The Institute of Chartered Accountants in Australia
Professional judgment: are auditors being held to a higher standard than other professionals?

Professor Ken Trotman, Centre for Accounting and Assurance Services Research, University of New South Wales
The Institute of Chartered Accountants in Australia

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About this report

Professor Ken Trotman of the Centre for Accounting and Assurance Services Research, University of New South Wales, has prepared this report. All information is current as at August 2006.

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The audit profession has never been more under the microscope than it is today. Major international corporate collapses have lead to new independence rules, while auditing standards have been given the force of law in Australia.

Some regulators are calling for the bar to be raised even higher, with a zero tolerance policy to errors in judgment by auditors.

In this time of change, it is crucial things do not go too far.

This paper discusses judgment and how it is core to the audit profession. It examines independent inspection process and reports, concluding that a balanced approach is needed to help improve market confidence.

Professional Judgment was commissioned by the Institute and written by Professor Ken Trotman from the Centre for Accounting and Assurance Services Research, University of New South Wales. It forms part of the Institute’s objective to deliver effective and visionary thought leadership initiatives that profoundly and positively impact business and the accounting profession.

Neil Faulkner FCA
President 2006
The Institute of Chartered Accountants in Australia
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Executive summary

Auditors today are subject to increased expectations from regulators and the investing public. At the same time, corporations are expanding, transactions have become more complex and there are requirements on auditors to provide much greater levels of assurance related to financial fraud.

This paper notes that judgment is the ‘cornerstone’ of auditing and describes some of the 40 years of research that has considered judgment and expertise. While the literature recognises that ‘of course experts make mistakes’, there appears to be a growing presumption that this should not be the case for auditors.

In many professions, the difficulty of making judgments is recognised. This paper discusses the role of judgment in medicine, the legal system, police investigations and marketing. It is recognised that errors of judgment do sometimes occur in these professions. The question that arises is whether auditors are being held to a higher level of accountability than other professions. This is particularly important where the scope of audits is constrained by the price society is willing to pay for such services. It is suggested that even a well-conducted audit, following all appropriate audit standards, can fail to detect a material fraud in the financial statements, particularly where management has gone to great lengths to cover up the fraud. These considerations are important in an environment where audit standards have the force of law.

The concept of cumulative evidence is discussed by reference to the Public Company Accounting Oversight Board (PCAOB) reviews of the Big 4 in the US. It is concluded that any inspection process should be concerned with whether sufficient cumulative evidence has been obtained rather than specific aspects of particular audit tests. The paper suggests that Australian inspection agencies have an opportunity to more fully inform investors than has been the case with the PCAOB, by providing a more even-handed assessment that describes both the good and the bad. The market needs to be aware of not only problems but also enhancements in independence procedures and quality controls and whether the enhanced policies are continuing to work effectively.
1 Introduction

A recent newspaper report noted that for the High Court of Australia in the 2004–2005 financial year, 53 of the 73 appeals (73 per cent) were upheld (SMH 28 December 2005, p 12). The number of appeals upheld in various state appeal courts was similarly high. The president of the NSW Court of Appeal, Justice Keith Mason, said ‘mishaps do occur in any human system’. Justice Mason is clearly correct. In fact, there is over 40 years of judgment and decision-making research (JDM) in psychology that shows that both novices and experts from a wide range of professions do, on occasions, make incorrect judgments.

It is worth reflecting on the relevance of the above information in respect of the auditing profession. For over 50 years, professional judgment has been considered the cornerstone of auditing. The American Institute of Certified Public Accountants (AICPA 1955) states that ‘judgment is the most important factor in the making of an audit’. According to Mautz (1959), ‘judgment must inevitably play a major role in auditing’. In the last 50 years, the auditing profession, like all professions, has seen errors in judgment. Over the last five years, many countries, including the USA and Australia, have witnessed some of the most spectacular corporate collapses in history. These corporate failures have been notable because they involved frauds of enormous scale, they involved materially misstated financial statements, they appear to have involved the highest level of company management, and the independence of the auditor has been questioned in some of them. Arthur Andersen, one of the Big Five audit firms, was auditor of a number of these firms including Enron, Worldcom and HIH Insurance. The firm subsequently ceased operations in the USA and globally.

In response to the above, consider the changes in the life of an auditor over the last five years. The profession has been subject to unprecedented criticism, the definition of a ‘quality audit’ is increasingly complex, there are a variety of new independence rules, auditing standards have been given the force of law, new inspection regimes have evolved (both internal and external to the firms) and the profession is no longer self-regulated. While there is considerable agreement that many of the above changes were needed, it is surprising that there are still some calls for greater regulation and some support to move closer to the American system. Regulators around the world seem to be taking the attitude that any error in judgment is unacceptable and that the public have the right to a zero tolerance on errors in judgment by auditors or the existence of financial fraud. This is the case even when the auditor has carried out a quality audit and has been deceived by management who have gone to extraordinary lengths to cover up the fraud.

Corporations are expanding, transactions are more complex, there is a high-tech global world, and there are requirements on auditors to provide much greater levels of assurance related to financial fraud. The question arises as to how easy it is to conduct a financial statement audit in the 21st century. The investing public rely on auditors to ensure a fair playing field. When this fails, there is a serious erosion of confidence in public financial reports and the credibility of the audit report. It is clear that not many groups in society understand the complexities of carrying out an audit and the numerous judgments to be made. The question becomes whether auditors are being held to a higher level of accountability than other professionals.
2 Raising of the audit quality bar

Not surprisingly, there have been a large number of calls asking ‘where was the auditor?’ and ‘how could these corporate collapses occur?’ Governments and professional bodies were quick to react with substantial amounts of legislation and other actions aimed at improving auditor independence and enhancing audit quality. The introduction of new legislation, regulations and authoritative audit guidance was extensive. In particular, these new changes included society’s demand for improved fraud risk assessment and detection. In the US, the Sarbanes-Oxley Act was introduced in 2002. This Act contains numerous provisions aimed at enhancing the financial reporting of public companies. It created a new dual opinion audit for public companies covering both financial statements and management’s assessment of the effectiveness of internal control over financial reporting. The Sarbanes-Oxley Act created a new body called the Public Company Accounting Oversight Board (PCAOB) whose responsibilities include the oversight of the quality of audits as well as the setting of auditing standards of public companies. One of these new standards covers increased documentation requirements for the audit of public companies. Of particular interest is the PCAOB’s establishment of an inspection program of audit firms covering both independence and quality control procedures and policies. These inspections cover a sample of audits conducted by the firms in the previous year. The first reports (covering 2003 audits) were issued in 2004, and the most recent inspection reports (covering 2004 audits) were issued late in 2005.

The International Auditing and Assurance Standards Board (IAASB) has been active in developing new audit standards and enhanced independence and quality control procedures internationally. Many of these new standards expand the minimum requirements for an auditor’s understanding of an organisation’s business and industry, and assessments of the risk of material misstatements for both errors and fraud.

In Australia, new legislation was enacted in 2004 as part of the Corporations Law Economic Reform Program (CLERP). This legislation covers a wide range of corporate governance, audit and financial reporting issues, and includes provisions for enhanced audit independence. The legislation increased the obligation of auditors to detect fraud and provided Australian auditing standards with the force of law. In Australia, an inspection program of audit firms has commenced. The Australian Securities and Investment Commission (ASIC) reviewed the Big 4 firms and second tier firms with respect to auditor independence last year (ASIC 2005). Their current focus is on audit quality and independence. Since July 2006, ASIC’s work also examines a firm’s compliance with auditing standards, in addition to the appropriateness of audit methodology and technology (ASIC 2006).

Worldwide, it is clear that auditors operate with heightened expectations from regulators and the investing public. The accounting profession is no longer self-regulated. One thing that all of the above demonstrates is that the audit quality bar has increased dramatically (Bell et al, 2005).
3 Audit judgments

As noted earlier, judgment is the cornerstone of auditing. In fact, reference to the need for auditors to ‘exercise professional judgment’ appears 244 times in the international standards on auditing (Pillar 2005). The Preamble (2006) issued by the Auditing and Assurance Standards Board (AUASB) notes that the standards are principle-based and the auditor is expected to use professional judgment in applying the mandatory requirements in light of the given circumstances.

Over the last 35 years, the field of decision-making has examined the judgments and decisions of individuals and groups. This research is typically called ‘judgment and decision making’ research (JDM). Much of the JDM research had concentrated on showing the limitations of human decision-making. Books and numerous journal articles have been written on describing and empirically testing human limitations and potential remedies. This research is dominated by studies using students and laypersons. There is, however, a significant number of studies addressing the judgments of a range of professionals including doctors, radiologists, scientists, judges, police and fire-fighters.

On the other hand, research by Klein and his colleagues (e.g. Klein 1998) studied humans under real-life constraints, such as time pressure, high stakes, changing conditions and personal responsibility. The professionals he studied included fire-fighters, critical care nurses, nuclear power plant operators and battle planners. Clearly the judgments of these professionals have serious consequences. Klein (1998) documents human strengths and capabilities that had previously been downplayed or overlooked in the above JDM research.

Since 1974 there has existed extensive literature on the judgment of auditors (see reviews such as Trotman (1996) and Nelson and Tan (2005)). One important finding from this research is that while auditors, like all humans, are subject to some deficiencies in judgments, auditors in these studies have generally performed at a higher level than other types of professionals. That is, auditors do make errors in professional judgment like every other profession but, in general, their performance in experiments is better than most professionals (Smith & Kida 1993).

While some groups in society may see any judgment errors by auditors as unacceptable, a closer examination indicates that some mistakes by professionals are inevitable. Bell et al. (2005) provide an interesting discussion of professional judgment. They note that it refers to judgments of persons with experience, extensive education and or specialised training within a profession (Bell et al. 2005; Gibbins 1984). Bell et al. note that these professional judgments typically are very difficult and even the most expert professionals encounter challenging problems when making these judgments. It is also suggested that the size of the professional/technical departments in the Big 4 and the extensive consultation process within these firms is evidence of how complex these judgments can be. Conflicting expert testimony in major court cases and debates among leading professionals and academics again illustrate the complexity.

It is thus not surprising that non-professionals as well as other professionals often disagree about judgments. This has been recognised in many other arenas. For example, Bell et al. provide the following quote from Sunstein (2002), p 77:

> ‘Of course experts make mistakes … But precisely because they are experts, they are more likely to be right than ordinary people. Brain surgeons make mistakes, but they know more than the rest of us about brain surgery; lawyers make mistakes, but they know more than most people about the law.

Where does this leave us? It suggests that many of the disagreements between experts and ordinary people stem from the fact that experts have more information and are also prepared to look at the benefits as well as the risks associated with controversial products and activities. Ordinary people often make judgments on the basis of quick, intuitive assessment, in which affect plays a larger role.’

The Preamble (2006) states that ‘… the auditor is expected to use professional judgment in light of the given circumstances …’.

The question arises whether we can expect auditors never to make errors in judgment. It is suggested that the answer has been ‘no’ in the past and it is even more likely to be ‘no’ in the future. Particularly in the case of fraud, where management has gone to elaborate lengths to cover up the fraud, there remains a risk that the fraud will not be detected. Bell et al. (2005, p 20) note that ‘even though auditors exercise professional scepticism in an attempt to mitigate risk of being deceived, there will always be some residual risk of material misstatement due to fraud …’

With the increasing complexity of accounting standards, these judgments for auditors are becoming even more difficult. There is growing recognition that standard-setters are issuing accounting standards that are difficult to audit or are even unattainable (Carmichael 2004; Palmrose 2005). Palmrose notes that the move away from historical cost accounting towards fair market value accounting can make financial statements very difficult, if not impossible, to audit. This issue of auditability problems has been raised in the US by the Panel on Audit Effectiveness (2000) and the PCAOB’s Chief Auditor (Carmichael 2004; c/f of Palmrose 2005).
4 Comparisons to other professions

In many professions, the difficulty of making judgments is recognised. For example, the use of second opinions in medicine is common. We are not surprised if sometimes doctors make the wrong diagnosis as generally the complexity of the human body is recognised. But at least these doctors, while facing these complexities, usually have the benefit of patients truthfully reporting their symptoms. However, Bell et al. (2005) note that this is unlikely to be the case for auditors if management is trying to cover up fraudulent financial statements. The auditor is faced with situations where management has altered information that the auditor would typically use as evidence. There are many examples of corrupt managers lying to auditors and fraudulently altering supporting documentation. There are also examples of managers manipulating accounting system numbers and account balances to align with the financial statements. Yet, when these frauds are discovered, the question is asked ‘why the auditor was unaware?’ It is suggested that it is naïve for the public to expect the auditor to align with the financial statements. Yet, when these frauds are discovered, the question is asked ‘why the auditor was unaware?’ It is suggested that it is naïve for the public to expect there to be zero probability of financial fraud.

Let us consider the medical analogy further. Assume a patient goes to a doctor with certain symptoms. The doctor asks a series of questions, including some about the patient’s daily alcohol intake. The patient, who is a heavy drinker, informs the doctor that he never drinks alcohol. The reasons for the cover-up could be various, including insurance claims, reactions of family, etc. Assume that the patient falsely answers a series of questions to direct the doctor away from the true cause of the problem. The doctor, however, using professional scepticism, doubts some of these answers and sends the patient for some blood tests. The patient sends a friend to take the blood test that shows up clear for all symptoms that the doctor was investigating. Three months later the patient dies. What is the probability of those most affected by the death successfully suing the doctor for an incorrect diagnosis?

Our legal system is structured around appeal courts because it is recognised that courts do not always make the correct judgments. It is known that some individuals lie, not all information may be presented and evidence may be fabricated. In addition, the possibility of unintended judgment error by either judges or jury can result in the wrong judgment. Consequently, there are appeal courts. Generally the higher the appeal court, the larger the panel of judges. This phenomenon takes advantage of the well-documented judgment literature on the benefits of group decision making. Note that it would be possible to eliminate some of the initial judgment errors if society was willing to pay the additional costs of larger panels of judges in lower courts.

The earlier reference to the newspaper article on the high number of cases upheld by appeal courts shows that errors do occur and that processes are in place to consider those situations. While appeal courts only hear particular types of cases (e.g. ones with reasonable prospects of success), once a case gets to be heard by an appeal court it has a reasonably high chance of success. For example, in 2005, 53 of 74 cases were upheld by the High Court, 17 of 21 by the NSW Court of Appeal, 14 of 16 by the Federal Court, 12 of 14 by the Queensland Court of Appeal, etc. (Sydney Morning Herald, 28 December 2005). That is, the court system recognises that not all professional judgments will be correct all the time. This is supported by a recent law lecture, ‘Can Judges Make Mistakes?,’ where Sir Neil MacCormick, a distinguished academic lawyer, noted that sometimes judicial decisions are not just controversial, but wrong. ‘They may, however, as easily be wrong by being too restrictive of the judicial function as well as by being too expansive in that respect’ (MacCormick 2006).

Police do not always find the criminal. When a person conceals the evidence of his crime, finding the criminal can be a difficult task. If we double the resources available to police, more crimes would be solved. But can society afford this? Similarly, by using more resources, audit firms can increase the likelihood of detecting material fraud. However this increases costs. The question is whether shareholders and society are willing to pay these costs.

MBA marketing subjects address the question ‘why do good (marketing) people make bad (marketing) decisions’. A further examination of this material shows that marketing experts on occasions make the wrong judgments. In summary, experts do not always get it right whether they are an auditor, doctor, judge, marketer or even a politician.

The major point is that other professionals are not free from judgment errors and we may be holding auditors to a higher standard of judgments than other professions. James Turley, chairman and CEO of Ernst & Young, in a presentation to the US congress (Turley 2005), noted congressional testimony from former PCAOB chairman Bill McDonough, who said ‘we’ve made it very clear to auditors that, yes we would be critical if you don’t do enough work on internal control’. But then he added ‘we’ll also be critical if you did too much’.

1. A medical analogy was introduced into the audit literature in Bell, Peacher and Solomon (2002).

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Professional Judgment
5 Cumulative evidence

It should also be noted that the scope of an audit is constrained by the price that society is willing to pay for such services. As a result, the auditor has to make choices on the approach to risk identification and assessment, judgments on what type of evidence to collect, and the size and types of samples to collect. If the auditor was unrestricted by price, they obviously could increase both the amounts of evidence and the types of evidence to be collected. Referring back to our medical analogy, every patient that enters a doctors room is not sent automatically for an electro cardiogram (ECG). While this would increase the early detection of heart problems and possibly lead to an average increase in life expectancy, the related costs would be substantial. At least at this time, however, society is not willing to bear that cost.

Following these analogies, the suggestion that the regulators and investing community have the right to expect a total absence of significant financial statement fraud appears inappropriate. Even a well-conducted audit, following all appropriate auditing standards, can fail to detect a material fraud in the financial statements. The above discussion needs to be considered in an environment where auditing standards have the force of law. What we need to ensure is that fraud is kept to a minimum by enhancing the independence of auditors and the quality of audit processes within the cost framework society is willing to bear. Auditors need to be held accountable, like all professionals, when there is negligence. However, they should not be held to higher levels of accountability than other professions.

Issues related to professional judgment in respect of the most recent PCAOB reviews of the US Big 4 firms are considered here. These reviews, referred to as ‘2004 Inspections’, were issued between 29 September 2005 and 17 November 2005. For all four firms, the inspection team ‘identified matters that it considered to be audit deficiencies’. For all firms it was stated that ‘in some cases the deficiencies identified were of such significance that it appeared to the inspection team that the firm had not, at the time it issued its audit report, obtained sufficient competent evidential matter to support its opinion on the issuer’s financial statements’. It should be noted in the above statement the term ‘it appeared to the inspection team’, i.e. the inspectors were making a professional judgment.

Of interest is the fact that some regulators across the world have interpreted the results of these inspection reports to indicate that there is still a problem and that, potentially, further regulation is still required. A reading of the responses of the four firms involved emphasises that the whole process involves a considerable amount of judgment by both the inspectors and the audit firm.

The responses of all four firms noted the importance of professional judgment. PwC noted that ‘the execution of an audit in accordance with PCAOB’s standards requires the exercise of significant professional judgment and that the views may differ on matters such as the nature, timing and extent of audit procedures and related documentation’.

KPMG noted that ‘while we may have differing views on specific issues relative to the scope of audit procedures and documentation necessary to comply with applicable professional standards, we recognise that judgments are involved in both the performance of an audit and the subsequent inspection process …’. Ernst&Young also stated ‘that judgments are involved both in performing an audit and in subsequently inspecting it’. Deloitte made two references to the importance of professional judgment in ‘respectfully disagreeing’ to some of the comments of the inspectors in Part 1 of the Draft Report.

The strongest response came from PwC who stated that for many of the findings they respectfully disagreed with the conclusions that:

- the Firm had not, at the time it issued its audit report, obtained sufficient competent evidential matter to support its opinion on the issuer’s financial statements. In that respect, for approximately two-thirds of the findings we believe:
  - The work performed was adequate in the context of the audit as a whole and therefore such findings present good faith differences of opinion on the application of professional judgment
  - While certain individual tests may not have been completely sufficient, when the totality of the work done in the specific audit area was considered, and/or the significance of the test was evaluated in the context of the audit as a whole, the finding was considered not sufficient enough to warrant performing additional audit procedures
  - Appropriate testing was done, but the documentation in the work papers may not have completely captured all testing and/or the rationale underlying all conclusions. However, considering the totality of the procedures performed in the context of the audit as a whole, we believe that the documentation was adequate.’

What lessons can be learned from the above discussions of auditor judgments as Australian audit firms face a new regulatory regime? It is suggested that common ground needs to be reached between the audit firms and the inspectors on what constitutes reasonable assurance and what constitutes well-justified beliefs. This common ground will be impacted by constraints placed on the price of audits and the legal liability regime faced by auditors.

It is suggested that the inspection process should be concerned about whether sufficient cumulative evidence has been obtained rather than specific aspects of particular tests. The role of the inspection process should be to conclude whether the cumulative evidence is sufficient and appropriate for forming sufficiently well justified beliefs. Effective audit quality control ‘necessitates the auditors’ timely evaluation of whether the cumulative evidence obtained during each element of the audit workflow is sufficient and appropriate for the objective at hand and facilitates the auditors’ development of well justified beliefs’ (Bell et al. 2005, p 41).

2. See Bell et al. (2005) for an excellent discussion of the concept of ‘well justified beliefs’.
There have been big advances in the approach to auditing over the last five to eight years with larger audit firms moving towards a strategic systems approach (Bell et al. 1997; Bell et al. 2005). Consistent with these frameworks, international auditing standards now require the auditor to obtain an understanding of the entity and its business environment. This understanding not only provides a context against which to evaluate other audit evidence, it is evidence itself. The auditor needs to use his/her professional judgment to determine the cumulative level of evidence needed. It would not be appropriate for the audit firms to be selecting sample sizes and type of evidence based on what they believe will satisfy an inspector. It is important that auditing avoids becoming much more programmed and regimented, rather than auditors acquiring a deep understanding of the client’s business so they can ‘conduct business-informed tests and assess business-informed evidence before they can draw reasonable conclusions about the veracity of financial statements’ (Solomon & Peecher 2004). Support for the importance of avoiding a more prescriptive approach is provided by the UK Accounting Principles Board (APB) in their response to the IAASB Clarity Project:

“However, the key underlying issue that is being addressed relates to the level of prescription to be established by auditing standards. Some take the view that audit quality is likely to be improved by having detailed prescriptive standards that facilitate external monitoring of audit quality. Others, including the APB, favour a more principles based approach recognising that many of the key features of good auditing are dependent on auditor experience and judgement and that too many rules can be distracting and lead to a “tick box” approach to auditing … The APB has, however, a residual concern that the exercise will result in a significant increase in the number of requirements and that this will deter experienced practitioners from adopting a thoughtful and sceptical approach to an audit and from focussing on the assessment of the risks of financial statements being misstated and then performing work in response to such risks’ (Auditing Practices Board Limited 2005, p 2).
6 Concluding comments

The aim of this paper has been to re-emphasise the importance of judgment in auditing and to raise the question whether auditors are being held to a higher standard than other professionals. This paper recognises that top experts in every field can sometimes be wrong, particularly when some of the facts are purposely hidden from them.

The development of independent inspection of audit quality has been a positive step. It is critical, however, that the inspection process has the respect of both the accounting profession and the business community. It is suggested that a much more positive approach to inspection than we have seen overseas is appropriate. For example, the PCAOB by only reporting negative issues just gives the market part of the picture.

There is an opportunity for Australian inspection agencies to inform investors more fully than has been the case with the PCAOB. There have been major improvements in the policies and procedures of the large audit firms with respect to independence and quality control over the last four years (Houghton & Trotman 2002; 2003; 2005; PricewaterhouseCoopers Oversight Board 2004). If the aim is to improve the confidence of capital markets in financial reporting and the audit process, then capital markets should be given a more even-handed assessment that describes both the good and the bad. This could include an update on new improvements by the audit firms, as well as any deficiencies detected. The market needs to be aware of these enhancements and be able to assess whether the policies are continuing to work effectively. Otherwise, if all that appears each year is a negative document, it is hard to see how market confidence will improve.
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## Glossary of abbreviations

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<td>CLERP</td>
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