AUSTRALIAN ACCOUNTING RESEARCH FOUNDATION

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Inquiry Secretary
Joint Committee of Public Accounts and Audit
The Commonwealth Parliament
Parliament House
Canberra ACT 2600

26 July 2002

Dear Mr Cunningham,

Re: Review of Independent Auditing by Registered Company Auditors

Thank you for the opportunity to respond to the supplementary questions forwarded to the Auditing & Assurance Standards Board (AuASB) as Attachment A of your letter of 5 July 2002. Please find the AuASB's responses below.

1. What is your opinion on the following proposals:
   - The Corporations Act be amended to require that accounting firms undertaking audits of public listed companies to be incorporated and publicly listed.

   It would be helpful to the AuASB to know whether there is some facet of the existing structural arrangements for accounting firms that prompts this proposal. It is unclear whether the proposal is meant to: (i) address liability issues facing auditors; (ii) bring accounting firms under a regime of continuous disclosure; or (iii) regulate auditors via market forces. It is not clear to the AuASB how changing the structural legalities of accounting firms could create any greater reputational damage than exists currently for accounting firms negligent in their responsibilities. The efficiency of market mechanisms in acting punitively toward accounting firms that transgress has been well demonstrated in recent months. Imposing a new regulatory structure when it has not been demonstrated adequately that the existing structure is flawed needs careful consideration.

   With this uncertainty in mind, the proposal would have several effects if implemented. Accounting firms would be obliged to publish financial reports, the veil of incorporation would be available to limit their liability, and share prices may reflect the expected future cash value of the firms' earning streams.

In response to the first point, the AuASB would support the major accounting firms in recognising the need to disclose aspects of their financial performance and their accountability processes. In relation to the second point, the accounting firms welcome an approach to limiting liability in a way that maximises incentives to perform quality audits. Implementing proportionate rather than joint and several liability could achieve this, without requiring accounting firms to list publicly. In terms of the third point, which seemed from the Hearing of 28 June 2002 to reflect the thinking of the Committee, the following observations are made:

- *It is likely only the largest accounting firms would meet the listing requirements, in which case any disciplinary mechanism imposed by the capital market will be limited in its application;*
- *Unintended consequences may follow in restricting competition in the market for audit services in that smaller accounting firms currently undertaking audits of public companies may become ineligible to do so;*
- *In terms of demand for and supply of shares and capital flows in these listed accounting firms, it would be difficult to ascribe growth in value for investors. Audit is a mature market with limited prospects for growth. Such a market is likely to be thinly traded, and to not appeal to investors;*
- *Many accounting firms have already listed the portions of the firm which are able to be incorporated, their consulting arms, and it is these portions that are more likely to appeal to investors;*
- *It is the level of oversight, quality control standards and programs within each firm that influence the quality of the output. Factors external to the firms are not likely to operate in a timely way;*
- *The correlation between share price and entity performance is not high for existing listed companies and is declining over time. This is not likely to be any different for accounting firms for which the primary asset is intellectual capital. Valuing intellectual capital would be a major challenge for accounting firms and the market may also ascribe a margin for reputation capital;*
- *It is unlikely the market for information about the performance and quality processes of accounting firms could be any more efficient than it is currently, even with the capital market involved. Alternatives that might be considered include re-examination of the current constraints on resignation by auditors from engagements and limitation of liability in some way.*

- The Corporations Act be amended to require firms undertaking audits of publicly listed companies be required to lodge an independent performance report' to the regulator (ASIC) every twelve months. The report would provide details of the outcome of each audit, including details of mechanisms in place to ensure the independence of the external audit function. Additionally, ASIC would have the power to investigate any matters arising from the report and to take action to rectify any deficiencies or matters of concern.

  Again it would be helpful to understand the intent behind this proposal. If the intent is to discipline auditors, then, in the AuASB's view, adequate mechanisms exist via the market.

  It is important that the benefits and costs of both the existing situation and any proposed changes to existing structures and mechanisms are analysed *carefully before any changes are made. There is a risk that in the absence of careful consideration, analysis and consultation, any response could undermine public confidence. Whilst the AuASB would be pleased to consider this proposal, the liability considerations for auditors must be borne in mind.*

2. Would you care to elaborate on your recent comment that the setting of auditing standards was under-resourced and the accounting profession should consider putting more funds into the process?

   The questions may be answered in one of two ways. One way is to compare the current level of activity and output of the Australian Auditing & Assurance Standards Board (AuASB) to the equivalent Board in Canada. Canada and Australia have comparable demographics. The Canadian Board [the Assurance Standards Board (ASB)] has a Director, 4 Principals and 3 Consultants. The Australian Board presently has three staff members, one of whom is part time.

   Another way is to look at the projects that have been identified as opportunities by the AuASB, but remain unallocated to staff on the work program because of resources currently available. An implication of this is that choice has to be made between essential and non-essential projects. Some of the projects that are not receiving the attention the AuASB would prefer are in the areas of Governance and Assurance that could arguably lead to a strengthening of public confidence in corporate reporting. One such project that has been recently completed is the "Audit Committees: Best Practice Guide", which was extensively cited by Professor Ramsay in his recent Report on Auditor Independence. Further work in providing material that interfaces between corporate governance and the audit function is an aim of the AuASB.

   The Committee might be interest to know that a Consultative Meeting involving a wide range of constituents is planned for 25 October 2002 to provide input external to the AuASB on priorities and content of the AuASB Work Program.

3. What changes to the auditing standards would be required to refocus or expand the role of the registered company auditor from attesting to the financial statements to providing a more comprehensive and value-added service, responsible for reviewing and assessing say, corporate governance and risk management practices or conducting audits of performance.

   The basis for providing assurance on matters other than financial reports is largely in place within the current Auditing and Assurance Standards and Guidance Statements. Work is underway to develop a comprehensive framework that would enable the assessment of corporate governance and risk management and provide appropriate levels of assurance. It may be necessary to amend the Corporations Act 2001 to extend the scope of the statutory audit to enable these different levels of assurance to be provided. Whilst the AuASB is happy to consider this proposal again it raises liability issues for auditors that would need to be addressed.

4. How would you respond to the proposal to bring the development of internal auditing standards into line within the development of the external audit standards?

The objective of an external audit is to provide an independent opinion on the truth and fairness of the financial report. An internal audit is a management control tool and represents an internal governance mechanism where there is not intended to be independence from management. Internal auditing is much broader in scope than just financial statements. The worldwide organisation of the Institute of Internal Auditors (for which there is an Australian Chapter) currently issues standards and guidance for internal auditing. Australian Auditing & Assurance Standards include guidance on working with internal auditors (AUS 604 "Considering the Work of Internal Auditing"). However, the AuASB would be happy to expand its agenda to include providing more guidance on internal auditing, contingent on resources being available.

5. You took on notice a question from Senator Watson concerning what the Australian accounting standards permit in regards to the capitalisation of expenses. (Hansard, PA 81)

The formulation of Accounting Standards is not within the mandate of the AuASB, residing instead with the Australian Accounting Standards Board. However, the issue of capitalisation versus expensing in one of the judgement areas that auditors must address. Various Australian Accounting Standards and the Statement of Accounting Concepts No. 4 deal with the issue:

- ***AASB 1011 – Accounting for Research and Development Costs***
  Costs are to be written off, however can be deferred to future years where such costs in relation to a project are expected beyond any reasonable doubt to be recoverable. The costs are to be amortised over future financial years.

- ***AASB 1013 – Accounting for Goodwill***
  Purchased goodwill in connection with the acquisition of an entity, representing future benefits from unidentifiable assets can be recognised as an asset if the following criteria are satisfied:
  a) it is probable that future benefits embodied in the asset will eventuate
  b) the cost of the asset can be measured reliably
  Amortisation requires to be provided from the date of acquisition to the end of the period during which benefits are expected to arise. However period must not exceed 20 years from date of acquisition.

- ***AASB 1022 – Accounting for the Extractive Industries***
  Costs arising from exploration, evaluation, development and construction:
  Costs arising from exploration and evaluation are to be written off as incurred except where:
  - *costs are expected to be recouped through successful development and exploitation; and*
  - *further work is expected to be carried out in the area to enable an assessment to be made of the development potential of the area.*

Development costs can be carried forward to the extent that such costs are expected to be recouped through successful exploitation of the area or sale.

Construction costs, which represent depreciable assets are to be accounted for under ASRB 1021 – Depreciation of Non-current Assets.

- ***AASB 1036 – Borrowing Costs***

Borrowing costs to be capitalised:
Borrowing costs are to be written off in the year in which they are incurred except to the extent they are capitalised, ie costs that are directly attributable to the acquisition, construction or production of an asset must be capitalised as part of the cost of the asset.

- ***SAC 4 Definition and Recognition of the Elements of Financial Statements** (conceptual framework for general purpose financial reporting)*

Definition of an asset – assets are future economic benefits controlled by the entity as a result of past transactions or other past events.
Criteria for recognition of assets:
- *it is probable that the future economic benefits embodied in the asset will eventuate; and*
- *the asset possesses a cost or other value that can be measured reliably.*

6. You took on notice a question from Senator Watson as to whether the audit report should refer to significant risks faced during an audit and outline measures taken to minimise those risks. (Hansard, PA 83)

The reporting standard AUS 702 "The Audit Report on a General Purpose Financial Report" requires the auditor as part of the audit opinion to state that: "Our audit has been conducted in accordance with Australian Auditing Standards to provide reasonable assurance whether the financial report is free of material misstatement." As such, compliance is required by auditors with AUS 708 "Going Concern" and AUS 402 "Risk Assessments and Internal Control". Furthermore, under AUS 702, if a going concern issue is detected, auditors are required either to provide an adverse opinion or to include an emphasis of matter in their report. Auditors would welcome the opportunity to consider the need to refer to significant risks in the report, however, again, reform of liability rules or other protective measures would need to be considered concurrently .

7. Senator Murray asked if you would provide the Committee with an outline of the International Auditing Standards Board's risk-model project. (Hansard, PA 83)

The current Risk Standard applicable to audits in Australia is contained in AUS 402 "Risk Assessments and Internal Controls". The current guidance defines audit risk as the risk of giving an inappropriate opinion when the financial statement is materially misstated. It also clarifies the effects of several elements in relation to risk (for example the control environment and the quality of audit evidence).

The international guidance currently under development is far more detailed and specific, and clarifies aspects in relation to obtaining an understanding of the entity, *the auditor's response to risks identified, and audit evidence, in three separate auditing standards. The documents are currently being revised with a view to public exposure of these standards internationally and locally in the near future. The revisions entail a clarification of the standards' application to small entities, and updates to reflect contemporary language and approaches. It is proposed that the final standards will require that all audits incorporate a formal risk assessment; and that there should be clear linkages between risks of material misstatement and audit procedures (nature, timing and extent); and substantive procedures required for material classes of transactions, account balances and disclosures.*

I enclose for your information a copy of the *Report of Activities* of the AuASB for 2001 and if there is any other form of assistance the AuASB can offer the Review Committee, please do not hesitate to contact either myself or Christine Jubb on 03 9641 7440.

Yours sincerely,

W.R. Edge,
Chairman
Australian Auditing & Assurance Standards Board