

31 May 2002

The Secretary  
Joint Committee of Public Accounts and Audit  
Parliament House  
CANBERRA ACT 2600

Dear Sir,

**Review of Independent Auditing by Registered Company Auditors**

The Australian Institute of Company Directors (AICD) welcomes the opportunity for making a Submission to the Joint Committee's Review of the extent to which it may be necessary to enhance the accountability of public and private sector auditing and where the balance lies between external control through government regulation and allowing industry the freedom to self regulate.

The accountability of auditing can always be enhanced. AICD believes this can be achieved in a number of ways including;

- improving the understanding of the role of the audit committee and its functioning
- fostering and protecting the independence of auditors
- maintaining the levels of competence of auditors and company boards
- ensuring that markets are informed and transparent

AICD believes that there is a need for both government regulation and self-regulation. The issue is to find an optimal balance between the two.

AICD's Submission is enclosed, together with a copy of AICD's Submission in response to Professor Ian Ramsay's Report on the Independence of Auditors and a copy of the AICD's 'Audit Committee's Best Practice Guide'.

Please contact me if you should wish to discuss the Submission further.

Yours faithfully,

Rob Elliott  
**Policy Manager/Company Secretary/Legal Counsel**



AUSTRALIAN  
INSTITUTE OF  
COMPANY  
DIRECTORS

ABN 11 008 484 197

*Professionalism in Directorship*

**Submission**

**To**

**The Joint Committee of Public Accounts and Audit**

**Review Of**

**Independent Auditing By Registered Company Auditors**

**31 May 2000**

## ***Australian Institute of Company Directors***

Australian Institute of Company Directors (AICD) is the peak organisation representing the interests of company directors in Australia. Current membership is over 16,500, drawn from large and small organisations, across all industries, and from private, public and the not-for-profit sectors. Membership is on an individual, as opposed to a corporate basis.

AICD is a federation of seven State divisions, each of which is represented on a National Council. Overall governance of the AICD is in the hands of its National Council which is comprised of the seven division Presidents, plus a National President, two National Vice-Presidents and a National Treasurer. AICD has several national policy committees, focusing on issues such as law, accounting and finance, sustainability, taxation and economics, and national education, along with task forces to handle matters such as corporate governance.

The key functions of AICD are:

- to promote excellence in director's performance through education and professional development
- to initiate research and formulate policies that facilitate improved director performance
- to represent the views and interests of directors to government, regulatory bodies and the community
- to provide timely, relevant and targeted information and support services to members and, where appropriate, government and the community
- to maintain a member's code of professional and ethical conduct
- to uphold the free enterprise system
- to develop strategic alliances with relevant organisations domestically and internationally to further the objectives of the AICD

## **Introduction**

AICD welcomes the opportunity of making a submission to the Joint Committee's review of registered company auditors ('the Review') on the extent to which it may be necessary to enhance the accountability of public and private sector auditing and where the balance lies between external control through government regulation and allowing industry the freedom to self regulate.

As company directors are intimately associated with, and ultimately responsible for the audit process AICD members are pleased to have the opportunity of canvassing a number of the issues. Given the profile of its membership, AICD's remarks focus on private sector auditing.

The accountability of auditing can always be enhanced. AICD believes this can be achieved in a number of ways including;

- improving the understanding of the role of the audit committee and its functioning
- fostering and protecting the independence of auditors
- maintaining the levels of competence of auditors and company boards
- ensuring that markets are informed and transparent

AICD believes that there is a need for both government regulation and self-regulation. The issue is to find an optimal balance between the two. Over the years, a succession of corporate collapses has encouraged a great upsurge in the volume of 'black letter' law aimed at improving corporate governance - but sadly governance problems continue. We need to be selective in proposing additional prescriptive detailed legislation as it can be counterproductive. It can encourage the view that conformity with the letter of such legislation is sufficient, even if the effect (and perhaps the purpose) is in conflict with the underlying objectives of the law.

A new financial reporting paradigm is needed, which emphasises substance over form and where the detailed approaches selected are based on effectiveness and have regard to the cost of their application. For this reason, AICD is impressed with the new 'principle based' approach to the self-regulation of independence proposed by the International Federation of Accountants which has been adapted to Australian conditions by the Institute of Chartered Accountants in Australia and CPA Australia. Under this approach, self-regulation is to be based upon principles, which are illustrated by example, but not over-ridden by such illustrative or other detail. We commend this initiative to the Committee's attention, as it holds out the promise of a more cost-effective balance between government and self-regulation.

AICD acknowledges that it may be necessary to revisit current views on auditing practice in light of what emerges domestically and internationally following the current inquiries into corporate collapses.

In this Submission AICD has considered both limbs of the Committee's Terms of Reference; the extent to which it may be necessary to enhance the accountability of public and private sector auditing and where the balance lies between external control through government regulation and allowing industry the freedom to self regulate.

## ***Enhancing private sector auditing***

### ***The audit committee***

There is currently much public discussion regarding the role of company audit committees and the role they play in the audit process. The recent report by Professor Ian Ramsay on 'The Independence of Australian Company Auditors' (the 'Ramsay Report') discusses their role in detail and makes a number of recommendations. AICD has already made a number of specific comments on the Ramsay Report recommendations that may be of interest to the Inquiry. A copy of AICD's submission is **enclosed** for the Committee's assistance.

AICD believes that establishing an audit committee comprised of independent non-executive directors is good practice. However AICD stresses that an audit committee, where it exists, is a delegate of the board: the board **must and should** retain ultimate responsibility for decisions in relation to the audit. More broadly, it is the board that must bear full responsibility for the financial statements and as a result the outcome of the audit and be responsible to the shareholders (who appoint the auditor) for the decisions that it takes. Delegation to a committee does not absolve board directors of their responsibilities. Individual members of the board are obliged to reach their own decisions based on a proper assessment of the information, which includes but is not limited to audit committee recommendations.

AICD accepts that establishing an audit committee might not be appropriate or possible for all companies, especially smaller companies with fewer resources. In the case of smaller companies, directors and management need to assess carefully the elements of best practice that are relevant to their entities.

AICD, the Australian Accounting Research Foundation and the Institute of Internal Auditors have recently published the second edition of the 'Audit Committees Best Practice Guide' (a copy is **enclosed** for the Committee's assistance). This publication provides assistance for audit committee members and to external and internal auditors.

### ***Fostering and protecting the independence of auditors***

AICD has made submissions on a number of the Ramsay Report recommendations relating to the independence of auditors.

An incompetent audit means that financial reporting information is inaccurate or misleading, giving rise to incorrect assessments of a company's financial position. However, there is no reason to believe that auditing standards are a significant issue. On the contrary, Australia is a leader in terms of international best practice in accounting and auditing standards and has no reason to be defensive about their quality.

As noted above, AICD supports the current international move towards enhancing the effectiveness of self-regulation in the area of independence of auditors; by the International Federation of Accountants' Rules and the recently released Australian statement on Professional Independence. These initiatives base self-regulation upon principle rather than detailed prescriptive rules, providing examples to illuminate the application of principles – without, however, allowing those examples to over-ride the application of the principles. The development of this principle based approach is aimed squarely at confronting the tendency, which arises naturally from the detailed, prescriptive approach, whereby technical conformity with the detailed rules is judged sufficient, even if the result is in obvious conflict with their underlying purpose. AICD supports this approach and sees it as an important development.

### **Competence**

AICD believes that there is a necessity to have regard to the need for a trade-off between purity of principle and competence. For instance, there are concerns that provision of non-audit services by an audit firm may introduce conflicts of interest and risk compromising the auditor's independence. Consequently, some have urged prohibiting the provision of additional services by audit firms. However, an audit firm which also has a thriving consultancy service in say taxation or information technology issues will as a result be more competent as an auditor of such issues. In addition if audit firms are not able to offer other specialist services they will find it difficult to recruit talented staff. Banning the provision of non-audit services will materially reduce the competence of auditors.

This trade-off is particularly acute in Australia, where a few full-service audit firms dominate the market and such a prohibition could make it difficult for each to maintain the scale necessary for high professional competence in such services. AICD believes that the pursuit of principle should not be at the expense of competence. Where a potential for conflict is identified, it will often be more effective to recognise the issue and provide pragmatic safeguards (including full disclosure of non-audit services, as mentioned below), rather than simply banning audit firms from providing non-audit services.

The capacity of audit firms to provide non-audit services to audit clients has also lead to them playing a significant role in coaching business and transferring business and technological knowledge from one company to another and enhancing the overall competence of business.

Improving the financial competence of individual directors is also an important means of enhancing the audit process. Financially competent directors will make better financial decisions. This is best achieved through improved director education and training.

### ***Informed and transparent markets***

AICD believes that shareholders need to be informed about the audit process and that ensuring that there is full disclosure surrounding the audit process and such matters as the details of the provision of non-audit services is a key means of enhancing the accountability of the audit process.

### ***The balance between government and industry self-regulation***

Corporate collapses can have many causes, including market or regulatory risk, strategic misjudgment, incompetence, and dishonesty. Enquiries into recent failures are still afoot, and we cannot now know their conclusions. However, we do know that no amount of regulation can remove the risks inherent in the free market system. Beyond a certain point, additional regulation can be counterproductive.

Each time there is a corporate failure the tendency is to write more black letter law, so that the manner in which corporations are regulated and the applicable accounting standards are now highly complex, beyond the comprehension of all but the most highly trained specialist. The average shareholder is understandably confused.

It is in AICD's view a question of striking a balance between encouraging innovation and the taking of legitimate business risks, and protecting investors (large and small). No amount of regulation can eliminate business risk. No amount of regulation can prevent fraud and malpractice where the parties involved are sufficiently determined. What is certain is that increasing regulation increases compliance costs.

Increasing the amount of 'black letter' law encourages a tendency to look to technical compliance with requirements as opposed to meeting the underlying purpose of those requirements. Paradoxically this can have the effect of reducing the effective accountability of the board.

In addition, detailed prescriptive legislation is less able to keep pace with and respond to changes in the business environment. In many instances self-regulation is more flexible and more likely to be effective when there are active professional bodies, as exist in Australia.

AICD believes there is a need for external as well as self-regulation and, as indicated elsewhere, the issue should be to find an appropriate balance. In addition, there will be occasions where external regulation is necessary simply because self-regulation is impractical; for instance, any regulation of the timing of auditing partners being appointed to a board cannot be left to self-regulation by the accounting profession, for the simple reason that the individuals in question may cease to be members of those institutions.

However, even when the necessary elements of external regulation are agreed in principle, there is an issue of how they should be provided. Enshrining such matters

in legislation is on occasions appropriate, especially when a lasting principle is involved, but we need to recognise that changing such legislation is subject to long delays. In highly technical matters, particularly those that can be affected by unforeseeable market developments, it will often be better to provide such external control by regulation under the relevant act.

### **Conclusion**

There is no reason to believe that there are now systemic problems in Australia of the order that applied in the 1980's. AICD concurs with the view of Australian Securities and Investment Commission Commissioner, Professor Berna Collier, outlined in a recent speech to the Institute of Chartered Accountants conference:

‘I reiterate the view of the Commission as expressed by the Chairman and the Deputy Chair on other occasions that we are not reliving the 1980's, and that the collapses which took place last year do not appear to represent a systemic failure of corporate governance in Australia. It is the nature of our free enterprise system that businesses will fail, for reasons not necessarily associated with culpable behaviour of the board or the management.’

AICD believes it is timely to consider financial reporting within a broader framework which emphasises substance over form, based on effectiveness with regard to the cost of application. We believe that the elements of such an approach are beginning to emerge.

In a sense, we are able now to contemplate such a ‘higher level’ perspective because of the work done in the past, which has removed many of the more egregious causes of malpractice in corporate governance.