



14 December 2011

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Public Company Accounting Oversight Board,  
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Washington, DC, 20006-2803 USA

Email: [comments@pcaobus.org](mailto:comments@pcaobus.org)

Sir / Madam,

**PCAOB Rulemaking Docket Matter No. 37  
CONCEPT RELEASE ON AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION**

The Institute of Chartered Accountants in Australia (Institute) is pleased to have the opportunity to respond to the above Concept Release. The Institute is Australia's premier accounting body, which represents over 55,000 professional accountants. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

The Institute is a founding member of the international accounting coalition called the Global Accounting Alliance (GAA), which provides reciprocal arrangements with ten other leading accounting bodies in the world. The Institute is the only Australian accounting body within the alliance. The GAA represents more than 780,000 members world-wide and includes leading professional accounting organisations from the USA, Canada, Hong Kong, England/Wales, Ireland, Scotland, Japan, Germany, New Zealand and South Africa.

We recognise that we are not an immediate constituent for whom PCAOB has responsibility but we believe that, as a premier audit regulatory body, PCAOB and its findings has an important influence on how audit is regulated globally and it is for this reason that we are seeking to make comment on what would otherwise be an American domestic matter.

In summary we support the PCAOB's efforts to bolster auditor independence and thus the broad direction of the paper. However, we are concerned with the proposal that audit firm rotation should be mandated. Whilst the American experience may have been different to that experienced in Australia, from our experience such a process would not tackle the root cause of audit failure or provide an effective mechanism for enhancing audit independence and scepticism.

We elaborate below on this concern and two alternatives, which are not mutually exclusive: pursuing more stringently the drivers of audit quality and enhancing the role of audit committees as delegates of boards.

**Audit failures**

We have some concerns at the characterisation of audit failure described on page 5 of the paper as ". . . a failure to obtain reasonable assurance about whether the financial statements are free of material misstatement". Auditing involves skilled professionals bringing professional judgement to bear on areas that are often complex. Because of this the possibility always exists for another professional to view the same material and reach a slightly different conclusion as to what constitutes sufficient appropriate evidence in the circumstances. This does not, in our view, necessarily represent audit failure.

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However, the paper goes on to acknowledge that the “audit failures” identified during PCAOB inspections are not necessarily from a lack of objectivity or professional scepticism, but may also be due to a lack of experience or competence or other issues such time pressure or staffing pressure. Given that there are a number of reasons for “audit failures”, the issue is complex and cannot in our view be addressed simply by mandating audit firm rotation as a path way to increasing audit scepticism.

In our view and from our observations of the causes of audit failures in Australia, a better focus would be:

- to continue to work on the drivers of audit quality to continue to press for firms to have in place, by training, staff selection and appropriate culture, the processes needed to achieve audit quality; and by
- enhancing the role of the audit committee. We see the audit committee as an important part of the processes needed to ensure fearless audit work free from fee or other concerns with free and open communication with those charged with governance. As the primary contact point with the auditor the audit committee is in a position to encourage and demand open conversations with auditors which will, in our view, enhance audit scepticism and thereby audit quality.

In our Guide, *The Benefit of Audit: A Guide to Audit Quality* (a copy of this Guide is attached), five drivers of audit quality are identified (which are drawn from the Financial Reporting Council’s (UK) Audit Quality Framework), being:

- The culture within an audit firm
- The skills and personal qualities of audit partners and staff
- The effectiveness of the audit process
- Factors outside the control of auditors
- The reliability and usefulness of audit reporting.

The Guide is aimed at audit committees and includes points an audit committee should consider about its auditor in relation to each of the five drivers of audit quality. The audit committee’s role, even though it has been strengthened in recent years, could be enhanced further to assist in raising the level of quality in audits.

### **The role and responsibility of the auditor**

The paper on page 4 includes a quotation from the U.S. Supreme Court regarding an auditor’s overriding duty to put the investors’ interests first. Indeed the purpose of auditing standards is to provide a framework within which an auditor can meet this objective whilst recognising the intrinsic test based nature of auditing. An auditor is required to complete the audit in compliance with relevant standards and obtain sufficient appropriate audit evidence in the circumstances. This has the effect of reinforcing the importance of independence, professionalism, scepticism and the need to exercise judgement.

The audit process involves not only the auditor; it also involves the company and its audit committee. While there has been some improvement in enhancing the role and responsibility of the audit committee, we continue to advocate a greater role for the audit committee.

In our view, whilst an audit is an independent investigation, it is not a forensic inspection and is enhanced by an independent but symbiotic relationship with the board who, in our view, have obligations to provide independent oversight of the company in investors’ interests, that parallel the auditor’s obligation to audit with those interests as primary. Taking the audit committee as a board’s delegate in our view each party (the auditor and the audit committee) has a part to play and a responsibility to shoulder in ensuring that the audit process is effective.

Further, the paper on page 3 of the paper mentions that the Board is seeking ways in which to “. . . assure that auditors approach the audit with required independence, objectivity and professional scepticism”. Given that the nature of audit involves exercising professional judgement, in our view further rules are not necessarily the answer.

## General comments about mandating firm rotation

In our view, audit firm rotation is likely to lead to an increase in costs associated with an audit without the expected benefits. The only country we are aware of that has long historical experience of audit firm rotation is Italy and we note that that did not preclude the Parmalat audit matter.

Some of the problems we consider are likely to arise if firm rotation was mandated include:

- Decrease in audit quality due to the knowledge lost when the audit firm changes
- Increased audit costs due to the high learning curve each incoming audit firm faces
- Increased client costs associated with the incoming audit firm becoming familiar with the business
- Difficulty for the audit committee in choosing a new audit firm that has the relevant industry experience and expertise
- Difficulty for the audit committee in choosing firms for its non-audit services.

## Concluding comments

Our view is that mandating firm rotation is not the solution to reducing audit failures and improving auditor independence. Whilst further work is required to isolate the problem, we would encourage the PCAOB to consider ways in which to strengthen the role of the audit committee and to look at how the five drivers of audit quality could be further enhanced.

Yours sincerely



**Lee White**  
Executive General Manager – Members  
Institute of Chartered Accountants in Australia

# The benefit of audit

A guide to audit quality



The Institute of  
Chartered Accountants  
in Australia

# The Institute of Chartered Accountants in Australia

The Institute of Chartered Accountants in Australia (the Institute) is the professional body representing Chartered Accountants in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing more than 50,000 Chartered Accountants and 12,000 of Australia's best accounting graduates who are currently enrolled in our world class Chartered Accountants postgraduate program.

Our members work in diverse roles across commerce and industry, academia, government, and public practice throughout Australia and in 119 countries around the world.

We aim to lead the profession by delivering visionary leadership projects, setting the benchmark for the highest ethical, professional and educational standards, and enhancing and promoting the Chartered Accountant brand. We also represent the interests of members to government, industry, academia and the general public by actively engaging our membership and local and international bodies on public policy, government legislation and regulatory issues.

The Institute can leverage advantages for its members as a founding member of the Global Accounting Alliance (GAA), an international accounting coalition formed by the world's premier accounting bodies. With a membership of around 775,000, the GAA promotes quality professional services, shares information, and collaborates on international accounting issues.

Established in 1928, the Institute is constituted by Royal Charter. For further information about the Institute, visit [charteredaccountants.com.au](http://charteredaccountants.com.au)

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First published November 2009

Published by: The Institute of Chartered Accountants in Australia  
Address: 33 Erskine Street, Sydney, New South Wales, 2000

### **The benefit of audit: A guide to audit quality**

First edition

The benefit of audit: A guide to audit quality  
ISBN 978-1-921245-60-2

## Foreword

Since the ASX Corporate Governance Council was formed in August 2002, we have been committed to developing and delivering practical guidance to boost corporate governance practices in Australia and to meet global expectations in this area.

A key component of good corporate governance in Australia and internationally is the role and responsibilities of the audit committee. Recognising that ultimate responsibility for the integrity of a company's financial reporting rests with the full board of the company, an audit committee provides an efficient mechanism for focusing on issues relevant to such reporting.

I welcome the initiative by the Institute of Chartered Accountants in Australia to produce *The benefit of audit: A guide to audit quality*. For the first time, there is practical, plain-English guidance available to fuel understanding of and communication on audit quality. This will be a valuable tool for directors and audit committees.

High-quality auditing is integral to capital market confidence. At times, the role of audit can be understated and undervalued. This guide will help ensure Australia remains focused on the benefit of audit.

A handwritten signature in black ink, appearing to read 'Eric Mayne', written in a cursive style.

**Eric Mayne**

Chairman

ASX Corporate Governance Council



# Contents

<b>Introduction</b> .....	6
<b>Purpose of this guide</b> .....	7
<b>Role of the audit committee</b> .....	8
<b>The five drivers of audit quality</b> .....	9
1. The culture within an audit firm .....	10
2. The skills and personal qualities of audit partners and staff .....	11
3. The effectiveness of the audit process .....	12
4. Factors outside of the control of auditors .....	13
5. The reliability and usefulness of audit reporting .....	14
<b>Further reading</b> .....	15
<b>Glossary</b> .....	15



# Introduction

Given its significance, there have been various attempts to clearly define 'audit quality.' A good example is the following statement from the United Kingdom Financial Reporting Council's Audit Inspections Public Report:

'Undertaking a quality audit involves obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgements... A quality audit [also] involves appropriate and complete reporting by the auditors which enables the Audit Committee and Board to discharge their responsibilities.' (June 2005)

While there can be differing views on the definition of audit quality, it is clear that shareholders, company directors, audit committee members, auditors and regulators all agree that quality external auditing is fundamental to business and capital market confidence.

Australia's auditing profession, along with the current framework of auditing standards, is among the world's best. However, we should be continually challenging ourselves to identify and develop actions that aim to improve auditing practices and outcomes.

To date, there has been little guidance available of which we are aware to help businesses understand the quality of the audit service being provided to them. This lack of information has compounded the concept of the 'audit expectation gap,' which we have seen emerge in the business and investor communities.

The Institute of Chartered Accountants in Australia is committed to addressing this expectation gap by raising awareness of the benefits of audit and by educating the marketplace on the specific drivers of audit quality. A follow-up to this guide will be released in 2010 and include the development of measures of audit quality and examples of external communication strategies for audit practitioners.

We hope this guide will foster better communication, interaction, and understanding between audit committee board members and their external auditor.



**Graham Meyer**

Chief Executive Officer

The Institute of Chartered Accountants in Australia

## Purpose of this guide

The purpose of this guide is to enhance communication between the audit committee and the external auditor. The guide provides assistance to audit committees and other relevant stakeholders to:

- > Better understand the role and scope of an external audit
- > Engage more effectively with the external auditor
- > Consider the drivers of audit quality and the components of each driver.

This guide does not set out compliance requirements or override any existing requirements to which boards and committees may be subject, and it is not intended to deal with better practice of audit committees which is addressed in other publications, such as *Audit Committees: A Guide to Good Practice*<sup>1</sup>.

Audit committees using this guide will need to determine when to communicate with the external auditor on the drivers of audit quality. For example, some discussion might occur at the initial planning phases of the external audit, while other communication will relate to the audit findings and conclusions. Audit committees could also consider using this guide during the proposal process to assist with auditor selection.

This guide addresses five drivers of audit quality, drawn from the Financial Reporting Council's (UK) Audit Quality Framework. This framework, the first of its kind, was developed following global consultation.

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1. Auditing and Assurance Standards Board, Australian Institute of Company Directors, and the Institute of Internal Auditors in Australia (2008).

# Role of the audit committee

An independent audit committee is a fundamental component of a sound corporate governance structure.

Audit committee charters will typically focus on engagement with the external auditor and the quality of the external audit service. Examples of focus areas in audit committee charters include:

- > 'Review the performance of the external auditor'
- > 'Consider the overall effectiveness and independence of the external auditor'
- > 'Review, at least annually, the scope, results and performance of the external auditor'
- > 'Assess and monitor the performance and effectiveness of the external auditor'
- > 'The committee will progressively evaluate the performance of the external auditor during its term of appointment and the progress of the audit. The committee will ensure that the criteria for evaluation of performance extend to cover the value delivered to shareholders and the audit.'

This guide, and in particular the questions supporting each driver of audit quality, is designed to help audit committees meet the responsibilities of their charters.

## The five drivers of audit quality

1. The culture within an audit firm
2. The skills and personal qualities of audit partners and staff
3. The effectiveness of the audit process
4. Factors outside of the control of auditors
5. The reliability and usefulness of audit reporting.

This guide includes a practical range of questions to accompany this list. These questions are not designed to be comprehensive; rather they are intended to provide a foundation and will need to be tailored to the specific circumstances of each organisation and its auditing requirements.

## The five drivers of audit quality (continued)

### 1. The culture within an audit firm

#### Points for consideration and discussion with your external auditor

- > What are the core values of your auditor?
- > Does your auditor's code of conduct include commitments to:
  - Honesty and integrity
  - Professional competence
  - Independence.
- > How does your auditor regularly communicate the core values and principles of the code of conduct to staff?
- > How does your auditor communicate to its staff about the importance of audit quality?
- > How does your auditor assess compliance with independence requirements?
- > Does your auditor create an environment where achieving high quality is valued, invested in and rewarded?
- > Does your auditor have appraisal systems for partners and staff that promote audit quality?
- > Does your auditor take appropriate action for poor ethical behaviour or poor decisions?
- > Does your auditor have robust systems for client acceptance and continuation?
- > Does your auditor promote and support consultations for exercising professional judgement in challenging circumstances? How?
- > Does your auditor monitor audit quality across its firm and/or network? What actions would they take for shortcomings in these activities?
- > Has any partner in your audit firm been the subject of regulatory action on the public record during the past year?
- > How is your auditor structured to ensure appropriate focus on the quality of its audits? How does it commit to continuous improvement in audit quality?

## **2. The skills and personal qualities of audit partners and staff**

### **Points for consideration and discussion with your external auditor**

- > Do the partners and staff of your auditor demonstrate a thorough understanding of your business and the legal framework in which you operate?
- > Do the partners and staff show technical competence and a thorough understanding of auditing and accounting standards, and professional and ethical standards? Do they receive regular training on these standards?
- > Does your auditor provide you with details of your engagement team including the role and experience of the team and the way in which the team is managed and supervised?
- > Where your audit requires specialised industry knowledge, have audit staff received adequate industry training?
- > Are the partners or staff involved in relevant industry based groups?
- > How do audit staff receive mentoring and on the job training?
- > Do the partners and staff show appropriate professional scepticism and address issues identified during the audit in a robust manner?

## The five drivers of audit quality (continued)

### 3. The effectiveness of the audit process

#### Points for consideration and discussion with your external auditor

- > Do you understand what your auditor does and does not do, including how the auditor reviews the various operations of your business?
- > Do you understand clearly the roles and responsibilities of each of the following groups: the audit committee, the board of directors, management, and the external auditor?
- > Are the audit partner(s) and manager(s) closely involved in the planning of your audit?
- > Is the external audit plan discussed at audit committee meetings well before year end?
- > Are your reporting deadlines realistic and achievable for the delivery of reliable and relevant information to your auditor to allow a quality audit?
- > Does your auditor's methodology, technology and/or tools:
  - Provide a framework and processes to obtain sufficient appropriate audit evidence?
  - Comply with all legal and professional requirements?
  - Require appropriate audit documentation?
  - Require an effective review of audit work?
- > How does your auditor use technology to support its audit approach?
- > Is sufficient technical support available to the audit team when required?
- > How does your auditor review the work of experts, including assessing their terms of reference, competence, capabilities and objectivity?
- > How does your auditor gain appropriate assurance on audits of group entities that operate overseas?
- > How does your external auditor engage with, and use, the work of your internal auditor?
- > Does your auditor have appropriate access to the audit committee, including 'in camera'?

#### **4. Factors outside of the control of auditors**

- > Does your organisation attach appropriate importance to financial reporting and the audit process?
- > What qualifications and level of experience do the preparers of financial statements have in your organisation?
- > Is the composition of your audit committee sufficiently balanced in skills, experience and industry knowledge to ensure audit quality?
- > Does your audit committee engage in a robust and professional manner with issues identified during the audit?
- > How does your audit committee assess the quality of financial information provided by management?
- > Is there sufficient capacity (nature, mix and size) in your organisation's financial reporting capability to meet your expectations?
- > Are your organisation's financial reporting deadlines realistically focused to ensure quality financial reporting and auditing?
- > Who in your organisation is responsible for communicating with investors?
- > Does the audit committee approve releases to the market?
- > What remuneration systems does your organisation have and how do they relate to key accounting judgements? Is there potential for bias and how is that monitored?



## The five drivers of audit quality (continued)

### 5. The reliability and usefulness of audit reporting

#### Points for consideration and discussion with your external auditor

- > Does your auditor communicate with sufficient detail on the scope of the audit and the accompanying report, including the way in which the risk of material misstatement in the financial statements has been addressed?
- > Does your auditor report on the key judgements made by management in assessing the application of accounting standards and the auditor's assessment of these judgements?
- > Are your auditor's reports written in a clear manner? How could they be improved?
- > Does your auditor suggest potential ways of improving financial reporting and internal controls?
- > Does your auditor provide the audit committee with a list of unadjusted differences identified during the course of the audit?
- > Does your auditor seek feedback from its clients on a formal basis?

## Further reading

**The Actuarial Quality Framework (2009)** Financial Reporting Council (UK) [www.frc.org.uk](http://www.frc.org.uk)

**Audit Committees: A Guide to Good Practice (2008)** Auditing and Assurance Standards Board  
The Institute of Internal Auditors Australia  
The Australian Institute of Company Directors

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## Glossary

**Audit committee** A sub-committee of the governing board of a corporate entity, normally with responsibility for interacting with the external auditor and monitoring the audit process.

**Audit opinion** The auditor's overall conclusion.

**Audit report** The auditor's formal report, normally addressed to the board of directors of a company (or the equivalent for other entities), containing a written expression of the auditor's overall conclusion.

**Auditor** The independent external individual who leads a team responsible for conducting an audit of the annual financial statements of a corporate entity. The auditor is normally responsible for forming and expressing a professional opinion on whether or not the financial statements 'present fairly' (or are a 'true and fair' representation of) the state of affairs of the entity and the results of its operations, for the period being audited.

**Auditor independence** The concept of independence is fundamental to compliance with the principles of integrity and objectivity. Auditors and their staff are required to be independent of their audit clients both in fact and in appearance.

**Audit committee charter** A document that sets out the functions and powers that have been delegated to the audit committee by the board of directors or governing board.

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