



Audit Quality Review Board Ltd

Report Review of PricewaterhouseCoopers Australia

February 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 PwC uses to ensure its compliance with 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 PwC, 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 PwC 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 PwC 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) PwC in Australia

3.1 PwC is one of the four major Australian accounting 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 PwC are:

- PwC is a member of the PwC global network of firms.
- PwC Australia is registered, owned and controlled by the Australian partners of the firm. The Australian partners elect a Board of Partners and Chief Executive Officer (“CEO”) who have ultimate responsibility for the conduct of the firm with the CEO having responsibility for the day to day operations of the firm.
- There are three service lines within PwC one of which, Assurance, conducts listed entity audits and is therefore the subject of this AQRB review. Assurance is headed by a Managing Partner responsible to the National Managing Partner Businesses and the CEO.
- World wide methodologies and procedures are adopted by the PwC Assurance practice. The PwC Australia, Assurance practice, to the extent necessary as determined by Australian laws and professional standards, modifies the PwC global procedures so as to comply with Australian requirements.
- PwC Australia has offices in each State capital and some other regional cities. Listed public company audits are serviced from all offices throughout Australia.

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

3.3 In considering this report it is useful to understand the roles of those charged with responsibility for quality, risk and regulation, both firm-wide and within the Assurance practice.

Firm-wide:

- PwC has established a Risk & Quality Council whose main role is to provide a governance function giving authority to the firm’s policies and procedures. Membership of the Council

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

comprises a senior partner as chairman, two members of the Board of Partners, the National Managing Partner businesses and the Risk & Quality Group Leader.

- A Risk & Quality Group, comprised of permanent members and of senior personnel seconded to the group for a period of time from the lines of service and has the responsibility of ensuring that the firm maintains appropriate systems of quality control, processes and controls, assesses and manages the risks associated with the PwC business. Within each business unit are appointed Risk Management Partners who have, in conjunction with the Risk & Quality Group, the authority to guide and direct all PwC personnel on matters of risk and quality.
- Within the Risk and Quality Group, is a group dedicated to independence issues, under the direction of the Partner in Charge of Independence. This group monitors PwC personnels' compliance with PwC independence policies and provides them with guidance and advice on all independence issues.

Within the Assurance practice:

- The Chief Quality Officer, reports to the Australian Assurance Managing Partner and is operationally responsible for quality controls throughout the Assurance practice. The Chief Quality Officer is also responsible for the planning and conduct of the annual Global Quality Review of the PwC Australian Assurance practice.
- The Accounting Consulting Services Group advises PwC personnel on accounting and reporting issues as they arise on Assurance engagements.
- The Assurance practice also includes certain partners, directors and managers who have been identified as "Assurance Coaches". Their role is to assist in the effective implementation of the PwC audit methodology. This group is led and monitored by the PwC Implementation Partner.

(c) PwC participation in AQRB

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

4. PwC Quality Control Report (QCR)

- 4.1 As described in 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 PwC 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 PwC 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 PwC's quality control systems. AQRB has made a number of findings and recommendations to PwC in relation to the application of the systems. Subject to appropriate resolution of those matters, AQRB has found no reason to believe that the QCR does not reflect, in all material aspects, practice within the firm.

5. Review process

- 5.1 The review was conducted in PwC's Sydney office with the files for audits serviced out of Adelaide and Brisbane offices being sent to Sydney for our review. The AQRB review team, consistent with the steps set out in Appendix 1, took the actions set out below:
- We studied the QCR filed by the firm and the various policy and other documents referred to in the QCR (this included examination of both hard copy and electronic 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 Managing Partner (Businesses), the Assurance Managing Partner and other practice leaders;
 - We interviewed partners, directors and managers 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 PwC policies are applied in practice;

- We examined a selection of five audit engagements. A schedule of questions was provided to the engagement teams for each of the audits selected and we received responses on the matters raised;
- We examined the firm's own monitoring programs including some of the PwC 2006 Global Quality Review results, and spoke with those responsible for the work; and
- We discussed resulting issues with the management of the firm.

5.2 On the occasion of this first review of PwC 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 PwC, 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 are met.²
- 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 PwC represents the manner in which its quality control system operates is contained in its QCR and this has been reviewed by AQRB.
- 6.4 PwC provided the AQRB review team with a document which "mapped" the legal and professional audit and independence requirements to its policies and systems. The AQRB review of this mapping document and supporting documentation concluded that PwC

² A summary of the Australian requirements at the time of this review is set out in Appendix 1.

appeared to have addressed each of the applicable requirements and to have developed methodologies and procedures which, if appropriately applied, should ensure compliance with the Australian professional and legal requirements.

- 6.5 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.
- 6.6 The AQRB review team identified some issues to be addressed by PwC and some best practice recommendations to be considered. These relate to those areas where AQRB believes further progress to be desirable.

7. PwC Policies and Systems

- 7.1 PwC has made a significant effort to ensure compliance with Australian professional and legal requirements. There is evidence of a consistent effort to monitor and review policies (both globally and within Australia) which, as a result, appear to AQRB to be comprehensive. PwC has employed electronic databases for the maintenance of firm manuals, training materials and self help educational modules, audit working procedures, maintenance and retention of audit working paper files and the prompt distribution of current information and training materials to all levels of personnel. Use of such databases appears to AQRB to have allowed PwC to build into their systems various controls which can highlight the non-application of approved controls and procedures. The AQRB review team, based on its review and interviews, concluded that these electronic databases and tools appeared well entrenched and understood within PwC.
- 7.2 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.
- 7.3 Personnel planning, recruitment, training and retention is an ongoing business issue in a constantly changing business environment. PwC currently employs approximately 4000 people in Australia, including 400 partners. AQRB understands that, of the 400 partners, 140 have been appointed in the last 4 years, whilst about 110 partners have left the firm in that time, not including those partners who left with the sale of the management consulting practice. Such partner movements

reflect a significant change in the composition of the partnership and hence the corporate memory and culture. Maintaining a strong business and compliance culture in what is now a highly regulated audit environment, will, in AQRB's opinion, represent a continuing business issue for PwC. AQRB acknowledges that PwC is applying significant ongoing resources to deal with the changed audit regulatory environment in Australia.

8. Leadership and Values

- 8.1 In the view of AQRB, the PwC leadership team has made a serious commitment of senior people to responsible and time-consuming roles in the areas of quality, risk and legal regulation, with firm-wide responsibilities and professional practice development clearly identified within 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 PwC values and firm procedures and demonstrates this through the messages consistently given to the firm and adoption of incentives and sanctions through the various performance assessment and compensation systems. The remuneration of partners is assessed annually, based on both an annual and a half yearly review assessment process, which also takes into account the results of staff training and the results of the inter firm assignment quality reviews through the annual Global Quality Review process. The total assessment factors for each partner are published internally for the Australian partners, to permit an understanding of the remuneration ratings amongst partners and to reinforce the application of the PwC values in the evaluation process.
- 8.3 AQRB noted that, whereas PwC values, including quality, are assigned weightings in partner performance appraisals, such issues do not impact as strongly in the appraisal process for staff below partner level. This is perhaps understandable since PwC staff members are ultimately subject to the direction of partners and their employee appraisals must reflect this employer/employee relationship. Nevertheless the PwC leadership has tried to articulate for partners and staff, acceptable levels of conduct, and those matters that are clearly unacceptable. PwC has formal policies on a variety of behavioural issues as well as a Code of Conduct to give guidance to partners and staff on behavioural and personal conduct. The Code of Conduct is supported by formal electronic training and an evaluation as well as a formal Ethics committee. Certain unacceptable levels of conduct would give rise to instant dismissal under the firm's current policies and AQRB was advised that there have been a number of such instances in recent years. AQRB has been advised that effective from 1 July 2006, PwC has introduced a risk and quality metrics process, similar to the partner process for directors, senior managers and managers assigning a risk and quality rating which forms part of their annual performance

appraisals. Furthermore, the “Grow Scheme” (Bonus scheme for these staff grades), also incorporates ratings arising from the local quality reviews. Prior to this quality was an implicit element of the appraisal process even though there may not have been an explicit measure.

9. Independence and threats to independence

- 9.1 The CLERP 9 amendments to the Corporations Act, the associated changes in the Australian professional standards, and changing foreign legal and professional requirements required Australian auditors of listed entities and firms with international affiliations to significantly change their firm’s procedures to ensure compliance with the new independence requirements. PwC was no exception.
- 9.2 PwC Australia is required to adhere to PwC Global independence policies and the Australian firm provides both input to a PwC Global database on prohibited securities and entities and uses this database on a day to day basis to seek to ensure partners and staff of PwC Australia do not breach the PwC Global independence rules. Compliance with these rules ensures compliance with all Australian legal and professional independence requirements. The current PwC independence declarations by personnel assigned to each audit surpass the current requirements of Australian law.
- 9.3 PwC has invested considerable resources in this matter including the establishment of a dedicated Independence Group comprising partners, directors and managers, advising PwC Australia personnel on independence matters on a day to day basis, the development of new policies and procedures in response to emerging firm wide independence issues, oversight of the PwC Australia independence databases and their regular updating and maintenance, liaison with PwC Global on such matters, oversight of PwC annual independence declarations and advice on the acceptance or rejection of non-audit services as referred to them by the respective engagement leaders so as not to breach the independence requirements of the Corporations Act.
- 9.4 This specialist group has sole authority to rule on any such matters within PwC Australia and their decision on any independence matter is binding on all PwC partners and the Australian firm.
- 9.5 AQRB acknowledges the significant level of resources PwC has committed to this area and the efforts made to achieve cultural change, including the introduction of financial sanctions for breaches of PwC policies.
- 9.6 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 Quality Review Partner (QRP), in reviewing key audit judgments.

- 9.7 It is for this reason that AQRB regards the effectiveness of the QRP role as of great importance in ensuring audit quality.

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. PwC has introduced many sign off requirements and checklists in an effort to ensure nothing is overlooked and full compliance with all legal and professional requirements, as embodied in PwC policies, is achieved.
- 10.3 Whereas completed audit programs and 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 AQRB has identified, and focused upon, three areas, the effectiveness of which it believes to be crucial in achieving audit quality. These are:-
1. The Client Acceptance and Continuance/Risk Assessment process, and how it influences the conduct of the audit,
 2. The pre signing quality control review conducted by the QRP, and
 3. The firm's monitoring processes, designed to test adherence to policy and the quality of work performed.

AQRB offers detailed observations and recommendations on each of these areas.

11. The Client Acceptance and Continuance/Risk Assessment process

- 11.1 Miscellaneous Professional Statement (APS 5: Statement of Quality Control for Firms) requires 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 PwC policies are designed to reflect these requirements and require that engagements be assessed annually. When there is a significant change in ownership, management or the business during the course of an audit, a re-evaluation of the entity's risk profile is required to be made. PwC has developed an automated tool to assist in measuring the risk. The PwC acceptance & continuance ("A&C") assessments are completed on a dedicated database and require that PwC personnel completing the assessment respond to a series of identified risk elements in respect to the entity being assessed and the A & C provides a risk rating.
- 11.3 Where the risk rating shows that the client is considered to be "higher risk", the acceptance or retention of such clients is required to be separately assessed by the engagement leader and the QRP having regard to the other controls and procedures put in place to compensate for the higher risk. In respect to such identified higher risk clients, the industry and business unit lead partners have a responsibility to monitor their respective partners' workloads and staff utilisation and to determine whether changes need to be made to the assignment of personnel to such clients.
- 11.4 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 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.
- 11.5 AQRB noted that the application of the PwC A&C assessment policies was reviewed on each audit assignment selected for independent review by the reviewers conducting the PwC 2006 Global Quality Review. Two of the audits selected for review by AQRB had also been reviewed by the PwC 2006 Global Quality Review team. In both cases the PwC 2006 Global Quality Review team agreed with the A&C assessments determined by the engagement leaders and the additional audit procedures tailored for the respective audits to compensate for identified risks.
- 11.6 The assessment of relative risks on each audit assignment is a professional judgment, but in the five audits selected for review by

AQRB we did not disagree with the process of risk determination followed.

12. Pre signing Review by Quality Review partners

- 12.1 Until recently, the role of the QRP was not formally 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 from the current policies of PwC, that the QRP carries a significant responsibility for which they are accountable. In particular, QRPs are required to be involved in all listed entity audit engagements, with a much higher “hands on” role for audits assessed as higher risk.
- 12.3 PwC policies reflect this change and audit programs and checklists have been introduced by the firm to assist in raising the effectiveness of the QRP’s role. AQRB observed that these documents were completed on the small number of engagements we reviewed.
- 12.4 AQRB believes that the QRP review should be one of substance and be effective in providing a quality review prior to audit completion. Suggestions have been to PwC aimed at enhancing the effectiveness of the QRP role.

13. Monitoring – the Global Quality Review process

- 13.1 AQRB observes that PwC makes a large time investment in its annual Global Quality Review monitoring program. There are comprehensive policies, instructions and checklists, together with a training program for reviewers. The firm also deals seriously with review findings, both in terms of sanctions for underperformance and in identifying the need for changes in work practices, training and guidance. The Global Quality Review Questionnaire is used by PwC reviewers globally on PwC Global reviews. Annually, separate teams visit various offices throughout Australia, reviewing completed audit files. The teams comprise partners, directors and managers from both overseas PwC firms and other offices of PwC in Australia. A member of a review team may not be involved in the review of their home office.
- 13.2 AQRB believes that effective monitoring is an essential component of PwC’s Quality Control system and has therefore sought to identify means whereby the Quality Review program can be made more challenging and thereby more effective.
- 13.3 AQRB has made a number of suggestions which it believes may enhance the organisation and conduct of the Quality Review program.

14. Overall Conclusion on the PwC Quality Controls

14.1 PwC has invested heavily in maintaining effective policies designed to enable its people to conduct the business of the firm in an effective manner. AQRB has concluded as a result of its 2006 review that PwC 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.

John Richardson³

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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:
 - Auditing Standard 206: Quality Control for Audits of Historical Financial Information
 - APS 5: Statement of Quality Control for Firms.

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.

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.