31 May 2002

The Committee Secretary
Joint Committee of Public Accounts and Audit
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REVIEW OF INDEPENDENT AUDITING

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to contribute to the Joint Committee of Public Accounts and Audit's (JCPAA) 'Review of Independent Auditing', and looks forward to providing further evidence in person to the Committee.

Our submission is structured in the following manner:

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3. Ramsay Report Supported
4. The Australian Financial Reporting and Auditing Framework – A Co-Regulatory Model
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Annexure 2: The Institute of Chartered Accountants in Australia, and CPA Australia– 'A Research Study on Financial Reporting and Auditing – Bridging the Expectation Gap'

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1. Background Information on the Institute and the Australian Audit Profession

The Institute was constituted by Royal Charter in 1928. The Institute now operates under a Supplemental Royal Charter (as amended from time to time) granted by the Governor-General on behalf of Queen Elizabeth II in 2000.

The Institute has in excess of 37,000 members in Australia and overseas. Of this number, more than 16,000 are in public practice firms in Australia. 30% of these members are in the so-called "Big 4" accountancy firms. Most registered company auditors are members of the Institute.

Membership of the Institute (or Australia's other professional accounting body, CPA Australia [CPAA]) is not mandatory, although in the case of auditors and liquidators membership of either the Institute or CPAA (the accounting bodies) is a relevant factor taken into account for registration by the Australian Securities and Investments Commission (ASIC) (see registration requirements discussed below). Furthermore, no general statutory registration system applies to accountants per se; that is, no licensing or certification system applies in respect of the use of the generic title "accountant".

However, here, as in other major countries, education, experience, and adherence to high standards of ethical and professional conduct distinguishes the "Chartered Accountant" designation from other persons with lesser or no qualifications who may nevertheless describe themselves as "accountants".

2. Requirements of Membership

Both the Institute and CPAA require prospective members to possess an approved degree from an accredited university and the successful completion of post-graduate programs conducted independently by both bodies. In the case of the Institute this is the CA Program.

Applicants for membership of the Institute must also satisfy requirements in respect of practical experience before being admitted as a member and entitled to use the designation "Chartered Accountant".

Both the Institute and CPAA set binding rules of conduct for members covering a range of matters relating to professional and ethical conduct. A Joint Code of Professional Conduct covers matters such as:

- principles of conduct
- use of designations and descriptions
- remuneration of members in public practice
- compliance with technical standards
- use of incorporated companies and trusts
- professional appointments
- professional independence
- professional competence
- advertising, publicity and solicitation

In combination the Code of Professional Conduct and accompanying guidance statements provide a comprehensive outline of the high professional standards expected of members.

All members must comply with Continuing Professional Education requirements and are subject to the Institute's disciplinary procedures.

Institute members in public practice, including all members who are registered company auditors, must hold a practicing certificate. Within six months of being granted a Certificate of Public Practice, Institute members are required to undertake the Public Practice Program, which has been designed to maximize the standards of practice and professional conduct for all new practitioners.

Since July 1991, all members in public practice have been required by the Institute to maintain professional indemnity insurance to specified levels and standards. The Institute's standard was developed with input from the insurance industry and was designed to ensure that Chartered Accountants maintained the highest possible standard of insurance cover both for their protection and the protection of their clients.

In addition, all Chartered public practice firms are subject to quality review every five years. This involves a systematic peer review of the practice, its work papers and its compliance with Institute requirements, including compliance with our mandatory requirement for PI insurance.

3. Ramsay Report Supported

Professor Ramsay was commissioned by the Government to "..examine Australia's existing legislative and professional requirements on independence of company auditors and compare them with equivalent overseas requirements."

The Institute has earlier provided support to Professor Ramsay's October 2001 Report '*Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform'* and would expect that the Government will take account of both responses made on the Ramsay Report and the JCPAA Inquiry, as well as the Royal Commission's Report on HIH which is now due in early 2003.

Whilst the Institute's 15 March 2002 Submission on the Ramsay Report has yet to be responded to by Government, we believe that many of the issues canvassed in our Ramsay Submission equally have relevance to the JCPAA's Inquiry, and for that reason our Ramsay Report response is attached for the Committee's information.

The Institute supported the majority of the Ramsay Recommendations which are summarized as follows:

- **Keeping Accounting Firms Independent of their Audit Clients**

Recommendations are either enhancements to the current Corporations Act or are incorporated in the accounting bodies Professional Statement F1 'Professional Independence':

- Statement of Audit Independence,
- Employment relationships between the audited company and the audit firm,
- Financial and business relationships, and non-audit services.

- **Other Measures that Enhance Audit Independence**

These recommendations cover:

- Mandatory audit committees for listed companies,
- Appointment and removal of auditors,
- Disciplinary issues (strengthening the Companies Auditors and Liquidators Disciplinary Board [CALBD]), and
- Attendance of the auditor at the annual general meeting

- **Other Issues**

These recommendations date back to the 1997 Audit Review Working Party and cover such issues as:

- Educational requirements,
- Ethical rules for auditors who are not covered by the accounting bodies' rules,
- Competency based registration, and
- Quality reviews etc.

The only recommendation not totally supported by the Institute is the proposal to establish an Audit Independence Supervisory Board sponsored by the Accounting Bodies. The Institute in its Ramsay response acknowledged the arguments contained in the Ramsay Report but is yet to be convinced that the Ramsay - proposed structure of an Audit Independence Supervisory Board is the most effective way to proceed. Since the release of the Ramsay Report some of the major global Audit Firms have announced that they will establish Internal Audit Oversight type Boards that will have a public reporting function.

The Institute supports the concept of an Independent Oversight Board that would enhance the public's perception of the way the audit process is conducted, monitor the structure of the co-regulatory model and respond publicly on any improvements that may be recommended in the public interest. To this extent the Institute is currently reviewing various international public oversight models that could both bring tangible benefits to those that rely upon the integrity of audited financial statements, and be cost effective in terms of the regulatory impact such a publicly funded Board is likely to have. It would be desirable to not add any unnecessary costs to the overheads funded by Government and to this extent models such as the Financial Reporting Council and the Professional Standards Council may be worth reviewing to see that if properly constituted, they could be a cost effective structure.

4. The Australian Financial Reporting and Auditing Framework – A Co-Regulatory Model

(a) Co-Regulation

The Australian co-regulatory model is one that is generally consistent with the models operating in the major overseas capital markets. It is a mixture of legal requirements, such as the requirement to have audited 'true and fair' financial statements, compliance with Accounting Standards issued by a Government appointed, but Government and private sector funded Board, along with Auditing Standards that are internationally based and funded by the local and overseas accounting organizations. In addition companies listed on the Australian Stock Exchange have reporting requirements that relate to the frequency of financial statements (half yearly reporting typically with an audit review, plus a more comprehensive annual report), together with a continuous disclosure regime.

(b) Corporations Act

Public companies which include those listed on the Australian Stock Exchange are required by the Corporations Act to annually prepare a financial report that includes financial statements consisting of a profit and loss statement (statement of financial performance) for the financial year, a balance sheet (statement of financial position) as at the end of the financial year, and a statement of cash flows for the year. The financial statements, which are required to be in compliance with accounting standards issued by the Australian Accounting Standards Board (AASB), are required to give a true and fair view of the financial position and performance of the company, and the consolidated entity. In addition, the directors are required to state in their opinion whether there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due. The financial statements, unless otherwise stated, are prepared on a going concern basis.

The Corporations Act requires public companies to have the financial report audited by a registered company auditor who has been registered by ASIC. The Auditor is required to report to the members (shareholders) on whether the auditor is of the opinion that the financial report is in accordance with the Corporations Act, including whether the financial statements are in compliance with accounting standards, and are true and fair.

(c) Auditing Standards

Auditing Standards are issued by the accounting bodies and are mandatory for their members (in practice auditors of listed companies are members of the accounting bodies). Auditing Standards contain the basic principles and essential procedures and are mandatory for all audits. Australian Auditing Standards are consistent with International Auditing Standards and are developed in conjunction with overseas professional accounting bodies including the International Audit and Assurance Standards Board which has representation from the major capital markets, auditors and other key constituents.

(d) Quality Review Program

In addition, the Institute has established a Quality Review Program that applies to Chartered Accountants who provide professional accounting services, (such as audit) to the public. Miscellaneous Professional Statements APS 4: 'Statement of Quality Control' defines quality control as the "policies and procedures adopted by a practice designed to maintain adherence to professional standards". This includes professional independence; client evaluation; professional development; guidance and assistance; conduct and supervision; internal inspection and review; assignment of personnel to engagements; and employment and promotion.

Practices are selected for review on average every 5 years. Our process reviews the quality control policies and procedures that are implemented in the practice. A review considers the quality control procedures that the practice has established, and during the review:

- examines the manuals, working papers and other documents to ensure adherence to professional standards

- selects a cross-section of current engagement files (including audit engagements) to assess whether the quality control procedures are being implemented. Whilst the review of audit files focuses on the quality control system, the nature and extent of the review does not involve "second guessing" the audit opinion. Where audit workpapers appear to be insufficient to support the audit opinion or other weaknesses are noted, the practice is requested to address the issues and a follow up review is conducted, where considered necessary.

All our reviewers are experienced Chartered Accountants and are selected because of their professional reputation and practice experience.

(e) Investigation and Discipline

From an investigation and disciplinary perspective the Australian co-regulatory model can be seen to be stronger than some of the overseas jurisdictions in that it has an independent publicly funded body, the CALDB that considers audit failures including non-compliance with Auditing Standards and has appropriate sanctions including the cancellation of an auditor's registration. Cases are referred to the CALDB by ASIC. This is complemented by the Institute's own internal disciplinary system that investigates and takes action against members who breach the Institute's Professional and Ethical Rules (including breaches of Auditing Standards).

For example, in the USA only recently the Chairman of the Securities & Exchange Commission called for the Public Oversight Board to have the powers to prosecute an auditor for substandard work (Washington Post 22 May 2002). This power is already conferred upon the CALDB via ASIC in Australia.

(f) Financial Statements Review

The Institute has for many years undertaken a review of financial statements of listed companies. This review has however been limited by the resources that experienced Chartered Accountants have been able to provide to the Institute. The Institute has sought to work with ASIC to investigate whether the ASIC Surveillance Program and the Institute's Review Program can be combined, or at least co-coordinated to better utilize the scarce resources of both organizations. It is unfortunate that ASIC so far has been unable to join with the Institute due to concerns over confidentiality issues.

5. No Systematic Failure in the Australian Financial Reporting (and Auditing) Framework

The Institute remains committed to high standards of financial reporting that are consistent with 'International Best Practice', be that accounting, auditing and other professional and ethical standards. However any changes to the current financial reporting framework need to satisfy a Cost/Benefit approach, a theme that was promoted in the Institute's (joint with CPA Australia) Expectation Gap Report issued in 1993 (The report and a follow up Review in 1996 is attached for information). The framework also needs to be consistent with international best practice as the limited size of Australia's capital market means that we need to ensure that we are both internationally attractive to global investors and competitive.

The Institute concurs with the view expressed by the Corporate Regulator ASIC that there has been no systemic failure in the Australian financial reporting framework, but rather some individual and at times high - profile failures (attached Risk & Responsibility 27 April 2002 Paper presented by Professor Berna Collier (ASIC Commissioner) to the Institute's 2002 CA Conference – Risk + Governance = Reward). To that extent the Institute reiterates the view that any changes to our financial reporting framework need to be both internationally consistent (given the influence that global trading and environmental issues have on Australian business), and also take into account the lessons learnt from recent and not so recent corporate collapses locally and overseas.

It should not be forgotten that the vast majority of audits are conducted to the high standards expected by the market. Corporate collapses are generally caused by poor management, poor business models, and assisted often by a down turn in the economy. We need to study the causes further to see if there are further contributing factors that need to be addressed. There is no evidence that there has been a systemic failure in either audit independence or audit quality, or that these have significantly contributed to corporate collapses.

Professor Collier's paper also notes that whilst ASIC has an obligation to investigate corporate collapses, this "…does not inevitably imply a failure of corporate governance in an organization, or fault warranting regulatory intervention. It is inherent in our free enterprise system that directors of a company may cause the company to assume risks which, in hindsight, were unwise.". The same argument applies to the audit process, as it is not the role of the auditor to stop a company from failing; instead the audit provides assurance over the quality of the financial statements.

Still it is inevitable that a number of high - profile corporate collapses will raise questions as to the effectiveness of the financial reporting framework including the role of auditors. This is notwithstanding that most of the major corporate collapses have been telegraphed by a steadily declining share price, indicative that the market has demonstrated its efficiency by casting doubt on the longer term viability of the particular entity. At issue is the precise time that the particular entity is no longer solvent and whether the financial statements prepared after that time were appropriate.

The public needs reassurance that the processes are working, but more importantly that lessons from each failure are translated into action to enhance the financial reporting framework. Apart from the various Quality Control measures outlined in this submission, the Institute remains of the view that having a properly functioning Independent Audit Committee will be an important step in re-assuring public perceptions. More importantly they will enhance the corporate governance and audit processes, and inhibit the type of corporate behavior that appears to have contributed to some of the recent large corporate collapses.

6. The Financial Reporting Process – Risks and Responsibilities

Any major corporate failure (be it public or private) raises the issue of whether those involved in the financial reporting process have properly discharged their civil and professional responsibilities. Wherever a Chartered Accountant is involved in such failures, the Institute reviews the activities of the relevant member to ensure that the Institute's high professional requirements including professional and ethical standards have been followed. Just because there has been a corporate failure, it does not automatically mean that there has been a breach of the Institute's Standards. Each instance needs to be, and is, carefully investigated, and may result in exclusion from membership of the Institute and notification to the regulatory authorities for action affecting their audit registration. Taking a professional's livelihood away is a powerful sanction.

The public has a right to expect that all those involved in the financial reporting process have properly discharged their respective civil and professional duties. This includes shareholders who appoint the directors, directors who have the legal responsibility for financial statements, management who has delegated responsibility for preparing financial statements for the directors approval, auditors who provide an independent opinion on the financial statements, and other advisers who have an involvement in the financial statements (e.g. lawyers and actuaries).

Whilst there is a clear obligation that the financial statements are ‘true and fair’, there is no absolute guarantee that the financial statements will always contain all the appropriate information necessary for users of those financial statements. What is important is that any subsequent failure to have ‘true and fair’ financial statements is investigated, both to ensure that those responsible for the financial statements have properly discharged their duties, and that appropriate action can be taken to minimize the risk of any further such failures. In short there can never be an absolute guarantee that financial statements will always clearly predict a future corporate failure.

The Institute remains supportive of the International Harmonization Program of the Australian Accounting Standards Board and continues to provide resources to the Board from both a funding and member contribution perspective. However, there is a need to ensure that Australia’s Accounting Standards, whilst harmonized, also do not have significant gaps, and the Institute has continued to encourage the AASB to move on contentious issues such as: Financial Instruments, Executives/Directors’ Remuneration, Share Options, and Performance Reporting including the concept of Maintainable Earnings.

The financial reporting process is dynamic and hence is continually under review both nationally and internationally. However the impact that Enron has had internationally has resulted in a consideration of potential new models of financial reporting. Still adding a broader array of information will not necessarily provide any guarantee regarding predicting future corporate failure either.

7. Accountability of Public and Private Sector Auditing

The Committee’s Terms of Reference seek “…to explore the extent to which it may be necessary to enhance the accountability of public and private sector auditors,” with this linked to “…the spate of recent noteworthy corporate collapses both within Australia and overseas.”. As detailed in the Ramsay Report, the Institute’s response to Professor Ramsay’s Report and elsewhere in this submission, the Institute has since the initial Expectation Gap Report in 1992, argued for mandatory Independent Audit Committees.

It is disappointing that neither the Government nor the Australian Stock Exchange, both of which have the power to mandate such Independent Audit Committees have been willing to implement such a recommendation. This is notwithstanding a Government Working Party in 1997 (and Professor Ramsay’s 2001 Report) which argued for mandating such Committees. The Institute believes that mandating Independent Audit Committees would significantly enhance the audit process for major entities in both the private and public sector.

As detailed in the Institute’s Ramsay Submission there are a number of other initiatives that the Institute believes are needed to enhance the audit process, but none as significant as Independent Audit Committees.

8. The Balance between Government and Self-Regulation

The Ramsay Report recommended a continuation of the current co-regulatory model, which relies upon the Corporations Act having specific financial reporting and audit requirements in place (registration, duties, appointment etc) and the accounting bodies mandating Auditing Standards and Guidance including Independence Standards. This model is similar to those in place in the major capital markets, and the Institute is not aware of any strong or consistent support for changes to the current model either in Australian or internationally.

9. Key Recommendation: Mandatory Audit/Governance Committees

A key recommendation from the Expectation Gap Reports was the need for mandatory Audit Committees to provide support to both directors and auditors. One of the lessons from some of the recent corporate collapses is that there appears to have been management fraud which has seen some critical information being withheld from directors, their advisers (e.g. actuaries and valuers), auditors, and the Prudential Regulator. Court evidence from the HIH Royal Commission as well as civil action in the One.Tel Court evidence is telling.

The Institute continues to believe that it is vital that listed companies and government entities at the local, State and Commonwealth level have mandatory Independent Audit Committees that not only have the oversight of external audit activity on behalf of the Board (i.e. appointment, reporting and remuneration) but also have management reporting direct to the Committee on a half yearly basis (perhaps just annually for government entities that do not report half year results to the market) in writing on issues such as proper internal controls over financial records, appropriate accounting treatments, and representations made to the Board, auditors and appropriate external advisers (e.g. actuaries, valuers, lawyers and regulatory authorities).

The Independent Audit Committee should have responsibility to the Board for all corporate governance activity and in the case of any disagreement between the Board and the Committee, have a responsibility to report direct to the shareholders. A copy of an Institute (joint via the Australian Audit and Assurance Standards Board with CPA Australia, The Australian Institute of Company Directors and The Institute of Internal Auditors – Australia 'Audit Committees Best Practice Audit Guide, updated August 2001) is attached for the Committee's information.

10. Management Representations to the Independent Audit Committee

In addition consideration could be given to require the major listed companies and government entities to have management reporting direct to the Independent Audit/Governance Committee, a view that has recently been advocated by the Chairman of the SEC for adoption in the USA. This may have inhibited the management frauds that have been uncovered via the HIH Royal Commission (e.g. re-insurance side letters) and falsification of financial results to Boards (e.g. FAI, HIH, One.Tel and the New South Wales Grain Corporation). Honest employees need protection via legislation just as much as directors and auditors.

For example in the One.Tel Liquidators Court Hearing, evidence was given by One.Tel's accounting staff that they were only able to talk 'honestly and openly' once the then joint managing directors resigned from One.Tel (The Sydney Morning Herald 27-28 April 2002 page 9). Equally disturbing is the evidence emanating from the HIH Royal Commission where the FAI Actuary in 1997 stated that 'he did not think it was up to him to tell Andersen's auditors about the difference between the two numbers' - internal and external actuarial estimates of FAIs Professional Indemnity Insurance varied by 42% (Australian Financial Review 23 April 2002 page 9).

The Institute believes that consideration should be given to require the major listed companies and government entities to have a system in place which requires senior employees involved in either the management or financial reporting process to sign a management representation letter which states whether there has been any attempt to distort or hide information that is used to inform either the Board, external regulators or the auditors. This proposal is similar to Recommendation 3.8 of the accounting profession's Beyond the Gap Report. A number of public sector agencies already report direct to the audit committee.

Whilst the auditor has unfettered right to whatever information and explanations are required for the purpose of the audit, the penalty provisions for withholding information or providing misleading information may need to be strengthened to discourage some of the abuses that have been alleged in a number of recent corporate collapses. Such a penalty regime could also apply to management representation letters provided to the Independent Audit Committee.

11. Specific Audit Independence Issues

(a) Auditors Providing Non-Audit (Other) Services

There has been discussion both in Australia and internationally on whether there should be restrictions on auditors also providing non-audit services to the entity that is being audited. On 26 March 2002 the Institute announced the release of a revised Professional Independence Statement F1– (copy attached for information) that adopts the international audit independence rules that were announced in November 2001 by the International Federation of Accountants (IFAC). These rules are broadly consistent with the current United States of America independence rules and are consistent with rules applying elsewhere in the major capital markets.

Whilst the core independence principles remain unchanged (must both be, and be seen to be, free of any interest which is incompatible with objectivity), there is considerable additional guidance to determine when an auditor might not be (or seen to not be) independent. Australia has adopted an application date of 30 December 2003, a year earlier than the IFAC application date. This date recognizes that there may be some existing contractual arrangements or appointments in place as at the date of the release of the revised F1 that need to be changed. The Institute however expects Chartered Accountants to make use of the F1 guidance now in place and will investigate any obvious departures from the Professional Statement.

Entities have valued the benefits derived from their auditors, who already have a good understanding of the business, being able to bring their knowledge and skill to bear in other non-audit related areas. In addition the provision of such non-audit services often results in the audit team obtaining other information about the business and operations, including financial risks, which can be helpful in the audit process. However the provision of non-audit services may create perceived or real threats to the independence of the auditor.

Professional Independence Statement F1 provides guidance to auditors considering the provision of non-audit services, and prohibits the provision of non-audit services where an audit opinion is provided on financial statements which materially rely on a non-audit services provided by the auditor or the audit firm. An example would be a material asset valuation, or where the there is reporting by the audit firm which effectively becomes a management role (e.g. preparation of and recommendations on financial information that forms part of the final financial statements that are subject to audit).

The Institute believes that an Independent Audit Committee should approve any provision of non-audit services having regard to the specific circumstances applicable to the particular audit. This would be far preferable to an arbitrary restriction on specified non-audit services. The Ramsay Report supported auditors being able to continue to provide non-audit services subject to certain safeguards (Ethical Rules, Disclosure, Audit Committee scrutiny etc).

A recent (May 2002) Auditing and Assurance Standards Board's Audit & Assurance Alert 'Communicating with Entities in Relation to Auditor Independence' provides information that auditors may find useful in discussions with directors on the oversight of auditors independence . A copy is attached for information.

(b) Auditor Rotation

Both the 1997 Government Working Party and the Ramsay Reports recommended audit partner rotation for listed companies but did not support audit firm rotation. The Institute's Professional Independence Statement F1 requires audit partner rotation for listed entities and is in line with audit partner rotation requirements in place in the United States of America. Recently the Group of 100 argued against audit firm rotation and pointed out the difficulties that large global companies would have where a limited number of global audit firms are used to provide audit and non-audit services. The Institute understands that internationally, audit firm rotation is rare, and of the few countries that in the past have had such a policy, Spain and Italy have both now abandoned such a policy.

The Institute believes that there are already appropriate quality procedures in place to ensure auditor independence which negate the need for an arbitrary time based audit firm rotation policy. In particular the proposal for an Independent Audit Committee to have continuous responsibility for audit firm appointment, remuneration and the provision of audit and other services, is a more effective way of enhancing auditor independence, rather than any arbitrary time deadlines.

(c) Investigation and Discipline of Auditors

Both the 1997 Government Working Party and the Ramsay Reports recommended a strengthening of the Companies and Auditors Disciplinary Board (CALDB), and the Institute supports such recommendations. This statutory Board, dealing with the regulated functions of audit and liquidation, is a critical plank in the co-regulatory model which shares responsibility between the profession and Government. Under the current regulatory arrangements, responsibility for the registration and discipline of company auditors rests with ASIC and the CALDB. It is only ASIC that can refer matters concerning the conduct of auditors (including compliance with Australian Auditing Standards) to the CALDB, with the CALDB being the only body that can remove an auditor's registration. Accordingly, even if one of the professional bodies were to impose the most serious sanction at their disposal, being exclusion from membership, that person would still continue as a company auditor until such time as their registration had been cancelled by the CALDB.

Given its limited powers and resources, the Institute believes that significant matters concerning the performance of auditors (including compliance with Auditing Standards) should first be dealt with by the statutory body charged with that responsibility, with the bodies then considering what impact the outcome of these investigations should have on the person's standing within the profession. If ASIC and the CALDB do not have adequate resources to carry out these statutory functions, resources should be increased.

The Institute actively pursues potential breaches of its professional and ethical requirements but, as these are often inextricably linked with other legal and regulatory issues outside the Institute's jurisdiction, in many cases it is not feasible or practicable to separately pursue these issues until the broader issues have been dealt with by the Courts or other regulatory processes.

The Institute has recently commissioned an independent review of its disciplinary process to ensure that it meets current community expectations and fulfils its role as one part of the overall co-regulatory and professional framework.

12. Liability of Auditors

In the context of the JCPAA's current review of audit independence and audit regulation, an issue that must be taken into account is that of auditors' unlimited professional liability.

Any consideration of the obligations and responsibilities of auditors must take account of the fact that auditors are exposed to liability risks without parallel in our community. The liability exposure of medical practitioners, whilst significant, pales by comparison to that of the audit profession. Any meaningful consideration of the scope and role of audit must have regard to the issue of auditor liability.

The Corporations Act requires that registered company auditors be natural persons. That is, an audit cannot be performed by an incorporated body. This means that auditors cannot avail themselves of the protection of limited liability. Yet this protection is afforded to most individuals and businesses in the community.

The consequence is that auditors are personally liable for their professional acts and omissions, as well as being personally liable for the professional acts and omissions of their partners.

The serious liability exposure of auditors has been the subject of protracted discussion with government over many years. This matter was first raised with government in the late 1960s. In the late 1980s and the 1990s, the liability exposure of members of the audit profession had reached crisis levels with serious consequences for the market for professional indemnity (PI) insurance.

At that time, there were a number of claims against members of the profession where damages in the order of several hundred million dollars were sought, and two actions, resulting from the collapse of Tricontinental and the State Bank of South Australia, where damages sought exceeded $1 billion and $4 billion respectively.

Simply put, the scale of risk facing auditors is uninsurable.

Audit firms do carry insurance – indeed this is a long-standing mandatory requirement of the Institute. The Institute requires members in public practice to carry PI insurance for their own protection and for the protection of the community.

Perversely, the fact that auditors carry insurance is also part of the problem. PI insurance makes auditors attractive targets for litigation. The joint and several liability of defendants then virtually ensures that auditors are sued should a company fail.

Under joint and several liability, where the acts or omissions of a number of parties have combined to cause loss to a plaintiff, the plaintiff may recover the entirety of their loss from any one party.

Whilst it is possible for a defendant who bears the full extent of a judgment to seek contribution from other parties that have also contributed to the loss, equitable apportionment in this manner is rarely satisfactorily achieved, usually due to the insolvency or lack of assets on the part of other parties responsible or because those other parties are untraceable, protected or out of reach.

The effect is to make any one defendant the insurer of the entirety of the plaintiff's loss, irrespective of that defendant's degree of responsibility for the loss suffered.

This explains why the scale of risk facing auditors is uninsurable. Under the law of joint and several liability, professional indemnity insurance is in effect being required to cover not only the potential negligent acts of an insured auditor, but potentially the acts of all other parties responsible for the loss as well.

Governments in Australia have recognised that this is a serious problem.

In 1994 the Federal and New South Wales Governments (with the endorsement of other members of the Standing Committee of Attorneys General) commissioned the Inquiry into the Law of Joint and Several Liability by Professor Jim Davis of the Australian National University.

Professor Davis' final report, delivered in 1995, recommended:

- That the present joint and several liability of defendants in actions for negligence causing property damage or purely economic loss be replaced by liability which is proportionate to each defendant's degree of fault.
- That the liability for loss arising from misleading conduct in contravention of the Trade Practices Act, the Fair Trading Acts or the Corporations Law be proportionate to each defendant's degree of responsibility for that loss.

The accountancy bodies strongly supported the recommendations contained in the Davis Report.

In July 1996 the Federal and NSW Governments released for public comment the Draft Model Provisions to Implement the Recommendations of the Inquiry into the Law of Joint and Several Liability.

However, the momentum that was building around this reform initiative stalled, for a variety of reasons. Accordingly, proportionate liability was effectively dropped by the Standing Committee of Attorneys General in the late 1990s, despite warnings from the accountancy bodies that the next, inevitable downturn in the economic cycle will invariably see another wave of massive liability suits against professionals and a worsening position in the market for PI insurance.

Recent developments in the insurance market have proven these warnings correct and have once again brought issues associated with professional liability into the foreground.

Legislators in other countries have taken steps to fix this same problem. The joint and several liability of defendants has either been abolished or modified in 39 states in the USA. On 14 June 2001, legislation that implements a modified proportionate liability regime under the Canada Business Corporations Act and the Canada Cooperatives Act received Royal Assent and, in doing so, became law in Canada, emphasizing the importance and currency of this issue in other parts of the world.

The Draft Model Provisions on proportionate liability referred to above set out a fundamentally more equitable basis on which to apportion loss in cases involving financial loss and will serve the interests of both consumers and professionals to the benefit of the community overall.

The enactment of these provisions is of critical importance and the Institute urges the Federal and State Governments to act on this as a matter of urgency.

The Institute also believes that professionals should be allowed the same scope to conduct their business affairs with the protection of limited liability as others in the community. Accordingly, auditors should be permitted to conduct their business through limited liability partnerships or limited liability companies.

Again, this is permitted in other countries with similar systems to ours, including the UK and the USA.

One further reform is worth serious consideration. The profession has long argued the benefits of a statutory cap on auditors' professional liability matched to compulsory professional indemnity insurance to the level of the cap.

Support for such an approach can be found in both NSW and Western Australia, where legislation in the form of the Professional Standards Acts in those two states permits occupational associations to limit the liability of their members. Members must maintain insurance and/or business assets to the level of the applicable cap and meet other standards prescribed in their association's scheme.

Capping and introducing proportionate liability to replace the joint and several liability of defendants are complementary reforms. Capping addresses the quantum of damages that a professional may face (and we have seen that such amounts can vastly exceed the reach of insurance cover), whilst proportionate liability in our view provides a more equitable and fair basis for allocating damages between co-defendants than currently exists under the law of joint and several liability.

These are essential reforms if auditors are to be able to achieve a reasonable balance between risk and reward in discharging their functions under the law.

Over the past decade we have witnessed dramatic increases in the cost of PI insurance for auditors whilst at the same time its availability has diminished. This, combined with the very real difficulties the profession is experiencing in being able to attract and retain high-calibre individuals because of the significant threat that unlimited professional liability poses, puts the longer-term viability of the profession at risk unless steps are taken to limit auditors' liability exposure.

The Institute believes that these matters warrant serious consideration. Liability reform is being advanced overseas. It is imperative that similar reform also be embraced in Australia if we wish the audit function to advance rather than collapse under the weight of litigation.

13. Broadening the Financial Reporting (and Auditing) Framework

The Institute has represented Australia as part of an international team that is looking at this issue. This work has in part been driven by the Enron corporate collapse but also reflects views expressed both overseas (UK and the USA) and locally that perhaps it is time to see if the current Financial Reporting Framework should be extended. Some issues already canvassed include a continuous financial reporting and audit assurance risk model (the Institute is the Australian representative on the International Innovation Network that represents 20 of the largest accountancy bodies internationally), and various non-financial reporting mechanisms (the Canadian Value Reporting Collaborative, Triple Bottom Line Environmental Reporting etc).

There have been calls for an expansion of both the financial reporting and audit mandate. For instance a Submission by the Major Accounting Firms on the Ramsay Report suggests "A more fundamental improvement would be to expand the audit report to comment on other relevant issues such as governance, risk management and internal control, together with key indicators of the financial health of the company. While this is a desirable outcome, it would be unfeasible for auditors to make such comments within the current litigious environment." Such a proposal needs to be addressed internationally given the international focus of financial reporting and auditing.

Additionally there has been debate about the need to be informed where an 'aggressive accounting treatment' is adopted. No doubt there will continue to be debate as to whether so called 'aggressive accounting treatments are in compliance with either existing Accounting Standards or meet the requirement for the financial statements to be 'true and fair'. It should be the role of the Independent Audit Committee to ensure that so called 'aggressive accounting treatments' are properly considered by the Board, and the assistance of the auditors would be useful. If it is conceded that such aggressive accounting treatments are legal (ie true and fair) perhaps there should be disclosure of the quality of the current and projected future earnings. This should be an issue for the AASB and the Australian Auditing and Assurance Standards Board (AuASB) as part of the International Harmonization Program and a potential expanded audit mandate.

The whole issue of auditors reporting on solvency, or more to the point, when is an Auditor able to report on when a company becomes insolvent, is an issue currently being considered by the AuASB following recent discussions with ASIC. This includes a review of Audit & Assurance Alert 6 'Auditors' Responsibilities in relation to Reporting Contraventions of the Corporations Law issued in October 1999 which sets out the current reporting requirements that the Institute believes are being complied with by its members. The Accounting Bodies Legislation Review Board is part of this process as from a co-regulatory perspective, there needs to be a workable and agreeable means of reporting that should also involve the Independent Audit Committee.

Such suggestions should not be seen as an admission of failure of the current Financial Reporting Model but rather the profession's mandate to continually innovate and improve the value that Chartered Accountants can and do provide, on a cost/benefit basis.

14. Registration of Auditors via an Audit Competency Model

A major recommendation from the 1997 Government Working Party Report which was endorsed by the Ramsay Report, is the replacement of the current 'hours based' approach for registering company auditors. This is an issue that is unrelated to the major corporate collapses, but rather reflects a major crisis in rural and regional Australia where new Auditors are unable to become registered because of a reliance by ASIC on a set number of audit hours experience rather than relying upon internationally accepted competency models. The Institute (jointly with CPAA) has developed an audit competency model which had the support of both ASIC and Treasury staff responsible for audit regulation, and which has also been supported by current auditors.

Audit competency applies not just at the time of registration as an auditor but continues through the life cycle of an auditor with appropriate mandatory training (120 hours over a 3 year period) required on a continuous basis (the Institute's Continuous Professional Education Program). The Institute takes such training seriously and provides a number of dedicated audit training courses including most recently a 'Survival Techniques for Auditors – focusing on the auditor's role, obligations and potential risks. Again the Ramsay Report endorsed the earlier 1997 Audit Review Working Party Recommendation that re-registration, as a registered company auditor should be more than just filling out a form.

The Institute looks forward to meeting with the Committee when Public Hearings are being conducted. If you require any further information at this time, please contact Keith Reilly (Institute Technical Adviser) – Telephone: 02 9290 5703, E Mail: keith@icaa.org.au

Yours sincerely

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