



**Audit Quality Review Board Ltd
Report
Review of Ernst & Young
Australia**

January 2007

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1. The Review

Introduction

- 1.1 AQRB (the Audit Quality Review Board) is a not-for-profit company whose objective is to help improve the quality of auditing with respect to listed entities. In doing so, AQRB aims to enhance the credibility and integrity of the Australian auditing framework, to improve public confidence in that framework and to contribute to the continual improvement of the audit profession for the benefit of the Australian public.
- 1.2 The member firms of the Australian auditing profession, in financially supporting AQRB, wish to demonstrate their commitment to ethical and professional standards relating to auditor independence and audit quality. The Company has been established as a body which will operate independently of the profession to monitor compliance with these standards.
- 1.3 This report contains the results of a review undertaken by AQRB during calendar year 2006.
- 1.4 A general description of AQRB, its role and review processes is at Appendix 1.

2. Scope and objective of the review

- 2.1 The key objective of the review was to assess the adequacy and effectiveness of the policies, procedures, and systems that Ernst & Young Australia (“EYA”) uses to ensure its compliance with professional standards and regulatory and professional requirements with respect to their audit of publicly listed entities in Australia.
- 2.2 The review was conducted in four stages. In the first stage we examined documentation provided by EYA (including the Quality Control Report (“QCR”) referred to later in this report) concerning their systems and processes for audit quality and independence. In the second stage we met with senior EYA personnel (usually partners) responsible for these systems and processes. In the third stage we examined a small number of audit files to seek evidence of the practical application of the policies and procedures. In the fourth stage we documented our findings, developed our conclusions and recommendations, and discussed these with EYA before finalising this report.
- 2.3 AQRB did not, as part of its review, examine the merits of a particular audit, the conclusions reached in that audit (including conclusions about the application of accounting policies to that audit) or the appropriateness of the audit opinion other than as merely incidental to

the review of processes and documentation described below under the heading “Review Processes”.

3. The firm under review

(a) Ernst & Young in Australia

- 3.1 EYA is one of the four major Australian auditing firms (Ernst & Young, Deloitte, KPMG and PricewaterhouseCoopers), colloquially known as the “big 4”, which collectively audit approximately 88% by composition and 96% by market capitalization of the 300 largest entities listed on the Australian Stock Exchange (“S&P/ASX 300”).¹
- 3.2 Details of the structure of EYA are set out in Para’s 1.2 and 1.3 of its QCR. Key points are:
- EYA is a member of a global network (EY Global) of practices in 140 countries;
 - The Australian CEO of EYA is appointed by the Board of Partners in Australia;
 - There is a National Director Quality and Risk & Regulation (reporting to the CEO) to oversight EYA firm wide quality and independence initiatives and risk management generally;
 - There are three service line divisions in EYA one of which, Assurance and Advisory Business Services (AABS), conducts assurance and advisory work including the audit of listed entities and is therefore the subject of the current review. AABS is headed by a Managing Partner responsible to the CEO; and
 - The firm is geographically based with regional offices in each capital city. Most major listed company clients are in Sydney and Melbourne and control of the work of those two offices is more closely integrated.

(b) Responsibilities for quality, risk and regulation within EYA

- 3.3 In considering the findings of this report it is useful to understand the responsibilities for quality, risk and regulation, both firm wide and within the assurance practice (AABS).

Firm wide:

- Under the direction of the National Director Quality and Risk & Regulation (QR&R):
 - Oversight of conflict of interest and related independence policies and recording and compliance systems. This work is integrated into EY Global (EYG) and is generally supervised in Australia by a National Director Independence; and

¹ ASIC “Audit inspection program Second report to FRC August 2006”

- Advocacy and promotion of quality, risk and independence issues raising their profile throughout the firm and in dealings with stakeholders of the firm.
- Under the direction of the Director People and Culture (who acts in conjunction with other national leaders) ensuring that there are effective procedures and activities in place for relevant EYA personnel to have induction, training, counseling and assessment all of which include appropriate weighting of quality and independence values.

Within the AABS practice:

- Under the general direction of the Managing Partner AABS:
 - Oversight of Quality and Risk Management, including implementation of EYA policies, is undertaken by a Professional Practice Director (PPD). Although located within the AABS practice, the PPD is also responsible to the National Director QR&R and to the EY Global AABS PPD. The PPD ensures that EYA policies and the various tools and practice aids that assist their implementation reflect the requirements of Professional Standards.
 - An inspection and review process, designed to monitor compliance with EYA policies within the AABS practice.

(c) EYA participation in AQRB

- 3.4 EYA is, along with the other big 4 firms, an initial subscriber to the AQRB process. It has willingly allowed the AQRB review team to undertake its task within the firm and has both provided the review team with the material requested and facilitated access to EYA personnel as requested. EYA has filed an appropriate QCR for inclusion on the AQRB website.

4. EYA Quality Control Report (QCR)

- 4.1 As described in the Appendix 1, the AQRB review process starts with examination of a QCR filed by the firm under review. The QCR summarises the policies and processes by which it seeks to comply with standards and laws relating to audit quality and independence. The QCR relevant to the current EYA review is at www.aqrb.org.au/. This QCR, together with a more detailed non-public QCR and associated reference material, was the starting point of this review. It is useful source material to assist in a better understanding of the EYA policies and procedures and the findings of this report.

- 4.2 AQRB has reviewed the contents of the QCR. The scope of this review was designed to assess the suitability of these quality control systems in terms of providing reasonable assurance as to compliance with the requirements referred to in Appendix 1, how they are being applied in practice and whether the description given in the QCR reflects practice within the firm.
- 4.3 AQRB is satisfied that the QCR fairly describes EYA's quality control systems. AQRB has made a number of findings and recommendations to EYA in relation to the application of the systems. Subject to appropriate resolution of these matters, AQRB has found no reason to believe that the QCR does not reflect, in all material respects, practice within the firm.

5. Review process

- 5.1 The AQRB review team, consistent with the steps set out in Appendix 1, took the following actions. Most of the work was carried out in Sydney and Melbourne, with a small amount being performed in Adelaide:
- We studied the QCR filed by the firm and the various policy and other documents some of which are referred to in the QCR (this included examination of both hard copy and intranet resources as were relevant). We talked to persons in the firm responsible for the preparation of the QCR;
 - We interviewed key senior personnel in the firm including the CEO, National Directors and the AABS Practice Manager, the PPD and some other practice leaders;
 - We interviewed other persons responsible for the key systems and processes involved in ensuring that the policies, standards and rules are followed;
 - We had demonstrated to us key systems and processes (including data and recording systems) where these were considered relevant to an understanding of how EYA policies are applied in practice;
 - We examined a selection of five audit engagements and spoke with representatives of the engagement teams involved;
 - We examined the firm's own monitoring programs including some of the recent results, and spoke with those responsible for the work;
 - We undertook a small amount of focus group work in Adelaide; and
 - We discussed resulting issues with the management of the firm.
- 5.2 On the occasion of this first review of EYA by AQRB, the review team necessarily spent considerable time gaining knowledge about the firm, its policies, and the manner in which it operates. Whereas AQRB examined some areas in depth and reports thereon, other areas that

merit more detailed attention in future reviews, were identified. In conducting future reviews, AQRB intends that the reviewers will update their knowledge of EYA, re-visit areas on which recommendations have been made this year and focus in greater depth on other key areas.

6. Findings of the review

The focus of the findings

- 6.1 New requirements for auditors, arising from the CLERP 9 legislative process, the revision of auditing standards and other overseas developments including, for example, requirements arising from the Sarbanes-Oxley Act of 2002 in the US, have caused auditing firms to review and upgrade their policies and processes for the conduct of public company audits. Such firms are required to have in place a quality control system that provides assurance that all legal and professional requirements (The Requirements) are met².
- 6.2 Further, the mandatory status of Australian Auditing Standards effective from 1 July, 2006 has heightened the awareness of all partners to the need to comply with audit standards.
- 6.3 As noted earlier, a summary of how EYA represents the manner in which its quality control system operates is contained in its QCR and this has been reviewed by AQRB. The findings below, which address the principal issues that emerged, result from consideration of the various matters observed by AQRB using, as general analysis benchmarks, the “Major Review Themes” set out in Appendix 1.
- 6.4 In its findings the AQRB review team (referred to in this section of the report as “AQRB”) has identified a number of issues to be addressed by EYA and in other cases, best practice recommendations to be considered. These relate to those areas where AQRB believes further progress to be desirable.
- 6.5 For those areas where the EYA initiatives appear to be working effectively, or are being further developed to achieve their purpose, this report contains observations that are of a general nature only.

7. EYA Policies and Systems

- 7.1 EYA has, over the recent past, made a significant effort to strengthen its policies so as to ensure compliance with The Requirements. There is evidence of extensive revisions to policies which, as a result, appear to AQRB to be comprehensive and reflective of The Requirements.

² A summary of the Australian requirements relevant to the time of this review is included in Appendix 1.

Sound policies, however, need to be effectively applied if they are to be of value. AQRB has attempted to assess the degree to which effective application of the policies has been achieved.

- 7.2 Many recent changes to The Requirements have caused auditors to review their working practices. EYA have found it necessary to extensively revise existing tools and procedures and to introduce new ones, in order to assist audit staff and ensure an appropriate degree of compliance.
- 7.3 The development and introduction of new and revised tools will take some time, needing appropriate training and, in some cases, attitudinal change for them to be fully effective. We also note that the EYA core training, both induction and ongoing, already includes units on quality and independence issues. After making improvements to recording systems, EYA has increased efforts to ensure that all relevant members of staff undertake the training.
- 7.4 AQRB acknowledges that at present EYA has in place tools and systems to enable policies to be applied, but some of these suffer from a lack of integration, are cumbersome and not easy to use. AQRB observes, however, that EYA is well aware of this and has embarked upon a program of enhancement designed to eliminate these problems and introduce a more “user friendly” environment.
- 7.5 AQRB observes that successful implementation of the firm’s policies depends upon several factors other than systems and tools. In particular, partners and staff:
- need to understand , appreciate and support the intent of policy;
 - need to be clear about what the policy expects of them;
 - need to have their performance monitored; and
 - need to be held accountable – rewards for good behaviour and sanctions for failure.
- 7.6 In formulating its findings, AQRB has addressed these issues, with particular emphasis on those policies that AQRB regards as most important.

8. Leadership and Values

- 8.1 In the view of AQRB, EYA leadership has made a serious commitment of senior people to responsible and time-consuming roles in the areas of Quality, Risk and Regulation, which has firm-wide responsibilities, and Professional Practice Development, which has responsibilities in the Assurance Practice. These functions are supported by significant staff resources below partner level.

- 8.2 Leadership has taken a position, firmly endorsing the importance of adherence to The Requirements and to EYA values. It demonstrates this through the messages consistently given to the firm and by the adoption of incentives and sanctions through the various performance appraisal and compensation systems. These messages appear to be strong and sincere.
- 8.3 It is noted that, whereas EYA values, including quality, are assigned weighting in partner performance appraisals, such issues do not yet feature as strongly in the appraisal of staff below partner level. AQRB understands that the appraisal criteria for some staff levels are under review.
- 8.4 AQRB will seek to review, on a future occasion, the progress EYA is making in giving due weight to values and quality issues in assessing performance and setting compensation.

9. Independence and threats to independence

- 9.1 EYA has recently been subject to reviews of its independence processes by ASIC, ICAA and its own internal review teams. EYA has addressed the findings arising from these reviews although some systems improvements are needed to fully resolve some of the issues that have been identified by these reviews.
- 9.2 Development work is being undertaken to improve the systems relating to confirmations of independence and declarations of relationships and interests, and to associated data recording and analysis, all of which aim to minimize threats to independence arising from conflicts of interest at both individual and firm wide levels.
- 9.3 AQRB acknowledges the significant level of resource EYA has committed to this area and the efforts made to achieve cultural change, including the introduction of financial sanctions for serious lapses.
- 9.4 In the view of AQRB, it is important to recognize that independence of the auditor is not an end in itself. Independence is of critical importance because, in its absence, the objectivity of the auditor, and hence the quality of audit judgments may be threatened. Independence standards recognize that a significant threat to independence arises from “familiarity” of the audit team with the client. This is addressed, to a degree, through the partner rotation process. However, in AQRB’s view, the strongest protection against this loss of objectivity is the involvement of others, particularly the Independent Review Partner (IRP), in reviewing key audit judgments.
- 9.5 It is for this reason that AQRB regards the effectiveness of the IRP role as of great importance in ensuring audit quality. As a consequence,

AQRB has particularly focused on how the IRP role operates within EYA and whether the effectiveness of the role can be enhanced.

10. Audit Quality

- 10.1 Briefly put, audit quality depends upon an audit team with the right skills, following policies and using tools that guide them to conduct the work appropriately and with the capacity to make sound, objective (“independent”) judgments.
- 10.2 In practice, the number of processes that require consideration and execution is significant and the need to ensure completeness places great pressure on the engagement team. EYA has introduced many signoff requirements and checklists in an effort to ensure that nothing is overlooked and full compliance with The Requirements, as embodied in EYA policies, is achieved.
- 10.3 Whereas signed checklists are valuable and provide a level of comfort that procedures have been followed, they say little about subjective matters such as the quality of judgments made and the quality of documentation.
- 10.4 In this review AQRB has identified, and focused upon, three areas, the effectiveness of which it believes to be crucial in achieving audit quality. These are:
 - The Client Continuance/Risk Assessment process, and how it influences the conduct of the audit,
 - The pre signing quality control review conducted by the IRP, and
 - The firm’s monitoring processes, designed to test adherence to policy and the quality of work performed.
- 10.5 AQRB offers detailed observations and recommendations on each of these areas.

11. The Client Continuance/Risk Assessment process

- 11.1 Audit standards (APS 5: Statement of Quality Control for Firms) require that a risk assessment be conducted prior to acceptance of a client or an engagement. The purpose of this assessment is to ascertain, inter-alia, whether the engagement poses an unacceptable risk to the firm and should therefore be declined, or to identify what resources and procedures the firm should bring to bear in order to ensure that the risk is appropriately managed.

- 11.2 EYA Policies reflect the requirements of the audit standards and require that engagements be assessed as normal risk, managed risk or managed risk- close monitor. EYA has developed an automated tool to assist in measuring the risk. Various approvals are required to confirm, or to change, risk ratings. All public company audits must be at least “managed risk”.
- 11.3 An effective assessment of risk, prior to accepting or continuing with an engagement, is important for three reasons:
- the firm has the opportunity to decline engagements that pose an unacceptable level of risk;
 - by identifying highest risk (“close monitor”) engagements, firm management is able to ensure that an engagement team with appropriate skills and experience is appointed, that such additional resources as may be needed are allocated and that decisions regarding those matters are made by persons of appropriate seniority; and
 - senior partners in the firm can be made aware of the highest risk clients, thereby enabling them to ensure that appropriate scrutiny is applied on a continuous basis and that developments in respect of those clients are monitored and responded to appropriately.
- 11.4 AQRB has made a number of suggestions and recommendations to EYA regarding the application of firm policies in this area.

12. Pre signing Quality Review by Independent Review partners

- 12.1 Until recently, the role of the independent review partner (IRP) was not recognized in audit standards and was often regarded as a useful consultative role, particularly as regards clients perceived to be difficult or risky.
- 12.2 The role is now well defined (AUS 206 paragraphs 36-40 and APS5 paragraphs 62-75) and regarded as an important quality control feature within the audit process. It is clear that the IRP carries a significant responsibility for which they should be accountable. In particular, IRPs are required to be more involved in engagements that are assessed as high risk.
- 12.3 EYA policies fully reflect this change and work programs and checklists have been introduced by the firm to assist in raising the effectiveness of the IRP role. AQRB observes that these documents were fully completed on the small number of engagements reviewed.
- 12.4 AQRB believes that the IRP review should be one of substance and be effective in providing a quality control review prior to completion of

the audit. A number of suggestions and recommendations have been made to EYA, aimed at enhancing the effectiveness of the IRP role.

13. Monitoring – the Audit Quality Review (AQR) process

- 13.1 AQRB observes that EYA makes a large time investment in its AQR monitoring program. There are comprehensive policies, instructions and checklists, together with a training program for reviewers. The firm also is attempting to deal seriously with review findings, both in terms of sanctions for underperformance and in identifying the need for changes in work practices, training and guidance.
- 13.2 AQRB believes that effective monitoring is an essential component of EYA's Quality Control system and has therefore sought to identify means whereby the AQR program can be made more challenging and thereby more effective.
- 13.3 AQRB has made a number of suggestions and recommendations regarding the organization and conduct of the AQR program.

14. Overall Reporting on the EY Quality Management Systems

- 14.1 EYA is representing to its constituency and the world at large that the work conducted by the firm complies with The Requirements. The firm has invested heavily in people and processes in an endeavour to ensure that this representation is justified and that reliance can be placed on its risk management systems. AQRB has concluded as a result of its 2006 review that EYA has established policies and procedures in Australia that are designed to enable it to complete effective audits within the framework of current Australian legal and professional requirements.
- 14.2 AQRB has seen evidence of reporting on risk management issues by QR&R to senior management on a regular basis and has made recommendations to further develop this reporting in line with the intent of EY's global policy.

William Coad³

Robert Lynn³

June 2007

³ Biographical details of the reviewers may be viewed on the AQRB website.

Appendix 1

The AQRB and its review processes

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AQRB

Structure and Role

1. AQRB is a company limited by guarantee with St. James Ethics Centre as the inaugural Member ('shareholder'). The Board of AQRB comprises up to ten eminent persons with a range of legal, regulatory, business and auditing experience.
2. The AQRB role is to assist in improving the quality of auditing and is carried out as follows. A participating audit firm provides AQRB with a written summary of how it seeks to ensure compliance with professional standards and other regulatory and professional requirements in the conduct of its work. AQRB reviews that summary and an AQRB review team then undertakes an on-site examination to determine the effectiveness of the processes in place in the firm.
3. AQRB prepares a detailed report on its review which it submits to the firm. A summary of the information provided by the firm, called the Quality Control Report ("QCR"), and a summary of the AQRB report, which excludes confidential material in the detailed report submitted to the firm, are made public.
4. The firm must pay a participant fee. Further details on AQRB and its role are available on its website at www.aqrb.org.au

Independence and Transparency

1. AQRB is a company with independent directors actively engaged in review and monitoring work. The majority of directors are completely independent of the audit firms having never worked in the auditing profession. Competent professional advice is available to directors both from within the ranks of its Board and through its contracted advisors.
2. The ethical stewardship and adequacy of funding of the company is overseen by St. James Ethics Centre. Perpetual Ltd is the custodian and administrator of AQRB funds.
3. Publication of the QCRs provided to AQRB by the audit firms and the subsequent independent reports of AQRB provide a window into the effectiveness of steps being taken by firms to enhance audit quality. This transparency is an important driver for continuous improvement in the profession.

A clearly focused role

1. AQRB was established specifically to focus on improving the quality of auditing with respect to publicly listed entities. It is empowered to examine the

participating audit firms' processes by which they seek to comply with the relevant requirements for independence and audit quality.

2. Two professional bodies (ICAA and CPAA) conduct periodic reviews aiming to ensure members comply with the professional obligations that they have established. ASIC conducts examinations of the firms to ensure compliance with the provisions of the Corporations Law.
3. AQRB conducts reviews of, and reports on, the audit quality assurance processes of firms with the aim of both continuing their improvement and aiding the firms' compliance with the various legal and professional requirements.
4. The starting point of the review is the summary by a participating firm of how it seeks to comply with professional standards and other requirements. The summary covers:
 - the policies in the firm on audit quality and independence;
 - management commitment and designated responsibilities;
 - programs, systems and databases that support and develop the quality and independence aims;
 - human development programs aimed at partners and staff through training, performance management and remuneration;
 - methods used to ensure the appropriate human resources are applied to particular audits of listed entities;
 - risk assessment, approvals, monitoring and review systems that keep check on key issues both firm wide and at the individual audit level; and
 - adequate documentation.

Standards, ethics and law

1. The conduct of audits of companies in Australia is governed by auditing standards and relevant professional requirements and the regulatory requirements of the Corporations Act. Key requirements are summarised below⁴.

Audit Quality

1. Auditing standards require that auditors establish and maintain quality control processes designed to ensure that quality audits are conducted. The relevant requirements are contained in:

⁴ These are the requirements that applied at the end of calendar year 2005, the relevant time for the current reviews. It should be noted that at this time auditing standards, whilst binding on members of the professional bodies who issued the standards, did not have the force of law. Audits of financial statements for periods commencing on or after 1 July 2006 are required to be performed in accordance with legally enforceable auditing standards.

- Auditing Standard 206: Quality Control for Audits of Historical Financial Information
 - APS 5: Statement of Quality Control for Firms.
2. The first (AUS206) is an Australian Auditing Standard which provides guidance on specific responsibilities of firm personnel (auditors) regarding quality control procedures for audits of historical financial information.
 3. The second (APS5) is a policy statement by the professional accounting bodies (ICA/CPAA) which applies to audit firms and requires that each firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances
 4. AUS206 firstly underscores the importance of the engagement partner and then:
 - requires the engagement team to implement quality control procedures that are applicable to the individual audit engagement
 - emphasizes the leadership responsibilities of the engagement partner for quality on audits;
 - requires that ethical matters, including independence, are properly dealt with;
 - emphasizes the engagement partner's responsibility regarding acceptance and continuance of client relationships and specific audit engagements including responsibility to ensure independence threats are dealt with;
 - requires the appropriate assignment of engagement teams and that the engagement partner needs to be satisfied that the appropriate competencies are utilized;
 - explains the requirements of the engagement team regarding engagement performance, including appropriate consultation and policies and procedures to follow when differences of opinions arise;
 - emphasizes the requirement of an engagement quality control review; and
 - requires the engagement partner to consider information circulated by the firm on its monitoring process, and whether any deficiencies noted and rectifying measures taken by the firm have implications for the audit engagement.
 5. APS5 establishes the requirements on the audit firm relating to firm wide conduct, processes and systems in effect to aid adherence to the individual professional expectations in AUS206. APS5 requires that the firm's system of quality control should include policies and procedures addressing each of the following elements:
 - (a) Leadership responsibilities for quality within the firm;
 - (b) Ethical and independence requirements;

- (c) Acceptance and continuance of client relationships and specific engagements;
 - (d) Human resources, particularly regarding assignment of engagement teams;
 - (e) Engagement performance, including policies and procedures for consultation;
 - (f) Monitoring; and
 - (g) Documentation
- The quality control policies and procedures should be documented and communicated to the firm's personnel.

6. Important elements of APS5 include:

- The firm should have a well defined management and leadership structure to underpin quality assurance together with policies and procedures to promote training and recognition within the firm that quality is essential.
- The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements, maintain independence (*see next section*)
- The firm should reasonably assure itself about the integrity of a potential client and that it has the competencies to carry out the audit role for a client while complying with ethical requirements. In this context the firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.
- The firm should ensure that an engagement quality control review is performed for all audits of financial statements of listed entities;
- The firm should establish policies and procedures designed to provide it with reasonable assurance that the system of quality control is relevant, adequate, operating effectively and complied with in practice. This should include ongoing evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.
- The firm should apply procedures to ensure that adequate consultation occurs on engagements, to deal with complaints; and
- The firm should ensure proper documentation exists to provide evidence of the operation of each element of its system of quality control.

Since AQRB is reviewing the audit quality assurance processes and systems of audit firms, APS5 is particularly significant.

Independence

1. Two sets of requirements apply:

- Professional Statement F1: Professional Independence; and
- Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosures) Act 2004 ("CLERP 9").

2. Professional Statement F1 is a policy statement issued by the ICAA and CPAA. The essence of F1 is based on defining several types of potential threats to independence (self-interest; self review; advocacy; familiarity and intimidation) and applying safeguards to deal with them.
3. The substance of those threats may arise from a number of sources including:
 - Financial relations with the client (e.g. investments, loans etc.)
 - Business relations with the client (e.g. the provision of non-audit services);
 - Employment relations (client staff working in the audit firm and vice versa);
 - Personnel issues (family and familiarity); and
 - Terms of dealing with clients (including fees; over dependence on a client; disputes).
4. F1 sets out a number of safeguards that a firm may apply to mitigate the risk detailed above. These safeguards fall into two groups:

Firm wide

- Leadership- senior management must be involved in overseeing the independence process;
- Policies and procedures that are documented with timely communication and training;
- Identification and evaluation of the significance of threats;
- Monitoring of quality control and compliance with independence policies;
- Procedures to enable identification of interests and relationships – a communication process to advise assurance partners and staff of those entities from which they must be independent;
- Management of issues related to reliance on fees and of the provision and effects of non-audit services;
- Disciplinary measures; and
- Empowerment of staff to communicate upwards concerns regarding independence.

Engagement specific

- Independent review
 - by a professional accountant;
 - consulting third parties;
 - involving another firm to perform part of the work where appropriate;
- Rotation of senior personnel;
- Discussing with and disclosure to the audit committee (other services, fees etc);
- Keeping audit personnel from being involved in management decisions of the client; and
- Where required, removing individuals from a team or withdrawing from the engagement (last resort).

5. CLERP9 (Corporations Act): The legislated requirements for auditors and audit firms that concern issues of independence and conflict of interest, in summary cover the following:

- a. General auditor independence requirements.

These provisions establish a set of requirements to enshrine a general concept of auditor independence and conflicts of interest. Individual auditors and audit companies are to be aware of conflicts of interest (*not capable of exercising objective and impartial judgment*) and to cease the conflicts when they become aware of them and if not to advise ASIC. It can be a contravention of the law for an auditor to not be aware of a conflict of interest, where the auditor would have been aware of it if there was a quality control system reasonably capable of making the auditor aware of a conflict of interest situation.

- b. Specific auditor independence requirements

These provisions are of similar effect to the general requirements but *define certain audit critical and other relationships* between the auditor and the client that might prejudice the auditor's objective and impartial judgment.

- c. Restrictions on auditors being employed by an audit company

These provisions include a cooling off period for employment of former auditors and limitation of the number of former auditors that a company can employ.

- d. Auditor rotation for listed companies

These provisions restrict auditors from playing a significant role in the audit of a company for more than 5 of 7 successive reporting years.

Major review themes

1. Consistent with the substance of the various matters in the aforementioned standards, ethics and laws, the following are the key areas that the AQRB reviews focus on:

- Quality and Independence: Leadership and staff development

Leadership attitudes, messages, and communication

Risk awareness

Recruitment, induction, and training

Feedback mechanisms

Performance management, remuneration, and discipline

- Independence and conflict of interest
 - Policies and systems for the communication of policies
 - Declaration requirements and systems
 - Threats to independence, controls in place for:
 - Conflicts of interest
 - Investment
 - Non-audit services
 - Personnel issues
 - Terms of dealing including client dependency and fee issues
 - Monitoring systems
 - Rotation
 - Current developments

- **Audit Quality**
 - Procedures for acceptance and continuance of engagements
 - Independence sign offs
 - Risk assessment of clients
 - Assignment of personnel
 - Use of specialists and consultation
 - Audit tools and practice aids including information databases
 - Quality control review by an independent partner
 - Audit check lists and sign off procedures
 - Current developments

- **Monitoring**
 - In house quality review program
 - Global firm reviews
 - Reviews by other bodies
 - Review follow up to performance (both office and individual)

AQRB review methodology

1. Summary

The AQRB review process is normally a four step process:

- Provision of written information by the firm to be reviewed
- Interviews in the firm and study of processes on site
- Review of selected audit files
- Reporting

These steps are summarised below but there is a full outline of these processes at www.aqrb.org.au

2. Review Team

AQRB reviews are carried out by a small team of directors of AQRB assisted by technical reviewers. The review team must consist of a minimum of two board members, one of whom must not have been a practicing accountant and one of whom must have previous audit experience.

3. Written information

The participating firm is required to file a Quality Control Report with AQRB. This document sets out information about the quality control processes and procedures in place, or planned in the immediate future. Two types of QCR are filed with AQRB. The first is a summary version which is made public. The second is a more detailed version which may contain commercially sensitive material and is therefore not made public.

The QCR broadly follows the 'Major Review Themes' set out above and becomes the starting point of the AQRB review since it sets out the firm's summary of the processes, policies and procedures, systems and databases, monitoring and reviews, training and human development, and documentation that it has in place to meet the requirements and safeguards required by the various standards, codes and law as set out in the last section.

4. Interviews and study of processes

The starting point of AQRB's review team work is to familiarise itself with the QCR responses and associated reference material and then to have discussions with senior members of the firm, typically:

- CEO
- Head of audit
- Head of risk
- Human Resources director/partner
- Partner in charge of independence function
- Other senior firm personnel responsible for elements of risk management, quality, and independence functions.

The review team considers all the material provided and arranges to obtain such additional material and undertake such additional interviews as it sees fit. It seeks to have a demonstration of any systems whose objective is to deliver the requirements and safeguards referred to in the relevant standards, codes, and law. It may have discussion forums with staff of the firm being reviewed. This further work enables the team to establish and explore what it considers to be the key issues.

5. Review of audit files

As part of its review, the AQRB review team selects a small number (presently limited to five) public listed entity audits which have been completed by the firm during the period under review. The selections are

made according to AQRB's criteria and the firm is not allowed an opportunity to limit or influence the selection process. There are a limited number of circumstances, set out in paragraph 5.9 of AQRB's Rules of Operation, where AQRB will exclude an audit from the selection population. The selection of a small number of audit files for review is not designed to give a specific level of confidence that the audits selected are representative of the total audit practice of the firm nor does AQRB seek to achieve statistical support for the selection of audits for review. The names of the files selected are not made public.

It is not the purpose of an AQRB audit file review to consider whether the audit has been conducted in all respects in accordance with audit and ethical standards. AQRB's review of an audit file should not, therefore, be understood to provide any assurance that that audit is free of any deficiencies not specifically described in the detailed review report.

The review team needs to perform procedures to provide it with reasonable assurance that the documented procedures have been applied in practice. The selection of audit files for inspection is *one* of the means of meeting this requirement

6. Reporting

When the review is complete, the review team prepares a draft report (two versions, one in summary and one containing more detail including commercially sensitive material). This draft report is reviewed by other members of the AQRB board and then sent to the firm for comment. The firm may raise any concerns about the content of the reports within 30 working days of receiving them, including correcting any factual inaccuracies, before the reports are finalised.

Inclusion of a comment in a report does not necessarily mean that the matter remained unaddressed after the review team brought it to the firm's attention. The report may describe deficiencies or potential deficiencies in the firm's systems, policies or conduct of an audit. The express inclusion of these deficiencies or potential deficiencies should not be construed as meaning that AQRB approves other aspects of the firm's systems, policies, or audit conduct or that AQRB judges that they comply with the relevant audit standards or legal requirements.

The final summary report is made public and the more detailed report is sent to the firm the subject of the review.

7. Future Reviews

Under the provisions of section 307A of the Corporations Act, effective for financial periods commencing on or after 1 July 2006, an auditor must conduct the audit in accordance with auditing standards i.e. Australian auditing standards have "the force of law".

Future AQRB reviews will reflect these enhanced requirements and be based on the new audit and ethical standards that have been introduced to replace the standards referred to above which applied for the 2006 reviews (The 2006 reviews were performed on audits of financial periods ending on 31 December 2005.)

Future AQRB reviews will also build on the learnings gained from this, the first review conducted by AQRB. In particular, AQRB aims to synchronise its reviews with those conducted by the firms' own Quality Review teams in a more effective manner.