PRICEWATERHOUSECOOPERS

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Mr R Charles MP
Chairman
Joint Committee of Public Accounts and Audit
Parliament House
Canberra
ACT 2600

27 May 2002

Dear Mr Charles

**REVIEW OF INDEPENDENT AUDITING BY REGISTERED COMPANY AUDITORS**

We welcome the opportunity to present our views to the Joint Committee of Public Accounts and Audit as part of their *Review of Independent Auditing by Registered Company Auditors*. We also welcome the opportunity to discuss the matters raised in this paper.

The integrity and ethics of the audit process are important aspects of an effective capital market. We believe that the auditing profession in Australia and the standards supporting the profession are sound and reflect world's best practice. However, we are fully committed to supporting any initiatives that enhance the process.

## The market framework

Any initiatives to enhance capital markets need to be considered as part of the governance framework as a whole. The audit is only one of a number of components contributing to effective capital markets. In our publication *Maintaining Confidence in Australian Capital Markets*, which is included at section 3 in the attached papers, we identified that the issue of audit independence needed to be considered in this broader context. In the publication we explain the role of audit and how it links into and contributes to an effective capital market. There is a three legged stool in investor protection – audit, management and corporate governance. Each 'leg' has its own role to play in addressing market risks.

Directors provide the basic assurance of responsible conduct of a company's affairs. Corporate governance activities, such as ensuring a balanced board with a relevant combination of skills and experience, and using audit committees to undertake certain duties, are elements to support that role.

Management is entrusted with managing the company so that it achieves its business objectives and ensures business risks are appropriately addressed. It is important to remember that capital markets have never been risk free and business success is dependent on judicious risk-taking.

The auditor provides confirmation on the company's financial position as portrayed by the directors in the financial report. It is a vital role in the process of reporting information of the markets. It is not, however, an alternative to good governance.

Generally speaking, the governance framework in Australia, and other major capital markets, works well. For example, PricewaterhouseCoopers globally signs some 360,000 audits a year, around 1,000 a day. The good work undertaken during this process is by its nature silent and low key. Similarly the majority of companies and company directors manage their business and market risk appropriately.

**Audit quality**

The audit is a collection of evidence to support the statements being made by the company. The most important aspect is the quality of the audit. Independence contributes to quality but quality is mainly dependent on personal integrity, strength of character and ability. A poor quality, independent audit is still a poor quality audit.

The auditing profession emphasises quality in training and career development. The experience and qualifications of team members, including professional scepticism, are key determinants. In the few cases where audits have failed, the evidence is that the failure was in the application of the auditing or ethical standards, not that the standards themselves were lacking.

PricewaterhouseCoopers has a policy of ongoing review of internal policies and procedures to ensure they continue to meet and maintain our high quality standards and continue to meet the changing environment in which we work. As part of this process, we decided, among other ongoing initiatives, to form an Audit Standards Oversight Board. The purpose of this Board is to oversee the manner in which the firm gains assurance that audit quality and independence standards are being met. The Board is composed of three eminent members from outside of the firm. We believed that the fresh perspective that such members bring to the oversight of these important areas will provide value and be a useful additional component to our quality control processes.

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## Regulation

In our publication *Maintaining Confidence in Australian Capital Markets* we highlight questions relating to the balance between regulation and co-regulation, some of which were raised in Professor Ramsay's report *Independence of Australian Company Auditors* in October 2001. We believe it is important to strike an appropriate balance between restrictions designed to meet concerns over audit independence and the needs of the capital markets.

We broadly support the balance proposed in the Ramsay report except for limited specific areas, for example we do not consider it appropriate for there to be a Corporations Act requirement for a statement of audit independence. As a general rule we believe that legislation should be kept simple, with specific rules promulgated through other mediums. Independence, for example, will be more effectively safeguarded by the International Federation of Accountants' independence rules, which the professional bodies have recently adopted, than by an additional requirement in the Corporations Act.

Duties and responsibilities of directors, management and auditors are set by a mixture of statute, regulatory requirements, and authorised standard setting bodies. Financial reporting, ethical and auditing standards are set by different bodies with differing accountabilities. Monitoring activities and disciplinary processes also fall under a number of bodies with differing status and accountabilities. Directors that fail to meet statutory requirements can be subject to judiciary proceedings, through ASIC action. In the few instances of audit failure over the years, disciplinary action has been taken through the profession, ASIC or the Company Auditors and Liquidators Disciplinary Board.

Accountability of directors, management and auditors through this co-regulation approach is achieved, but clarity and transparency, the other pillars of effective governance, are somewhat lacking.

The Ramsay report proposed an oversight body to monitor audit independence issues. In line with our other comments in this letter, we believe it would be a wasted opportunity to set up a body with such a narrow scope. Rather, it is timely to have a proper review of the regulatory framework encompassing financial reporting, governance and audit. These elements are intertwined aspects of investor protection which should support and complement each other. A review of the existing regulatory regimes and potential enhancements should be based on the fundamental issues of clarity, transparency and accountability. We set out in section 2 in the attached papers, a detailed commentary on the Ramsay report proposal for an oversight body and possible options to expand the scope of such a body.

We also believe such a review should cover not only the structure but also appropriate composition of the various bodies, for example whether an oversight body is made up of interested party representatives or of individuals selected solely on individual experience, skills and qualifications.

In addition, we believe that global convergence of standards, based on robust and transparent principles, should be the aim of the Australian market. For example, we believe that in the financial reporting area, Australia should move to a wholesale adoption of International Accounting Standards. Similarly in corporate governance, there are a number of global best practices developing which should be incorporated into our market regime. Auditing standards in Australia are already substantively harmonised

**Investor reporting**

There is market demand, globally and in Australia, for higher quality and more frequent reporting. In the financial reporting sphere, many initiatives have commenced around the world to establish how information which is relevant to markets, other than that provided in financial reports, can be collected and disclosed. At PricewaterhouseCoopers, our *Value Reporting* service helps companies provide investors with the information they need to make informed assessments of the value of their investment. Initiatives such as these, coordinated with development of high quality, principle based financial reporting standards, are essential to meet investor information needs.

The audit report sets out the auditor's opinion on the company's financial report as required by the Corporations Act 2001. Despite the legal remit for an audit, there remains an 'expectation gap' over the audit role. The audit report is the public description of the audit and in the current environment we have a responsibility to address whether this report is meeting investor's needs. One option is to simplify the style of the report to clarify the explanation of our role and scope of work.

In addition, as financial and non-financial reporting information expands, we foresee a corresponding expansion in the matters on which the auditor will report. This could cover issues such as governance, risk management and internal control, and indicators of financial health.

**Liability**

Reluctance to report publicly on these aspects at present is largely due to the real risk of spurious legal actions. The Australian unlimited liability environment, a legal prohibition on limiting liability and the concept of 'joint and several' liability, which is out of step with where other countries have moved, encourages a blame and litigious culture where auditors with deep pockets are targeted. Reform in Australia is vital.

**Attachments**

In the attachments to this submission, we are providing additional material that we believe will assist you in your deliberations:

Accounting for the World - this publication examines lessons being learnt from the Enron debacle for the world's capital markets. It addresses the essential requirements of a market economy and opportunities for global convergence of market and audit regulations and accounting standards. We are providing additional copies of this publication as it is of particular relevance to the Joint Committee's review

Section 1 - provides the PricewaterhouseCoopers perspective on the audit independence debate including the role of legislation and the quality audit process

Section 2 - contains a copy of the detailed commentary that the major accounting firms provided in relation to the Ramsay report. This examines financial, ethical and auditing standards, the governance and regulatory framework and specific Ramsay report proposals

Section 3 - contains a copy of our publication *Maintaining Confidence in Australian Capital Markets* which explores corporate governance responsibilities. This publication is particularly relevant to the terms of the Joint Committee's review and so we are providing additional copies for Committee members. It outlines the role of capital providers, directors, management, regulators, analysts and auditors in the context of an interrelated capital market. It explores the role and status of auditors and gives PricewaterhouseCoopers' perspective on the proposals made in the Ramsay report

Section 4 - contains an extract from one of our US firm publications which highlights what happened at Enron and potential implications for companies

Section 5 - provides a comparison of auditing practice, regulation and standards across Australia, USA, UK and Canada. Sections 6 to 8 provide supporting detail for this comparison

**Summary**

We support initiatives such as the Ramsay report and the Joint Committee review, which are designed to consider enhancements to certain aspects of governance. However, just as the Ramsay report recommendations were intended to be accepted as a package, rather than cherry-picking specific proposals, we believe any proposed changes should be developed and evaluated with reference to the 'package' of governance elements. The roles and responsibilities of all market participants need to be clear and mutually supportive.

We look forward to the opportunity of discussing these issues more fully with you.

Yours sincerely

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