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Mr Bob Charles MP
Joint Committee of Public Accounts & Audit
R1-108
The Treasury
Parliament House
Canberra ACT 2600

Dear Sir

RE: Review of Independent Auditing by Registered Company Auditors

We set out below our submission to the Joint Committee of Public Accounts & Audit on Independent Auditing by Registered Company Auditors. Our general comments are set out below. In addition Appendix 1 includes suggestions to improve the corporate governance environment in Australia. Appendix 2 contains suggestions on auditor independence.

General Comments

Too often company failures are considered the responsibility of auditors. Companies do not fail due to audit failure but generally due to changes in economic or other factors that adversely affect the business model (eg market forces, inability to raise further funds due to adverse capital market environment, etc) or mismanagement. Many of these factors may not be apparent or even exist at the time of the audit and may occur subsequently.

The public outcry in regard to audit failure stems primarily from the "audit expectation gap". Audits provide an opinion on **historical** financial statements in accordance with accounting standards and other requirements based on a going concern assumption. The auditor needs to be satisfied the going concern assumption is an appropriate basis, based on all reasonably foreseeable circumstances, for the preparation of the accounts. This does not mean the auditor is providing assurance on the future viability of the company by issuing an unmodified audit opinion. This is particularly the case when the factors mentioned above come into play.

The expectation that an un-modified audit report "guarantees" a company needs to be addressed. This will require a combination of the expansion of the audit mandate together with investor and director education and addressing the liability of auditors. It seems unlikely the audit profession would accept any extension of the audit scope without addressing the imbalance in the liability position. The content of the audit

report also need to be addressed to clarify not only what the audit covers but what it does not. It may be appropriate for some of the wording currently in the engagement letter to appear in an exclusions paragraph or a modified scope paragraph of the audit report.

The strength of a company is often predicated on the robustness of the business plan. This is a strategic business issue not an audit issue and as such the purvey of directors. Much shareholder value has been destroyed by management and it is the responsibility of directors to ensure decisions made by management are in the best interest of the company and shareholders. This requires independent directors and effective Audit Committees. Audit Committees and independent directors are also crucial to ensuring auditors have a forum to deal with issues arising from the audit.

The US Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee") recognised there "is a large grey area where discretion and judgement bear on the quality of financial reporting". Application of accounting standards, assessment of accounting estimates and the resulting audit opinion often operate in this grey area. The exercise of judgement by auditors is based on available evidence including management representations. In this context the importance of the "tone at the top" is all important. Directors need to understand and accept responsibility for the level of aggressiveness adopted by management in the application of accounting standards and assessment of accounting estimates.

The pre-eminence of the Audit Committee is well recognised. The Blue Ribbon Committee identified three groups responsible for financial reporting; the Board including the Audit Committee, financial management including internal audit and the external audit. The Blue Ribbon Committee considered the Audit Committee as the "first among equals". Given this acknowledged position it is important that regulators bolster the Audit Committee efficacy. While Australia has progressed in terms of Corporate Governance we still lag best practice and steps should be taken to address these shortfalls.

We trust you find the comments made above and in the appendices helpful. We would be happy to discuss any of the matters raised in our submission with the Committee.

Yours faithfully

Stephen La Greca
Director

Appendix 1 – Corporate Governance

1) Independence of Directors

Best practice Corporate Governance is underpinned by Independent Directors. The existence of strong Boards also enhances the external audit function. However Australia lags international best practice by not requiring listed companies to appoint a majority of independent non-executive directors. Many non-executive directors are not truly independent as they have trading relationships with the company or represent a significant shareholder.

Furthermore there is an increasing tendency for directors to hold large numbers of shares in the companies of which they are non-executive directors and also have the option to take directors fees in shares. These developments are alarming as it aligns the financial welfare of the directors with the share price to the possible detriment of taking action in assessing provisions, asset valuations, accounting practices and other matters which may have adverse effects on the share price. Independent directors should be subject to the same regulations and restrictions on financial relationships as applied to auditors to maintain their independence.

We therefore suggest the ASX Listing Rules be amended to include the following provisions:

1. The Chairman should be an independent non-executive director.

2. The majority of the Board be independent non-executive directors.

3. For a non-executive director to be independent they:

    a. Must not be a director or officer of a significant shareholder (i.e. 20% of any class of capital).

    b. Must not be a director or officer of a material trading partner (5% of turnover/purchases of either entity).

    c. Must not have a beneficial shareholding in the company greater than $5,000.

    d. Have not been employed by the company in the 2 years prior to appointment.

4. No non-executive director to hold office for more than 10 years.

2) Audit Committees

The ASX listing rules should require Audit Committees consisting of 2-3 independent non-executive directors with at least the Chairman of the Committee having financial qualifications and experience. This requirement should be in place for all listed companies. The argument for a different rule to apply to small companies ignores that these companies often have less independent directors and substantial executive director shareholding which exacerbates any motive to manage earnings and can provide a significant motive to misstate.

The Audit Committee Charter should ensure the auditor is invited to all meetings of the Committee and receives copies of all papers and minutes.

3) Audit Committee Report

In March 2000 the US Securities and Exchange Commission (SEC) adopted the recommendations of the Blue Ribbon Committee requiring the external auditor to provide a report in accordance with US Auditing Standard SAS 61 "Communication with Audit Committees" to the Audit Committee and for the Audit Committee to disclose to shareholders whether:-

i) the Audit Committee has reviewed & discussed the audited financial statements with management;

ii) the Audit Committee has discussed with the external auditor the matters required by SAS 61; and

iii) the Audit Committee has received a letter confirming audit independence.

The SAS 61 requirements were expanded to require the external auditor to communicate any uncorrected misstatements to the Audit Committee even if not believed material by the external auditor or management. In addition the quality of accounting principles and underlying estimates is to be discussed by the auditor.

We suggest the Appendix of the corresponding Australian Auditing Standard AUS 710 "Communication to Management on Matters Arising from an Audit" which has a similar scope to SAS61 be amended to also include the recent amendments to SAS61 including a discussion on the quality of the company's accounting principles encompassing the clarity and degree of aggressiveness or conservatism of the policies and other significant decisions made by management in preparing the financial statements. The report should be required to be in writing.

The Corporations Act should subsequently be amended to require the tabling of the report to the Audit Committee prepared by the amended AUS710 or its replacement.

4) Internal Audit Reports and Investigations

Audit firms should be provided, as a matter of course, with the results of internal audits, third party assurance engagement and fraud or other investigations the company is having performed. The auditor should be informed such assignments are underway particularly when third parties are preforming the assignment.

The Corporations Act should establish a positive reporting requirement for such information. In the absence of legislative change the requirement should be part of an Audit Committee's charter.

5) Board Reporting

In a number of cases of corporate failure allegations have been made that boards have been mislead. Consideration should be given to expanding the audit mandate to provide assurance to the Board the information it receives is accurate and complete. This would provide comfort to Boards and strengthen the relationship with auditors. There is precedent for this type of service. Audit firms have provided regulators assurance various returns are in accordance with company's records (APRA/RBA required audit firms in their report to APRA/RBA assurance on the various statistical returns submitted by the Banks). It should also be noted that the RBA as subject of one of its targeted reviews of Banks required Bank auditors to report on accuracy and the adequacy of credit reporting to the Board of Banks.

The Board would have to determine the reporting requirements and the audit firm could report on the accuracy and compliance with the requirements set out by the Board.

6) Independent Internal Audit

An independent internal audit function is integral to the control framework of any large organisation. For internal audit to be effective it should be independent. Therefore the internal audit should report directly to the Audit Committee. The Audit Committee in conjunction with management and the external audit should set the programme for internal audit. The position of Chief Internal Auditor should be appointed by the Audit Committee and his salary and operating budget should be determined by the Audit Committee.

7) Chief Financial Officer Sign-Off

Typically the Directors' Declaration accompanying the financial statements are signed by the Managing Director and another director (often the Chairman). There is no requirement for the Chief Financial Officer (CFO) to sign-off the accounts. We submit that the financial statements of listed public entities include a report by the CFO attesting to compliance with accounting standards, the company's status as a going concern and recoverability of assets.

Appendix 2 – Auditor Independence

1) Opinion Shopping

Companies often still “opinion shop” opinions on accounting standards. It is not unusual for an opinion to be obtained from another firm and presented to the incumbent firm as the company’s position based on independent advice. This undermines the position of the incumbent auditor. Opinion shopping could be controlled by requiring the Audit Committee to authorise the seeking of alternative accounting opinions and advising the incumbent auditor before doing so. The auditor should also be given a copy of the letter of instruction.

2) Associated Companies and Managed Investments

Auditor independence would be enhanced if listed companies which have significant shareholdings (i.e. greater than 20%) are audited by firms that are not auditors of the significant shareholder. There is the risk the audit firm would see their primary responsibility to the significant investor. This is exacerbated where the relationship between the companies is parent and partly owned subsidiary and there are few independent directors.

Similarly for Managed Investments the law should prescribe an audit firm independent from the responsible entity audits the managed investment scheme. Where a responsible entity is an audit client of the firm as well as the managed fund there is a potential conflict of interest which may be perceived as an impediment to auditor independence. This suggestion was in an early draft of the legislation but dropped in preference to different audit partners (from the same firm) auditing the compliance plan and the performing the financial statement audit.

3) Provision of Non-Audit Services

Many studies have been undertaken in relation to the effect of non-audit services (NAS) on auditor independence. There has been no conclusive evidence that NAS hinder the auditor’s independence. However restrictions on NAS may adversely affect an audit firm’s ability to conduct complex audits. Modern audits need the input of computer specialist, treasury and risk management experts and tax specialist. While these specialist do audits typically this may represent 20% to 40% of their available time. Firms could not effectively keep such specialist occupied without being able to use them on NAS. The NAS assignments are also important in retention of this specialist.

Given this dilemma the need to monitor an audit firm’s provision of NAS falls to the Audit Committee. We would suggest all NAS assignment be undertaken only with prior approval of the Audit Committee.

It should also be recognised certain NAS as a consequence of a firm’s appointment and imposed either by regulators (eg eligible revenue returns for telecommunications carries or APRA prudential audit requirements for banks), by capital markets, or

commercial arrangements (eg workers compensation certificates, outgoings and turnover certificates for shopping centre owners and retailers respectively).

Disclosure of Non-audit service (NAS) fees the disclosure should highlight NAS that arose from the firms being auditor eg workers compensation audits, reports under borrowing or fund raising activities etc.

The disclosure should also indicate when NAS are provided if they are for assurance services by way of sub-total.

4) Appointment and Removal of Auditors

NAS are not the greatest threat to audit independence. The real threat is insecurity of tenure. Provisions for giving security to a firm’s position as auditor should be considered by regulators. There is a disturbing trend to see a long term audit relationship as bad thing. Given the complexity of modern corporate entities any firm has a learning curve when it commences a new audit. Regular rotation of firms increases the risk of an audit failure because the firm has not enough familiarity with the audit client. It is not unusual for firm to invest significant time on a new engagement in understanding the client’s business and systems. This often is absorbed over a two to three year period.

Rather than emphasis rotation there should be an emphasis on security of tenure. One step that has a large degree of acceptance is for the appointment and fees of external auditors to be the responsibly of the Audit Committee. This is a measure with which we strongly agree.

We would also suggest that the initial appointment of auditors should be for 5 years. This would allow auditors to recover their investment in the client and provide a certain degree of security of tenure. At the end of the period the Audit Committee can decide whether to remain with the existing firm or go to tender or appoint a new firm. Regardless of the decision it should be put to shareholders together with the basis for the recommendation. We would suggest the information on proposed fees when changing of auditors include other conditions or services included as part of the successful tender eg the provision of "free" consulting services

During the 5 year tenure firms should have the right to resign at any time. They should inform ASIC and the shareholders of their reason. A company could apply to ASIC to remove an auditor but would need to “show cause” and still put the matter to the shareholder along with the reason for removal.

If a firm is appointed for another 5 year term rotation of audit partners should occur before 7 years. However we suggest the formalising of the requirement for a second partner on all listed audits and these partners should also sign. Most firms already have a second partner review requirement. The signing will raise the profile of this function and also facilitate the rotation of signing partners by ensuring continuity of knowledge is retained.