are subject to an annual inspection, eight firms were already subject to a second inspection in 2010.

The subject matter of the inspections was basically the last audits of a public interest entity conducted by the relevant firm. Essentially audits of annual financial statements and group financial statements for the fiscal years 2006 to 2009 were inspected.

Of the total of around 900 public interest entities in Germany, around 60% of these entities are audited by large firms. Corresponding to the significance of large firms for the annual audit of listed entities, time and personnel resources of the inspection unit are predominantly used to inspect these firms. In this respect, almost half of all audit engagements that have been inspected in 2010 were engagements of large firms.

The inspection scope varies greatly depending on the size and complexity of the respective firm. In the case of large firms along with selected audit engagements, selected areas of the system of quality controls also undergo detailed inspections. In contrast, in the case of small firms the system of quality control is in principle inspected on the basis of the audit engagement that is subjected to the inspection. In the case of mid-tier firms, the inspection

scope is authorized between the inspection scope for small and large firms depending on the individual case.

The focal points of the AOC's activities initially laid in contributing towards establishing the inspection procedure as well as setting up the inspection unit. After completing the development phase, the AOC focused on monitoring the effectiveness of the system, providing active support, planning and conducting the inspections as well as determining the focal points of the inspections. In the years 2009 and 2010, the inspections focused especially on the financial market and economic crisis and the effect on the audit approach as well as the audit procedure.

III. Results of the inspections

1. Findings on the system of quality control

Client acceptance procedure und independence

The assessment of the risks associated with the engagement during the client acceptance and continuing process as well as the measures and systems to ensure the independence of the firm and the personnel entrusted with performing an engagement are subject to each inspection because of their special significance for the trust of the public in the auditor's work.

Large firms must maintain comprehensive systems and internal controls due to the size and international networking of their organizations in order to be able to ensure the adherence to national and international requirements in relation to client acceptance and independence. The following findings (objections) were made:

- conclusive assessment of the client and engagement risk only after submission of the offer to the company to be audited or only after the firm was chosen as annual auditor at the shareholders meeting of the company to be audited
- dispatch of the engagement confirmation letter to the chairman of the supervisory board of the company to be audited only after the start of the audit process
- the completeness and up-to-dateness of the ownership structure of the company to be audited recorded in the systems of the firm, which are necessary in the case of complex group structures to check the independence and to identify possible conflicts of interest, are not consistently guaranteed

- breach of internal firm policies on the possession and disclosure of securities investments and on maintaining data in the systems set up to record corresponding transactions through individual employees
- completeness and correctness of the information in the databases set up for monitoring the obligations for internal rotations not guaranteed for all clients and professionals subject to rotation requirements

The following findings were made with small and mid-tier firms:

- a lack of declarations of independence by the personnel assigned to work on the audit, including assigned specialists
- breaches of the obligation for internal rotation
- quality control policies with regard to the identification of possible conflicts of interest because of other services by network partners to the company to be audited are partly only in development stage

Partner evaluation and remuneration

With the increasing size of a firm and as a consequence the growing number of partners, the question becomes more important as to whether and to what extent the firm ensures that sufficient and appropriate incentives are set to ensure a performance that promotes quality.

The inspections in the area of partner issues referred to questions of how in the partner evaluation systems of the large firms the targets are oriented at the audit quality and how the achievement of targets is measured.

In individual cases it was observed that the partner appointment, assessment and remuneration systems did not provide for any sufficient performance incentives to secure the audit quality. Instead, economic and acquisition aspects were put in the foreground. There was also partly a lack of consistent sanctioning of revealed quality defects.

Education and training

It was observed in the area of education and training – mainly with small firms – that the persons involved in the audit (among others the auditor responsible for the engagement, the engagement control quality reviewer, the individual responsible for the long-form audit report critique or other persons involved in the audit) did not fulfill their professional obligations for professional training or only fulfilled them insufficiently. This particularly referred to training in the field of International Financial Reporting Standards (IFRS).

Engagement quality control review

An engagement quality control review is mandatory in the case of annual audits of public interest entities. During inspections, however, it was repeatedly observed that the required engagement quality control review was not made at suitable points in time during the engagement processing or did not include all audit steps.

Furthermore, there were some indications that the engagement quality control review was not always carried out with sufficient professional due care. In individual cases, the engagement quality control review was also carried out by persons who were themselves involved in conducting the relevant audit.

2. Findings on the performance of audit engagements

2.1 Findings in the context of the financial market and economic crisis

Assessment of the risks of breaches and irregularities (fraud)

It was frequently observed that the necessary interviews with the management, the supervisory bodies and other persons regarding the risk of errors and fraud were either not documented by the auditor or it was apparent from the documentation that merely a formulaic interview not tailored to the company's individual circumstances had taken place.

In many cases the risk that the management may suspend control measures that appear effective was not counteracted with suitable audit procedures. A Journal Entry Test of the entries made in the reporting period and in particular at the end of this period with regard to inappropriate or unusual transactions was not always performed.

Audit of the Going Concern assumption

Repeatedly, no sufficient and appropriate audit procedures were recognizable with regard to the assessment of the forecast procedure and its underlying assumptions which the management had taken as a basis for its positive Going Concern assumption, although the client's economic situation would clearly have required this.

Audit of the measurement of goodwill and other assets as well as review of accounting estimates

In many cases it was observed that the auditor had not performed a sufficient evaluation of the measurement methods applied by the audited company and the underlying significant assumptions and data or at least had not documented their evaluation comprehensibly in the working papers. When checking the recoverable amount of goodwill, it was frequently observed that the business plans had not been recognizably assessed in terms of its plausibility. Furthermore, there was often a lack of a comprehensible assessment of the used discount rate.

In some cases the auditor did not attain sufficient audit evidence in several audited areas on the basis of an insufficient assessment of the business plans (e.g. review of the goodwill, the deferred taxes and financial assets).

Audit of the risk and forecast reporting in the management report

It was discovered in several inspections that the non-compliance with specific principles on reporting in the forecast report (now: opportunity and risk report) stated in the relevant accounting standard (German Accounting Standard, DRS 15) was not taken up by the auditor. Contrary to the standard, a forecast period of at least two years was not taken as a basis for the reporting or a trend statement on the further development of the results and financial situation was omitted.

In some cases it was also observed that clearly recognizable risks were not described or only described insufficiently in the management report.

Reporting on the accounting policies, discretionary powers and grooming transactions as well as on facts impairing developments and threatening existence

Findings in this area often referred to the reporting in the long-form audit report on risks threatening the existence of the company which were in contrast to the risk reporting in the management report of the audited company. In individual cases, auditors' comments on

significant accounting policies as well as on facts impairing the future development of the company and threatening its existence were missing in the audit report.

2.2 Other findings

Risk-based audit approach

The findings with regard to the implementation of a risk-based audit approach showed a considerable range. In some cases there was already a lack of appropriate risk assessment at the beginning of the audit, making it impossible to plan the audit properly.

Other findings referred to the assessment of the company's internal control system. In a series of audits, no assessment was performed of the design of control activities which were relevant for the audit. In other cases, insufficient understanding of the control measures of the company was developed during the assessment of the internal control system. Consequently, essential information on the controls was not documented in the working papers. Likewise, errors occurred in the concluding effectiveness test of the internal controls; among others, insufficient and inappropriate evidence had been obtained for the implementation of the controls by the responsible persons in the audited company, and the scope of random tests was not sufficient to be able to derive a statement on the efficiency of the controls.

In a series of inspected audit engagements, the connection between the risk assessment and the result from the audit of the internal control system on the one hand and the determination of type, scope and time of the substantive audit procedures on the other hand were not comprehensible on the basis of the audit working papers. This was particularly significant in situations where the result of the audit of the internal control system should have led to an extension of the substantive audit procedures in contrast to the original audit planning.

The inspection of substantive audit procedures repeatedly revealed findings with regard to obtaining and evaluating confirmations of balances. Objections were also raised to the fact that the selection, dispatch and response to inquiries were not under the auditor's control, no additional audit evidence in case of a confirmation date deviating from the balance sheet date was obtained and no appropriate alternative audit procedures were performed for unanswered inquiries.

In some cases it was also not comprehensible in the entirety of tests of controls and substantive audit procedures that the auditor had achieved a sufficient appropriate audit evidence in the inspected audit area.

Using the work of another external auditor (component auditor)

It was observed in this area that the group auditor did not always have the component auditor confirm in writing his compliance with independence requirements with regard to the audited company and the group.

Further findings referred to the monitoring of a timely submission of the reports and the appraisal of the essential audit results of component auditors. Sometimes the reporting from component auditors was included in the working papers without the responsible group auditor's own comprehensible assessment of these documents.

In several cases, no statement with regard to the audit of events after the reporting date (subsequent events) was obtained from component auditors near the date of the group auditor's report.

Using the work of experts

The auditor has to assess the objectivity as well as the professional competence of the expert as a prerequisite for using his or her work. It was observed in several cases that this assessment was not documented in the work papers. Moreover, it was not comprehensible in some cases whether the auditor had dealt appropriately and sufficiently with the expert's work and had in particular sufficiently assessed the assumptions and methods used by the expert.

3. Consequences resulting from the findings

If the inspection findings show indications of violations of professional standards, the audit firm is provided with the necessary information by means of a final inspection note. Furthermore, it is decided depending on the circumstances of the individual case whether measures should be taken against the owner of the firm or the responsible professionals to ensure the enforcement of professional standards, in particular whether disciplinary proceedings should be initiated (in the case of minor to medium default) or whether the case should be submitted to professional court procedures (in the case of serious default). At disciplinary proceedings, violations of professional standards can be punished with a

reprimand, depending on the case linked with a fine of up to 50,000 Euros. However, violations of professional standards can also result in advices and instructions.

In the reporting period, the findings from several inspections gave reason to initiate disciplinary proceedings.

	2007	2008	2009	2010	S
Inspections ordered	2	32	46	45	125
Inspections completed	0	16	58	44	118
Inspections completed which led to disciplinary proceedings	0	3 (19 %)	14 (24 %)	12 (27 %)	29 (25 %)

The disciplinary proceedings initiated against individual professionals in the inspected firms, were concluded as follows:

	2007	2008	2009	2010	S
Disciplinary proceedings initiated against individuals	0	10	44	25	79
Results:					
- Reprimand	0	4	13	7	24
<i>of which with fine</i>	0	2	11	2	15
- Instructions	0	4	19	4	27
- Dismissal	0	2	12	0	14
- Pending proceedings	0	0	0	14	14

In some cases fines of up to 30,000 Euros were imposed in connection with reprimands. In one case the concerned professional explained even before the end of the proceeding that he will not carry out statutory audits anymore; he also let expire his certificate of participation in the quality assurance program (peer review), which is a mandatory prerequisite for his appointment as a statutory auditor.

IV. Evaluation of the inspection results

The improvement of the audit quality is a major objective of the AOC. The independent inspections of auditors of public interest entities conducted under the supervision of the AOC are an essential instrument to assess and improve the audit quality. From the point of view of the AOC, the inspection findings show in general that irrespective of the size of the inspected firms there is still room for improving the audit quality.

This particularly applies with regard to the indispensable professional scepticism of the auditor towards statements by the audit client. In accordance with relevant standards, the auditor must plan and perform his audit with a professional scepticism. This means that the auditor cannot readily assume the correctness of the information provided by the representatives of the client just by relying on their credibility. Rather, the auditor must obtain evidence for this information and must assess the persuasiveness of the evidence.

This was especially significant for inspection areas in which increased risks were anticipated on the basis of the effects of the financial market and economic crisis (e.g. audits of accounting estimates, fraud or going concern issues). Especially in these areas there were indications that the audits were not conducted with the necessary professional scepticism.

According to current information so far the majority of firms acted on the findings of the inspections and derived quality improving measures from them. Measures which were initiated by the firms in specific areas of the system of quality control include, e.g.:

- compulsory training for the employees to maintain the knowledge regarding relevant professional standards and internal policies,
- strengthening of the internal controls and the monitoring by the firm management to ensure the quality of the processing of the engagement,
- adaptation of the systems used and implementation of additional IT-based controls,
- stronger focusing of the partner evaluation and target achievement systems on incentives which ensure the audit quality,
- adaptations of the internal policies and guidance for the conduct and documentation of the engagement quality control review.

In one case, comprehensive organizational restructuring was decided upon as a reaction to the inspection findings, which also included a significant strengthening of the position of the quality manager.

With regard to findings on the performance of audit engagements in particular, the following measures were taken:

- information of the audit staff on the findings from the inspection at training events,
- adjusting training events for audit staff in the light of the identified necessity to improve the audit process,
- the consideration of findings on an engagement in the subsequent audit, as well as
- the review of the assignment of responsibilities for certain audit engagements.

In principle the effectiveness of the measures initiated by the firms as a reaction to the inspection findings will be assessed in the subsequent inspection. As far as no annual inspection cycle is applicable, the cycle for inspections of a particular firm may be shortened if necessary. During subsequent inspections it was often observed that deficiencies addressed in the previous inspection had already been remediated.

Only few firms showed an insufficient willingness to take the necessary measures. These firms are being observed particularly closely.

The AOC has observed that since the introduction of the inspections at the end of 2007, recognizable quality improvements have already been achieved in the inspected firms. The AOC believes that the inspection process is a suitable instrument to reveal and remediate quality deficiencies of auditors of listed entities. This was also confirmed by a comparison in 2009 of the respective findings from the independent inspection process on one hand and the quality assurance review according to § 57a WPO (peer review) on the other hand. The AOC was hereby able to determine that the inspections in some cases revealed essential deficiencies in the audit firms' systems of quality control, which were not addressed in the peer reviews. In the opinion of the AOC, the inspections performed under the ultimate responsibility of an independent public body decisively contribute towards strengthening the credibility and independence of the audit.

V. Outlook

The experiences made in the first three years show that with the introduction of the inspections as an instrument of independent public oversight, the right path was taken to improve the audit quality with auditors of listed entities in Germany. The AOC will continue to monitor the effectiveness of the system of the inspections and continue to actively accompany the planning and implementation of the inspections. The AOC will thereby ensure that the personnel and time resources of the inspection unit is mainly used for the inspections of large firms due to their large number of audit clients with high market capitalization as well as important clients in the area of banking and insurance companies.

The AOC has determined the following focal points for inspections in 2011:

- Audits of financial institutes
- Audit approach with regard to the management report including the opportunity and risk report as well as the presentation of significant prospective assumptions and major sources of estimation uncertainties
- Compliance with independence requirements in the area of audit and consultancy

The AOC will continue to carefully observe how audit firms react to the identified deficiencies in the course of subsequent inspections.

Berlin, 6th April 2011

A handwritten signature in blue ink, appearing to read 'Volker Röhrich', is written over a vertical line that serves as a separator between the signature and the name below.

Dr. h.c. Volker Röhrich
(Chairman of the Auditor Oversight Commission)