



AQRB

Audit Quality Review Board Limited

Second Report on the Quality of Audits Performed
by Participating Auditors of Public Interest Entities

May 2008

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Chairman's Foreword

In the last year Australian investors have been exposed to a large number of serious losses by ASX listed companies. This has happened notwithstanding the measures taken by successive governments in recent years to improve financial reporting and corporate governance. These measures included improving and securing compliance with auditing standards which were given the force of law. Self evidently this is insufficient in itself to avoid new and disastrous corporate failure.

There is a continuing public perception that auditors are failing to meet the standards expected of them by the corporate sector and the investing public. However, by AQRB assisting the public to gain a better understanding of the audit process it may be that some narrowing of the oft quoted "expectation gap" may be achieved.

The question has been put whether the perceived failure lies in auditing standards, auditing practice or other features of corporate governance. For any appropriate assessment of this question it is necessary to have a proper understanding of the nature of the audit process and the manner of its implementation.

AQRB plays a significant role in assisting in this understanding. AQRB's function, currently involving the four largest accounting firms, is to inspect and make recommendations for changes and improvements to the quality assurance processes by which accounting firms ensure their compliance with auditing standards and related applicable legislation. The ultimate purpose of course is the enhancement of the audit process and effectiveness of the firms' audits.

Globalisation of auditing standards

Globalisation of capital markets has been a catalyst for a global perspective to accounting standards and now also to audit and independence standards. The Global Public Policy Symposiums held in Paris in November 2006 and New York in January 2008 focussed on this need and the report from the CEOs of the world's six largest audit and accounting firms arising from the New York meeting deals with it at some length. The near-universal support expressed for moving towards the global adoption of a single set of high-quality global accounting standards was noted. Support was also expressed, albeit with somewhat less passion, for more consistent audit and independence standards, and to a certain extent regulatory oversight across the borders

One of the driving forces for this global perspective to auditing standards and regulation is the need of global investors to have confidence that the rules applying in their home market also apply to overseas markets. Another and no less important driver relates to efficiency. Differing standards and regulations create immense difficulties for global service providers. They may have to comply with one set of rules in their home market but also comply with subtly or not so subtly different rules for international clients. They may also be subject to oversight and visitation by regulators from different countries who have different review and reporting criteria. This is one of the principal issues on the agenda of the International Forum of Independent Audit Regulators.

In pursuing its objectives AQRB is cognisant of these international developments and seeks to ensure that its review activities coordinate well, both as to timing and scope, with those of the firms' own monitoring processes, ASIC, FRC and the professional bodies. This coordination is sought to be achieved by regular consultation and, in the case of the professional bodies, a formal Memorandum of Understanding.

Notwithstanding considerable effort at coordination the fact is that the firms may still be subject to a multiplicity of inspections each year. This is costly, wasteful and generally not in accordance with best practice. There is ample room for elimination of duplication.

Emphasis on Compliance; the "Force of Law" Auditing Standards

Auditors have always considered themselves to be members of a profession which pursued its calling in accordance with the highest business and ethical principles. Historically, the profession was buttressed by a self-regulatory system which set out standards of practice in the form of auditing and ethical standards. The audit profession was largely driven by reputational risk (damage to the good name of the profession as well as its individual participants) to assure compliance with these auditing and ethical standards. The professional accounting bodies and their disciplinary processes stood behind this compliance.

Today, with auditing standards having the force of law, an additional consideration has been created for audit firms. They may now be subject to criminal and civil penalties for non-compliance with those auditing standards. Of course, such legal action in itself may further damage their professional reputation but the introduction of this legal risk may have contributed to the move by audit firms to emphasise compliance with auditing standards. AQRB would be concerned if this were at the expense of the application of audit judgement and has expressed its concern in both this and its individual reports to the audit firms on any move to "checklist" style auditing.

This concern is similar to that expressed by the authors of *"Indecent Exposure: Gilding the Corporate Lily"*, professors Frank Clarke and Graeme Dean. They have noted the need for less governance and for a shift from rules-based to principles-based regulations. Undoubtedly, in a more principles based regime, audit judgement based on professional training, experience and skill is correctly more highly regarded than ticking-off compliance with a multitude of regulations.

Risk Management

Well designed and efficiently operating risk management systems, incorporating as they must the highest quality audits, are the most effective means that audit firms have at their disposal to manage their legal exposure and reduce the incidence of potential legal action flowing from alleged audit negligence. In this regard they complement the advances that have occurred in Australia in the laws governing professional negligence, principally the ability of firms to incorporate, the recognition of proportionate liability and the professional standards legislation¹.

¹ The Professional Standard Schemes by which audit firms are regulated under the Professional Standards Legislation require that they have properly functioning risk management systems.

One of the most significant, if not the most significant, matter AQRB focussed on this year was the process by which firms assessed the risk to them in accepting or continuing with an engagement and, in the event that the engagement was continued, planned the additional audit steps and resources needed to deal with high risk situations. Typically this process involves not only the engagement partner but also a designated review partner and, in cases of perceived heightened risk, other specialist risk management professionals.

AQRB sees risk assessment in this context as something more than just the inherent accounting and audit risks in the engagement. It is wider and covers the risk to the firm of being involved in future financial scandals like those that have been so damaging in the past and have caused the aforementioned additional regulatory intervention. The significance of this issue for AQRB is illustrated by the decision this year to extend the scope of its reviews beyond that of listed companies to encompass other "public interest entities" such as superannuation funds, investment schemes and unlisted borrowing corporations where large sums of public monies are invested.

Proposal to Improve Company Reporting

In recent months we have witnessed the failure or near failure of a number of companies as a result of the increased costs of borrowing or drying up of traditional funding avenues.

The dismay of creditors, debenture holders and shareholders when companies fail is understandable. They frequently point to the fact that companies' continuous and periodic reporting has not properly alerted them to the risk of failure. It is beyond the scope of this report to seek to solve this problem. However, AQRB does make one suggestion which may be of some assistance.

Companies' financial reports record the results of their businesses to balance date but they do not provide forward looking statements; they do not attempt to forecast the future.

AQRB believes that the current directors report disclosure requirements about the future prospects of the company are frequently too general in nature and, having regard to the exemption provided (and most frequently availed of) by section 299(3) of the Corporations Act, are usually of little help in assessing the future prospects of the company. AQRB suggests that the Corporations Act should be amended to require the directors to report on what they assess to be the company's most significant business risks in respect to its future financial operations. The report should specify what action the company has taken to manage and mitigate those risks. AQRB notes that some companies do already report this sort of information, usually in a document entitled "Review of Operations" or similar.

In addition to listed entities, such information should be required by other public interest entities such as disclosing entities and registered schemes, and large proprietary companies, since the failure of certain of these types of entities has led to a large number of investor losses in 2006 and 2007.

AQRB's role and process

The AQRB role (as an independent body funded by audit firms) is to monitor the process by which audit firms seek to ensure their compliance with audit standards and legal obligations relating to independence and audit quality. AQRB's overarching commitment in examining, assessing and reporting on audit firms' quality assurance processes is to contribute to the improvement in audit quality. It is not AQRB's role to monitor compliance with auditing and accounting standards so as to initiate action on discovery of any non-compliance. To that extent it is distinguished from other organisations with similar monitoring roles such as the professional accounting bodies and ASIC in that its sole commitment is to improve audit quality. The policies, processes and systems that AQRB inspects as part of its review programmes are examined purely in pursuance of its stated mission. AQRB's objectives are of substantial importance to a well functioning and fully informed market.

Whilst it is for others to judge to what extent AQRB has been successful in meeting the objectives which informed its establishment, the directors believe that the recommendations and suggestions set out in its confidential reports to the firms together with those that follow in this report are an appropriate discharge of AQRB's aims and purposes.

AQRB has a transparent process (www.aqrb.org.au) which requires each firm to set out its policies, processes and systems describing how it seeks to comply with its legal and professional requirements and how AQRB goes about reviewing and assessing these representations. This transparency is a unique insight into the processes of the audit firms. It is a significant component of the firms' commitment to openness as part of a policy of promoting public confidence in their auditing practices.

Prof. The Hon Andrew Rogers, QC

May 2008

Overview

Overall Conclusion on Firms' Quality Controls

AQRB has concluded that all four firms have established policies and procedures in Australia that are designed to enable them to complete effective audits within the framework of current Australian legal and professional requirements.

As a result of its 2007 review, AQRB has found no reason to believe that the firms' Quality Control Reports (which can be viewed at www.aqrb.org.au) do not reflect, in all material respects, practice within the firms.

Structure and Role of AQRB

AQRB is a 'not for profit' independent company, funded by participating firms' fees, which aims, with respect to audits of public interest entities:

- to enhance the **credibility and integrity** of the Australian auditing framework
- to contribute to the **continual improvement** of auditing in Australia; and
- to be open to **public scrutiny** having clear objectives and transparent procedures.

The board of AQRB consists of up to 10 individuals with broad knowledge and experience in legal, regulatory, business and auditing affairs. A number of board members who are originally from the audit profession provide the experience and professional expertise necessary to carry out reviews. However, they are not permitted to carry out reviews of the firms in which they formerly practiced. Also, in order to maintain independence, the majority of the board members (including the Chairman) must be persons who have never been practicing accountants.

St James Ethics Centre is the inaugural member of AQRB and oversees the ethical stewardship and adequacy of funding of the company. St James Ethics Centre is particularly well suited for this role as it is a fully independent, not-for-profit organisation which provides a non-judgemental forum for the promotion and exploration of ethics. AQRB's annual budgets are submitted to St James for their approval and they have provided advice regarding the adequacy of funding to enable AQRB to fulfill its objectives.

Perpetual Ltd administers AQRB's funds.

This structure and the board composition provide interested parties with a guarantee of the independence of AQRB in the pursuit of its objectives. AQRB's chairman is a former Chief Judge of the Commercial Division of the Supreme Court of NSW, another director is a former Attorney General of Australia and a third is a former Chairman of ASIC. Other directors have high reputations for personal integrity and professional independence in thought and action. It would be an offensive and inaccurate generalisation were it to be suggested that people of this standing lack the appropriate degree of independence.

AQRB's role is to review, assess and report on quality assurance processes by which participating audit firms seek to ensure their compliance with independence and audit quality related professional standards and legal obligations in respect of financial statement audits of public interest entities in Australia.

Participation is voluntary and available to all Australian auditors of public interest entities. The four largest accounting firms have all agreed to be involved from the outset.

A description of the structure, role and review processes of AQRB including its relationship to the Australian Securities and Investments Commission ("ASIC"), the Institute of Chartered Accountants in Australia ("ICAA") and CPA Australia ("CPAA") is available on the AQRB website at www.aqrb.org.au

This Report

The purpose of this report is to give an overview of the matters which AQRB noted in the course of the 2007 review of the quality control processes of Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers ("the big four"). These four firms collectively audit approximately 88% by composition and 96% by market capitalisation of the 300 largest entities listed on the Australian Securities Exchange.

The report commences with certain observations that AQRB considers particularly relevant to the audit process at this time. Thereafter, the key findings from the review are presented and generally follow the same order and have the same titles as used in the auditing standard which deals with audit quality (ASA 220 "Quality Control for Audits of Historical Financial Information").

Not all of the matters referred to in this report apply to every firm and, where they do, the degree of relevance to each firm may vary. Where matters only apply to some or one of the firms this is made clear and where this distinction is not made the matter has general relevance to all four firms.

Applicable Legislation

Auditors must comply with the requirements of a substantial body of legislation, professional standards and professional regulations. In regard to quality control processes and procedures, including those concerning independence, the most significant of these are:

- The Corporations Act 2001 (as amended by The Corporations Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 ("CLERP 9") and the Corporations Legislations Amendment (Simpler Regulatory System) Act);
- APES 320: Quality Control for Firms²;
- Parts A and B of APES 110: Code of Ethics for Professional Accountants¹; and
- Auditing Standard ASA 220: Quality Control for Audits of Historical Financial Information³.

² Issued by the Australian Accounting Professional and Ethical Standards Board.

³ Issued by the Australian Auditing and Assurance Standards Board

The auditor independence provisions of CLERP 9 generally applied as of 1 July 2004. APES 320 and 110, which replaced Miscellaneous Professional Statement APS 5 and Code of Professional Conduct F1 respectively, applied from 1 July 2006. ASA 220, which replaced Auditing Standard AUS 206, applied to financial reporting periods commencing on or after 1 July 2006.

Review Scope

In 2006, five publicly listed company audit files were examined for each firm. This year the scope of the review was expanded beyond that of publicly listed entities to encompass other public interest entities, defined by AQRB as listed entities, unlisted disclosing entities, APRA regulated bodies and large proprietary companies (as defined in the Corporations Act). This increase in scope necessarily entailed an increase in the number of audit files reviewed from five to between eighteen and twenty for each firm.

Key Findings and Observations

Fraud and Error – Risk Assessment

The continuing evidence of high-level company fraud requires auditors to be constantly alert to evidence of malpractice. This requires the diligent exercise of professional judgement and challenging enquiry. AQRB considers it would be detrimental if firms placed undue reliance on the completion of compliance checklists.

In the last two decades there have been a number of high profile company failures where senior management (including directors in some cases) has in various ways either misappropriated company funds for its own use or misstated company results. This has invariably resulted in severe detriment (loss) to investors, both big and small, and it is proper that auditing standards should direct auditors to be alert to the possibility of such misappropriations or misstatements.

Client risk issues should be constantly challenged by the professional auditor particularly in the context of whether an audit relationship with a client should be continued where factors such as management integrity, pressures to show good performance arising from market expectations or aggressive performance based remuneration policies, the presence of significant related party transactions or the propensity to take legal and regulatory issues lightly, all fall for consideration. These factors can in some cases become the seeds of later malpractice that is detrimental to both investors and in consequence to the reputation of the auditor, and therefore should raise the level of scepticism and challenging inquiry of the auditor. All four firms to a greater or lesser extent have processes for considering such issues as part of the client acceptance and continuance process.

Australian Auditing Standard ASA 240 *“The Auditor’s Responsibility to Consider Fraud in an Audit of a Financial Report”* requires auditors to consider fraud issues during the audit of a financial report. Fraud is a legal concept from the criminal law and in common parlance tends to be viewed as akin to theft. The standard however requires auditors to consider wider concepts such as intentional misstatements and deception. AQRB noted in the course of the 2007 review that each firm has a checklist to aid these considerations and that most of these checklists are very long in content.

Reference is made elsewhere in this report to AQRB’s concern that checklists should not be allowed to create a “box ticking” mentality which becomes an end in itself and could therefore deflect an auditor from challenging inquiry and the proper exercise of professional judgement.

As part of its 2007 review programme AQRB selected application of the requirements of ASA 240 as an area of focus. This is a relatively new auditing standard and AQRB had noted from the reports of overseas review boards that they had observed some significant deficiencies in applying their equivalent standard.

In a number of instances:

- Documentation of consideration of fraud was merely by checking off items on standard audit programs and checklists;
- There was failure to comply with requirements regarding “brainstorming sessions”;
- Enquiries made about fraud risk within the audit client were not always extended into the operational areas of the company or with those charged with governance; and
- At times the procedures were carried out by relatively junior members of the engagement team when they should have been carried out at a more senior level.

The nature of the matters observed by overseas review boards (the Public Company Accounting Oversight Board in the USA and the Canadian Public Accountability Board) were remarkably similar to those noted by AQRB.

AQRB takes the view that it would indeed be unfortunate if the pre-occupation with long fraud checklists was coincidentally to narrow, dilute or remove the focus on wider client risk issues. AQRB has made recommendations to the firms in respect of these matters and notes that there was already recognition by some firms that their procedures needed to change, in particular to better integrate the processes designed to meet the requirements of the fraud standard with other existing audit processes, including those directed to client acceptance and continuance.

Resignation of Auditors

The Corporations Act requirement that ASIC must consent to an auditor's resignation may be causing unintended consequences since the nature of the retiring auditor's concerns about the company may not be communicated to the prospective auditor or others. It may also place the incumbent auditor in a position of contravention of auditing standards regarding independence where the auditee's capacity to pay professional fees is impaired. AQRB questions whether this is to the benefit of investors and suggests that the UK and USA practice whereby an auditor may resign during the course of an audit may be a better model for Australia.

The Code of Ethics for Professional Accountants ("APES 110") requires a member in public practice to consider whether accepting appointment as auditor to an entity would create any threats to compliance with the fundamental principles of the Code. Where it is not possible for the auditor to reduce the threats to an acceptable level, they should decline to accept the appointment. Similarly, in regard to an existing appointment, where a conflict of interest poses a threat to one or more of the fundamental principles, including objectivity, confidentiality or professional behaviour, the auditor should conclude that resignation from the engagement is the only sensible approach.

AQRB noted during the course of its 2007 review that firms may be precluded from complying with these requirements because ASIC declines to accept their resignation⁴. Section 329(5) of the Corporations Act provides that an auditor may resign from a company provided the auditor has applied to ASIC to do so and ASIC has given its approval to the auditor to resign⁵. This legal requirement is believed to be uniquely Australian as auditors in other countries, notably the USA and the UK, may resign during the course of an audit without regulatory approval. Furthermore, the fact that an auditor may be obliged to continue in office even when a conflict of interest may exist and their independence is consequently impaired is, as APES 110 makes clear, an untenable situation and one where the auditor's judgement may be questioned. Were Australia to adopt the rules which apply to auditor resignation in countries such as the UK and USA, whereby the auditor may resign during the course of an audit, this untenable situation would be avoided.

AQRB observed that audit resignation requests to ASIC were frequently declined⁶ and the auditor was therefore required to complete the current year's audit. At the completion of the current audit and prior to the annual general meeting, the auditor may advise the company that they wish to resign so that a replacement auditor, assuming one was willing to accept appointment, could be approved by shareholders at the annual general meeting.

⁴ The policies and principles which influence ASIC in the exercise of the power conferred on it by S329 (6) of the Corporations Act are set out in ASIC Regulatory Guide 26 Resignation of Auditors.

⁵ Such consent is not required for exempt proprietary companies.

⁶ This included instances where section 311 notices (a mandatory reporting requirement of the auditor where the auditor has reason to believe there have been breaches of the Act by the company or its officers) have been lodged by the auditor with ASIC particularly in respect to solvency issues and continued trading by the respective entity. The result is that the incumbent auditor is required to complete the audit with little or no prospect of being paid, itself a breach of the independence requirements of APES 110.

When the existing auditor applies to ASIC for permission to resign, the auditor is required to lodge a statement in writing to ASIC giving reasons for their request, pursuant to section 329(5) of the Act. The statements contained in the auditor's application to ASIC are, per section 329(7) of the Act, privileged statements, and ASIC is not permitted to make such information available to any other persons, including any proposed new auditor, the company's shareholders or creditors. If ASIC refuses the request from the existing auditor, the application lapses and the information given by the auditor to ASIC remains confidential to ASIC. ASIC may choose to take action on the information provided to it, but such action is independent from the actions of the auditor.

APES 110 provides guidance to both the prospective auditor and the current auditor on what information may be exchanged between them prior to the prospective auditor accepting nomination to the role. Clauses 210.10 to 210.18.1 detail the procedures which must be followed by both the retiring auditor and the prospective auditor. Clause 210.12 refers to the duty of confidentiality of the retiring auditor in respect to responding to requests from third parties for information in relation to the company. Clause 210.13 provides that *"an existing accountant (auditor) should not ordinarily volunteer information about the client's affairs"*. Consequently, based on legal advice, particularly in respect to defamation or potential commercial loss, retiring auditors typically respond to the communications from prospective new auditors in formal but uninformative language.

AQRB believes the provisions of the Act and professional standards, taken together, have unfortunate consequences since the nature of the retiring auditor's concerns about the company may not be communicated to the prospective auditor before appointment to the role. It is also notable that whilst the existing auditor has qualified privilege to advise the regulator of his concerns there is arguably no such privilege available for communications to investors. AQRB also questions whether this is an appropriate method of protecting the interests of the investing public.

AQRB suggests this matter may be partially remedied by legal immunity being made available to the retiring auditor, ASIC and the incoming auditor in respect to communications or statements made by any of them pertaining to the request for permission to resign from an audit.

Auditor Rotation

The Corporations Act requires lead auditors and review auditors to retire (“rotate off”) the audit of a listed entity after five years. Auditing standards require that an Engagement Quality Control Review (“EQCR”) partner be appointed for all audits of listed entities. It is not clear whether the requirements of the Corporations Act regarding review auditors are intended to apply to all EQCR partners appointed in accordance with auditing standards.

However, Accounting Professional and Ethical Standard APES 320 states that, in respect of the audit of listed entities, the lead engagement partner, the audit review partner (if any) and the engagement quality control reviewer should be rotated after serving in any of these capacities, or a combination thereof, for a pre-defined period, no longer than five financial years within a seven year period.

Applying the rotation rules to EQCR partners, given that they ordinarily need to have industry knowledge in order to perform the role, limits the pool of such knowledgeable partners to take over the lead auditor role and may create practice management difficulties for audit firms.

There are practical reasons not to apply the rotation rules to EQCR partners.

The purpose of preventing those carrying responsibility for the audit from serving too long in that capacity is primarily to avoid the development of close relationships with senior client management, because it is perceived that such close relationships may inhibit the objectivity of the auditor in the formation of key audit judgements. It is not an aim of the auditor rotation requirements that auditors should be prevented from becoming too familiar with the business of the client and the issues inherent in the audit. Indeed, most would consider that a sound understanding of the client and its issues is an essential foundation for a good audit. This is not to deny the benefit at some stage of a “fresh pair of eyes” on an engagement. It is therefore important to ensure that the rules designed to prevent over familiarity with client management do not inadvertently result in a loss of essential knowledge and understanding of the client’s business and related audit issues.

Section 324AF of the Corporations Act defines the role of the lead auditor as the “registered company auditor who is primarily responsible to the audit firm or audit company for the conduct of the audit.” The review auditor is defined as the “*registered company auditor (if any) who is primarily responsible to the individual auditor, the audit firm or the audit company for reviewing the conduct of the audit.*” Section 324DA of the Act requires that individuals who have played a “significant role” in the audit of a listed company for five successive years may not play a significant role in a later financial year until the expiry of a further two years (“the 5 year rotation rule”). A significant role is defined under section 9 of the Act to include a lead auditor or review auditor.

Paragraph 60 of APES 320 requires that an assurance practice’s policies and procedures shall require an Engagement Quality Control Review for all audits of financial statements of listed entities. Paragraph 40 of ASA 220 requires that for audits of financial reports of listed entities the engagement partner shall determine that an engagement quality control reviewer has been appointed.

APES 320 states (paragraphs 290.154 to 157) that using the same:

- lead engagement partner, or
- audit review partner (if any), or
- engagement quality control reviewer

on an audit over a prolonged period may create a familiarity threat. Accordingly in respect of the financial statement audit of listed entities it requires that the lead engagement partner, the audit review partner (if any) and the engagement quality control reviewer be rotated after serving in any of these capacities, or a combination thereof, for a pre-defined period, no longer than five financial years within a seven year period.

The complexity of many listed companies obliges audit firms to deploy additional specialist partners on these audits so as to both enhance their quality and provide assurance that there is proper consideration and audit response to the engagement's specific risks. One such additional specialist partner is ordinarily the EQCR who, while not part of the engagement team, must review key features of the audit as a quality control procedure. An EQCR partner may have industry expertise and, having regard to the complexities of the particular audits, need to delve into particular features of the audit to understand certain issues and to fully satisfy the quality control role expected of them. These additional quality inputs to audits are welcomed by AQRB.

The audit rotation provisions of section 324AF and 9 of the Act and APES 110 are creating practice management difficulties for the profession, particularly in respect to the use of partners on an audit other than the lead (signing) partner. AQRB has noted that some firms have been structuring and limiting the roles of specialist partners in an endeavour to limit their roles so as not to "play a significant role in the audit". This enables these industry-knowledgeable partners to avoid the rotation requirements and thus be eligible at a later stage to assume the role of lead auditor or to continue in a consultative role on the audit. AQRB believes this, perhaps unintended, consequence of section 324DA is not contributing to the quality of audits and should be corrected.

AQRB notes that APES 320, paragraph 70 requires that, apart from fulfilling the review role, the EQCR partner "*Does not otherwise participate in the engagement during the period of review*" and "*Is not subject to other considerations that would threaten the reviewer's objectivity*". Whilst there is no requirement that the EQCR should not have contact with the audit client, it may be desirable that paragraph 70 of APES 320 be amplified, to clarify that there may be very limited occasions where the EQCR partner contact with the client is permissible and desirable. Such a clarification would provide further support to AQRB's opinion that the existing APES 320 requirements, but not APES 110, favour the view that the EQCR partner should not be subject to the rotation requirements of the Act.

AQRB believes that section 324DA of the Act and APES 110 should be amended so that the rotation requirements in that section are limited to the lead (signing) partner and any other partner who takes significant decisions, makes significant audit judgement or has management responsibility for the audit. This would encourage audit firms to utilise other partners with industry expertise in advisory and EQCR roles on the audit, uninhibited by the threat of having them subject to audit rotation provided they continued to not take significant decisions, make significant audit judgement or have management responsibility for the audit

Checklists Should Be an Aid to Professional Judgement Not Supplant It

Extensive use of checklists has the risk of creating a “box ticking” mentality with consequent loss of critical audit judgement.

A high quality audit is not achieved only by compliance with regulations and professional standards. Intelligent and challenging inquiry, scepticism, the exercise of professional judgement and the fortitude to stand one’s ground are essential ingredients of the audit process. A firm aiming to deliver high quality audits must therefore seek to develop these attributes in its people.

AQRB recognises that the increased use of checklists is to some extent as a result of the need to improve audit documentation to comply with the evidence requirements imposed by legally backed auditing standards. AQRB is, however, concerned that this focus on compliance may lead to ever more checklists in response to the increased volume of regulations and standards. There is a risk that “box ticking” can become almost an end in itself and can deflect an auditor from challenging inquiry and the proper exercise of professional judgement.

If auditing were to develop in this mechanistic way, there could be adverse consequences, not only for the quality of audits, but also for the appeal of auditing as a career for persons of intellectual vitality and rigour. This would be unfortunate, since the conduct of an audit of a modern business entity requires a capacity to understand and deal with complex issues and to make difficult judgements, often under pressure.

None of this discussion should be taken to indicate that there should be no such checklists. But some of them are very long in content and run the risk of gaining an aura beyond their utility.

An effective checklist might well be a brief one.

Specialist Advice

The increasing complexity of audits, particularly the audit of the ever-evolving types of credit and equity instruments, requires auditors to place reliance on specialists for assistance in the valuation process.

In some circumstances the complexities of an audit require the auditor to call on another specialist(s), either within the firm or from an external organisation, to provide the expertise required to audit particular transactions or balances. For example, an audit firm might have a report from an international affiliate on operations of the client in that geographic area, there may be property valuation reports from experts or there may be valuation reports from actuaries on insurance liabilities.

One area that was of particular interest to AQRB concerns valuation reports on complex financial instruments such as the value of international trusts, hedge funds and other alternative investments. These are valuations where the make up and value of the underlying assets and liabilities may be somewhat subjective. The audit firm may receive confirmatory reports from international financial institutions that claim expertise in this field of valuation and that might also have some guardianship over the funds concerned. Whilst the valuation may be compared to that of a property valuation, the basis and methods of valuation are far less transparent than the valuation of real estate and considerably more volatile. Accounting standards will ordinarily require that the investments be valued at 'market value' with all the uncertainties and estimations that this may entail.

Investors and regulators will continue to expect auditors to have the competence, or be able to draw on others with the competence, to audit these valuations. As noted, the auditor may have to rely on another financial firm which in turn might be relying on someone else to perform this function.

AQRB notes that auditing standards require that the auditor shall not see the mere obtaining of the expert's report as an end in itself. Paragraph 39 of ASA 545 "*Auditing Fair Value Measurements and Disclosures*" requires the auditor to assess the appropriateness of the expert's work as audit evidence. ASA 545 also requires the auditor ordinarily to obtain an understanding of the significant assumptions and methods used, and consider whether they are appropriate, complete and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures. In other words, the auditor must still exercise professional judgement in respect of both the reports and the potential impact on the business of the underlying issues involved.

AQRB believes it is important to draw attention to this issue in view of the continued growth in the number and types of complex financial instruments and the valuation issues they create. In doing so AQRB is in no way criticising the policies and procedures that the audit firms adopt in this regard. Indeed from the limited number of files inspected in 2007 where such complex financial instruments were held by the audit client, it seemed to AQRB that an appropriate audit approach was adopted.

Leadership and Values

The leaders of all the firms, in their internal communications to partners and staff, continue to emphasize that audit quality is of paramount importance. This message is frequently coupled with a reminder that the firms' reputation is its biggest asset and relies to a substantial extent on this concept of commitment to quality.

AQRB has seen evidence that firm leaders are prepared to take decisive and strong disciplinary action whenever there is evidence of quality shortcomings.

The leadership of each firm has committed substantial resources and senior people to responsible and time-consuming roles in the areas of quality, risk and legal regulation. These functions are also supported by significant staff resources below partner level.

Policies and Systems

AQRB noted in its 2006 report that all firms have invested heavily to establish policies, systems and procedures to ensure compliance with new legislation and audit standards but that at some firms these new tools and systems suffered from a lack of integration resulting in some lack of utility.

Upgrading of existing systems and introduction of new online systems continued in 2007. At some firms the roll out and functional testing of these systems is ongoing, as is the process of obtaining optimum benefit from the information they are capable of providing.

In AQRB's view it is likely that all firms will continue to need to upgrade existing systems and, in some cases, introduce new systems to meet the ongoing challenges of new standards and legislation.

AQRB remains impressed with the clear commitment of all firms to the development of systems and automated tools to facilitate their compliance requirements.

Independence and Threats to Independence

AQRB noted in its 2006 report that no other areas of the firms' activities have received more attention, from both internal monitoring programmes and regulators' reviews, than their processes for ensuring that they remain properly independent of their audit clients in compliance with the law and auditing standards.

The firms take a pro-active approach towards independence. All firms require general independence confirmations at the start of employment, and then at least annually, for all professional staff; partners and senior professional staff must also disclose, on an ongoing basis, their investments on an inter-active database. These monitoring processes, which typically also include the audit of a random selection of independence declarations, on occasions detect that there have been independence breaches and these are dealt with by the firm according to their seriousness. AQRB observed that although some firms had a disappointingly high number of breaches in the current period, these were generally minor in nature, only

entailed a breach of the firm's own (more stringent) policies rather than legislative requirements and were appropriately responded to by the firm. Compliance with independence rules are taken to account in performance assessments for senior levels and serious breaches can attract financial penalties.

Three of the four firms require that all staff on a particular audit engagement make a comprehensive independence declaration in respect of that client, normally at the commencement of the engagement. The fourth firm relies on its systems, continual staff independence reporting requirements and annual independence declarations to provide it with assurance on the required independence of staff on each engagement.

All firms maintain comprehensive, normally global, client databases so as to enable monitoring processes both in respect of permissible investments and non-audit services. AQRB views these as very active, reasonably resourced monitoring schemes.

Human Resources and Professional Development

All firms have extensive human resource and professional development policies and procedures. A substantial investment of time and money is made in this area and there is no doubt of the firms' genuine commitment to the development and training of their people. The large accounting firms feature creditably in the published list of desirable employers and some of them have also received accolades for their commitment to the advancement of women in the profession.

A noticeable improvement in the training monitoring programmes, whereby attendance is tracked to ensure all personnel meet core training requirements, was noted at some firms. An improvement in performance evaluation systems, in particular their further emphasis on audit quality as a key element of evaluated performance, was also noted at some firms.

AQRB made few comments to the firms in regard to this area and none of these comments were substantive.

Client Acceptance and Continuance

All firms have effective policies dealing with the procedures which must be followed prior to acceptance or continuance of client relationships and specific audit engagements and the documentation of conclusions reached in this regard.

Typically these policies require that certain specific processes and enquiries be made to determine whether the firm should not accept the client or engagement, normally because of the unacceptable risks that may be associated with accepting the client or engagement. If the firm does decide that the risks of accepting or continuing with the relationship are acceptable these processes enable a determination of what resources should be employed on the engagement to manage the residual (acceptable) risks appropriately. Each firm has a process to categorise its engagements across the spectrum of perceived risk and its policies determine what additional resources and processes shall be applied to "higher" risk engagements.

AQRB believes that the firms' policies are comprehensive and provide an excellent basis for risk evaluation and employment of resources and, where needed, additional resources and processes. However, AQRB noted at some firms that the policies are not always well applied and the reasoning behind the policies may not always be well understood. Documentation of acceptance and continuance processes, particularly on the audit files of clients classified as higher risk, is not in some cases, in AQRB's view, adequate even though enquiry of the audit team members normally showed that they fully appreciated the heightened risk and had reacted appropriately. AQRB also had a concern with the timing of the acceptance and continuance processes on some of the files examined. In these cases, whilst the actual process may have occurred earlier, the documentation reflected a date sometime after the commencement of audit activity. In AQRB's view it is important that the process be concluded before commencement of any audit activity and that the documentation should reflect this.

Engagement Quality Control Review (EQCR)

AQRB continues to believe that the role of the EQCR partner is a most important element of quality control for listed company audits. Accordingly, this year's review again focused on EQCR policies and how each firm applied those policies in practice.

In a number of files reviewed the time records indicated that relatively little time was charged by the EQCR partner and AQRB formed the view that, if the time record accurately reflected the actual time spent, this was inadequate for a proper review to have been conducted. These time records, and the evidence available from the audit files, further indicated that the EQCR partner was not involved throughout the conduct of the audit, as required by the auditing standard, but merely completed the review at or close to the audit conclusion.

In respect of two of the firms, documentation of the review performed by the EQCR partner was typically limited to sign-off of a tailored programme thus making it difficult for AQRB or any other file reviewer to understand the full extent of the work performed. Most importantly it was not possible to establish which if any of the critical documents in the audit file, particularly those dealing with key judgement matters, had been examined by the EQCR partner.

In AQRB's view proper documentation of the processes followed by the EQCR, recording of what evidence has been examined and how judgements have been formed is essential to enable the firm's monitoring programme reviewers to form a view on the adequacy of the EQCR. AQRB has expressed to the firms its belief that EQCR partners should be held more accountable through the monitoring processes and that this should be reflected through the performance management system.

Given the importance that AQRB ascribes to the EQCR role, particularly in respect of higher risk and complex clients, AQRB has reported to the relevant firms that these shortcomings are considered to be matters to which urgent attention should be paid.

Monitoring Programmes

Each firm has its own programme to test compliance with its quality control systems and processes. AQRB observed that the firms make a large time and financial investment in their annual monitoring programmes.

AQRB noted that these programmes are the product of the firms' many years of global experience and therefore it is to be expected that they would be comprehensive in their coverage. Indeed the very extensive nature of the programmes has to be guarded against to avoid the "checklist mentality" to which reference has been made earlier. AQRB's review of audit files encompassed a consideration of the effectiveness of these monitoring programmes, in particular the extent to which it appears that their findings impact on the firms' quality control processes.

Typically the programmes are supported by comprehensive policies, instructions and checklists, together with a training program for reviewers. The reviews appear to be performed with appropriate rigour, according to directions of the global firms, normally lead by a non-Australian partner, results are reported to senior management, action plans are established with clear accountability and, in circumstances of unsatisfactory work being uncovered, proper consequences appear to follow.

Professional standards and the firms' own policies require that the primary basis for selecting engagements for review is that each partner should have an engagement reviewed every three years. Whilst AQRB noted that the firms also consider a number of other factors, including risk, in making selections, in some firms it is still possible that higher risk clients may never be subject to review. AQRB has again suggested to some firms that they review their selection criteria so that each engagement with a high risk rating should be considered for review on a regular basis.

Consultation

It is a feature of modern audit practice that there is a much greater level of consultation with other audit partners and specialist advisers than used formerly to be the case. Such consultation may frequently materially enhance the quality of the audit. AQRB observed on many of the audit files selected for review that a significant level of consultation with other partners and specialists had taken place. However, practice varies regarding the documentation of consultation with and advice received from these other partners and internal specialists. Where advice was sought from external providers this was usually well documented both as to the information request and the action taken on the report received from the external source. However, in some firms, when the advice was from an internal specialist (for example tax, valuation or accounting technical experts) there was a lack of consistency regarding its documentation.

The need for proper documentation is clear, both in compliance with the auditing standards but also from a possible need to demonstrate at a later date that appropriate consultation has taken place, with whom and to what effect.

Documentation

The need for proper documentation of audit processes has been referred to in a number of the matters discussed above. The new force of law auditing standards (in particular ASA 320 "Audit Documentation") set a much higher benchmark for the quality and extent of audit documentation. As has also been noted earlier in this report, unfortunately this has caused an increase reliance on checklists.

AQRB has observed that the firms are well aware of the need to improve audit documentation and have been using the period prior to the standards' application date to instil this requirement into their personnel by means of extensive staff training. Audit policies and manuals have been updated so as to comply with the standards and audit teams have been expected to comply with the new policies even prior to the standards application date.

Whilst AQRB has made recommendations to some of the firms on ways that it believes audit documentation could be improved, these recommendations should be viewed in the context of an overall view which AQRB formed that the audit processes were generally well documented in the audit files inspected.

Progress on 2006 Findings

AQRB generally saw evidence that the matters raised in last year's report had been considered and, where appropriate, were reflected in technical information bulletins, training material or the like delivered by the firms in the course of 2007.

A number of the matters raised in 2006 referred to the way matters were documented in audit files. The audits inspected as part of the 2007 review would mostly have been completed or at least commenced before these recommendations could have been communicated to the audit teams and it was therefore not reasonable to expect to see their implementation this year. With this proviso, in the time available since receipt of the 2006 report, AQRB was satisfied that appropriate action had been taken by the firms on the recommendations made.