12 July 2002

The Committee Secretary
Joint Committee of Public Accounts and Audit
Parliament House
Canberra. ACT 2600
jcpa@aph.gov.au

REVIEW OF INDEPENDENT AUDITING

As requested at the Joint Committee on public accounts and audits 21 June 2002 hearing, and in response to your subsequent 26 June 2002 letter, The Institute of Chartered Accountants in Australia provides the following comments for the Committee's consideration.

1. Accountability of Accounting Firms

(a) Corporations Act to be amended to require that audit firms of public listed companies be incorporated and publicly listed.

The main reason that appears to be behind this proposal is that the market itself would then value or judge the performance of the particular audit firm from a quality perspective. However as stated at the Hearings by a number of participants, the Institute believes that the market would only tend to value or judge the financial performance of the particular audit firm, and its financial statements would likewise only contain information on the financial performance of the firm - little to do with the 'quality' of the audit product being supplied. Whilst there could be some correlation between the market price of the listed shares as representing its reputation and the quality of the audit function, such a correlation would in the Institute's view be fairly minor, compared to the listed firm's financial performance.

The Institute also questions whether there would be sufficient interest by the market in the shares of such a listed company, particularly given the threat of litigation arising from audit. Whilst there could be benefits to the individual auditors who are employed by the listed audit firm in terms of their own limited liability, such a proposal on balance would in the Institute's opinion have no significant advantages over other proposals to redress unfair unlimited liability issues that apply to auditors.

A further potential complication could be the independence of the listed audit firm where the market capitalization is such that it would be normally included in the market index such that any shareholders in
the listed audit firm could not be audited by the listed audit firm. This could apply to financial institutions that have funds under management using an indexed market allocation portfolio.

The Institute does see merit in allowing auditors to incorporate, as this would provide some liability protection, however the proposal to take this further by requiring a listed vehicle, does not in the Institute's opinion appear to offer any significant advantages. The Institute is also not aware of any overseas experience in this regard.

(b) Audit firms of public listed companies be required to lodge an 'independent performance report' to ASIC annually

Whilst the Institute is not opposed to audit firms providing such an independence report, the Institute does question whether it is appropriate for the regulator, the Australian Securities and Investments Commission (ASIC) to receive individual reports for each individual listed company audit. The Institute in its submission to the Committee has argued for an Independent Public Oversight Board to monitor audit independence and it would seem more appropriate for such an Oversight Board to require this information from each firm on an annual basis, as part of its monitoring role. The Board would publicly report on the results of its operations and ASIC along with others such as the Institute would then be able to take appropriate action for any breaches of independence.

2. Auditing and Accounting Standards

(a) Should the Auditing and Assurance Standards Board be brought within the auspices of the Financial Reporting Council?

The Institute supports enhancement of the public's perception of the way the audit process is conducted, and to that extent the Institute's 31 May 2002 submission to the Committee supported the concept of an Independent Public Oversight Board. Such a board could be part of the Financial Reporting Council (FRC) process and as such the Institute would expect that such a board would have a monitoring role over all aspects of the audit function including the way Australian Auditing Standards are set and maintained.

However the Institute does not see any need for such a body to have 'control' over the Auditing Standards process. In particular it needs to be recognised that the accounting bodies (Institute and CPA Australia) fund the operations of the Australian Auditing and Assurance Standards Board (AuASB), and that Australian Auditing Standards issued by the AuASB are developed through Australia's participation in the International Audit and Assurance Standards Board which is likewise resourced by the various accounting bodies internationally.

Therefore it is unlikely that an oversight board would have a major influence on the development of Australian Auditing Standards, and hence such monitoring role for an oversight board would appear to be all that is needed. For the FRC to bring Auditing Standards within its 'auspices' would require public funding which at this time the accounting bodies have been prepared to fund separately.

(b) Should Auditing Standards be given the force of Law?

The Institute is not aware of any argument as to why Australian Auditing Standards should be brought within the requirements of the Corporations Act 2001. If such a move was made, this would, due to the parliamentary process, require Australian Auditing Standards to be subject to parliamentary approval and be set by a body that has parliamentary oversight and funding, an example being the Australian Accounting Standards Board.

As detailed in 2 (a) above, the Institute does not see any compelling reasons for parliament to 'control' the auditing standards process.

In particular, the Institute's 31 May 2002 submission to the Committee, noted that Auditing Standards are effectively enforced by both the Companies Auditors and Liquidators Disciplinary Board, and by the accounting bodies, and it is a requirement of auditing standards that auditors state in their auditor's report that they have complied with Australian Auditing Standards.

(c) What are the costs and benefits of harmonization of Accounting Standards?

The Institute has and continues to be a long-term supporter of international harmonization of both Accounting and Auditing Standards. The debate over the costs and benefits of harmonization had been resolved some years ago and the Institute is not aware of any significant criticism that would re-open this debate. Australia is part of the global economic community and as such needs to ensure that its financial reporting requirements are in line with international best practice. As such the Institute remains supportive of the international harmonization of Australian Accounting (and Auditing) Standards and in particular supports the 2005 deadline recently announced by the FRC for Australian Accounting Standards to be in line with International Accounting Standards.

3. The Role of Auditing

(a) Need to enhance the statutory role of auditing by, for example, introducing changes to dilute the growth of commercial/service provider - Reforms suggested

As detailed in the Institute's 31 May 2002 submission to the Committee, the major enhancement not just to the audit process but to corporate governance generally would be to mandate via statute (Corporations Act) the requirement for listed companies to have an Independent Audit Committee that has responsibility through the board of directors with public accountability to the shareholders.

Mandatory independent audit committees and mandatory management representation letters for listed companies would be a significant innovation to the Australian financial reporting framework and further enhance Australian listed companies reputation for quality financial statements. Given that it would appear that the major corporate collapses both in Australia and internationally have been due to a failure of proper corporate governance with significant management frauds, the Institute believes that requiring independent audit committees and management representation letters would be a significant inhibitant to such management frauds. Such measures whilst not preventing corporate collapses due to poor business decisions, could telegraph such weaknesses to the market much earlier.

(b) <u>Has the statutory role of audit been given adequate protection in the self-regulatory environment?</u>

The Institute supports the recommendations of the Ramsay Report which deals with proposed enhancements to the Corporations Act for audit (eg Statement of Audit Independence).

In addition the Institute has in its 31 May 2002 submission to the Committee argued for a reform of the current unlimited liability of auditors. Evidence given to the various hearings has reinforced the need for accountable and realistic liability reform. Indeed evidence provided by the auditors highlights the reality that they can do a great deal more in terms of providing assurance, even in relation to future prospects of the company, and assurance over non-financial indicators but the quid pro quo has to be reform of liability. Without that, auditors have untapped potential!

4. Financial Statement Review Program

(a) <u>Results of the Institute's Financial Statement Review Program and actions taken as a result</u>

For a period of around 20 years until it was discontinued in 2000, the Institute conducted reviews of a selection (around 150 each year) of published financial statements of companies and other entities (mainly listed). The purpose of the review was to identify apparent breaches of accounting standards and other statutory requirements and shortcomings in disclosures and presentation. The role of the review was primarily intended as educational with members taking steps to rectify any shortcomings in the following year, and in a very small number of instances over the years the program was in operation, formal disciplinary action was taken. While the review program identified a number of issues that were taken up with members (either as auditors or directors) each year, in the majority of cases it was established that these resulted from poor presentation and inadequate disclosure rather than being substantive breaches.

Although it no longer carries out the ongoing regular review program the Institute still carries out reviews of individual sets of financial statements where their may have been some public comment about their quality, or as a result of a specific complaint.

A summary of the Institute's last review (1999) is attached for information (Annexure 1).

(b) <u>Obstacles impeding collaboration between the Institute and ASIC and how can they be overcome?</u>

As detailed in the Institute's 31 May 2002 submission to the Committee, the major obstacle that appears to have impeded the Institute's desire to work with the ASIC Surveillance Program is the inability of ASIC to overcome its concerns over confidentiality issues given the requirement of section 127 of the ASIC Act that is seen by ASIC as limiting its ability to share confidential information with the Institute.

5. Non-Audit Services

(a) <u>Can guidance in Professional Independence Statement F1 be relied upon to address threats to independence from the simultaneous provision of non-audit services?</u>

The Institute believes that Professional Independence Statement F1 which is based on the International Federation of Accountants Ethic Code can be relied upon to address any perceived or actual threats to independence. The Australian predecessor to F1 – AUP 32 has been used for such purposes and the new F1 provides significantly more guidance on Independence.

(b) How will F1 be enforced and the extent of compliance monitored?

F1 like other Institute rules are enforced in a number of ways by the Institute. The Institute's Quality Review Program specifically tests for compliance by auditors with auditing standards and other Institute professional rules such as F1. In addition the Institute follows up any complaint or allegation made against a member and this includes F1. The Institute would also expect the regulator ASIC as well as the Companies Auditors and Liquidators Disciplinary Board to enforce the requirements of F1 or bring to the attention of the Institute where appropriate any alleged breaches of F1. A body such as a public oversight board would similarly work with the Institute in enforcing F1.

Already there is evidence in the market place that F1 is working, an example being the ANZ Bank which has listed the non-audit services that it will accept and not accept from its auditors.

A Substantial Improvement to the Financial Reporting

The Institute has attended each of the Hearings of the Committee held so far (Canberra 21 & 28 June, Sydney 8 July), and intends to attend the forthcoming Melbourne hearing (26 July 2002). The Institute has also reviewed all submissions made to the Committee. Whilst it is fair to note that a variety of issues have been raised, it is the Institute's view that a recurring theme relating to the major corporate collapses has been a failure of proper corporate governance.

From an audit perspective, a properly functioning independent audit committee will significantly enhance both perceived and actual audit independence. Given the heightened interest in audit independence, the Institute supports the concept of a public oversight board that would have responsibility for monitoring the performance of the audit function for listed companies.

If you require any further information, please contact Keith Reilly (Institute Technical Adviser) – Telephone: 02 9290 5703, E Mail: keith@icaa.org.au

Yours sincerely

Geoff Brayshaw
President
The Institute of Chartered Accountants in Australia

SURVEY OF PUBLISHED FINANCIAL REPORTS 1999

A total of 111 published financial reports have been reviewed in respect of financial years ending between 30 June, 1999 and 31 December, 1999. This has resulted in the issue of 59 letters to auditors and, in some instances, to member directors concerning apparent departures from accounting standards or Urgent Issues Group Consensus Views. In 23 cases, explanations for apparent departures were requested. In the remaining 36 cases, the departures were of a relatively minor nature and were reported as matters for attention not requiring a specific reply unless the auditor disagreed.

In the majority of instances the responses received were accepted as satisfactory. Some explanations claimed that the issue raised was not material or that it was not relevant to the entity. In a number of these instances, improved presentation and disclosures in the financial report would have averted the need to seek further explanation. The majority of auditors and member directors accepted the need for improved presentation and disclosure and undertook to make improvements in the following year's financial report. Disciplinary action has been taken where considered appropriate.

The highest numbers of apparent departures from accounting standards occurred in respect of the following standards:

- AASB 1017 'Related Party Disclosures'
- AASB 1026 'Statement of Cash Flows'
- AASB 1028 'Employee Entitlements'
- AASB 1034 'Information to be Disclosed in Financial Reports'
- AASB 1004 'Revenue' (reissued standard effective 30 June 1999)

It was disappointing to note instances of financial reports which, whilst not misleading or not presenting a true and fair view, were of an overall poor quality. In some cases it was evident from obvious errors made in additions, transpositions of numbers, cross-referencing errors and other typographical errors that the reports had not been subject to an adequate review before issue. Such poor quality reporting can only engender concern by users that the financial reports are inaccurate and lead to a loss of confidence in directors and auditors.

Some of the more glaring errors comprised:

- information reported in notes not agreeing with information reported in the financial statements and/or in other notes
- inconsistencies and conflicts between information contained in the financial report and information included in other parts of the annual report (eg chairman's report and directors' report)
- inclusion of descriptions of redundant accounting policies
- balance sheets not balancing and cash flow statements not adding up
- use of incorrect terms and obscure/incomplete descriptions of transactions
- notes missing, page numbers not in order and generally confused layout and referencing within the report

For some reports there were a significant number of departures from the presentation and disclosures required by accounting standards.

Identification of Issues by Accounting Standard

Accounting policies

- suitable description of accounting policy not provided/policy questioned [AASB 1001.6.1(b)]
- reasons for change in accounting policy not disclosed [AASB 1001.6.2(b)]
- incomplete disclosure of effect of change in accounting policy [AASB 1001.6.2(c)]

Events occurring after reporting date

- statement not made that financial effects of events have not been recognised [AASB 1002.5.1(c)]
- financial effect not disclosed or a statement made that it is not possible to estimate the effect reliably [AASB 1002.5.1(d)]

Revenues

- accounting policies adopted for recognition of revenue not disclosed or incomplete [AASB 1004.12.1(a)]
- methods adopted to determine the stage of completion of contracts involving rendering of services not disclosed [AASB 1004.12.1(a)]
- amount of each category of revenue recognised not disclosed (particularly sales of goods and rendering of services) [AASB 1004.12.1(b) (i)to(x)]
- non-disclosure of revenue arising from operating activities and revenue from outside operating activities [AASB 1004.12.2(a)/(b)]

Financial reporting by segments

- non-disclosure and/or composition of disclosed segments queried [AASB 1005]
- basis of inter-segment pricing not disclosed [AASB 1005.24(d)]
- segment information not aggregated and reconciled to agree with related information in the financial statements [AASB 1005.25]
- financial effect of change in accounting policy not disclosed [AASB 1005.30]

Accounting for leases

- amount of lease finance charges not disclosed [AASB 1008.50(d)]
- operating lease rental expense not disclosed [AASB 1008.51]

Construction contracts

- methods used to determine the stage of completion of construction contracts in progress not disclosed [AASB 1009.10.1(c)]

Accounting for the revaluation of non-current assets

- reasons for not reducing asset to recoverable amount questioned [AASB 1010.5.1]
- accounting for revaluation increments and decrements questioned [AASB 1010.6.1/.2]
- no or inadequate disclosure of basis of valuation [AASB 1010.9.1(b)]
- no or inadequate disclosure of policy re capital gains tax [AASB 1010.9.1(g)]
- whether expected net cash flows of non- current assets included in determining recoverable amounts have been discounted to present value not disclosed [AASB 1010.9.4]

Foreign currency translation

- methods used in translating financial reports of foreign operations not disclosed [AASB 1012.60(a)]

Accounting for goodwill

- reason for immediate write-off of goodwill on acquisition not disclosed/queried [AASB 1013.5.8]
- period over which goodwill is being amortised not disclosed [AASB 1013.10.1(c)]

Accounting for the acquisition of assets

- disclosures in respect of acquisitions of investments in controlled entities not made:
  - date of acquisition [AASB 1015.41(b)]
  - date from which operating results included in profit and loss [AASB 1015.41(f)]
- disclosures in respect of acquisitions of

entities not made:
- name of entity acquired [AASB 1015.40(a)]
- date of acquisition [AASB 1015.40(b)]
- cost of acquisition [AASB 1015.40(c)]
- description of purchase consideration [AASB 1015.40(d)]

Accounting for investments in associates

- non-disclosure of equity accounted information questioned [AASB 1016]
- summarised presentation of recognised amounts of assets, liabilities and profit or loss of associates not disclosed [AASB 1016.6.1(e)]

Related party disclosures

- banding of directors' income in conflict with the number of directors [AASB 1017.4.2(b)]
- aggregate number of shares and share options acquired by directors not disclosed in financial report [AASB 1017.4.15(a)]
- aggregate number of shares and options held by directors not disclosed in financial report [AASB 1017.4.16]
- nature of the terms and conditions of shares and options issued to directors not disclosed [AASB 1017.4.15(c)]
- nature of the terms and conditions of other transactions with directors not disclosed [AASB 1017.4.17(b)]
- names of directors concerned not disclosed [AASB 1017.4.17(c)(i)]
- each different type of transaction with related parties in the wholly-owned group not disclosed [AASB 1017.5.1(a)]
- nature of the terms and conditions of each type of transaction with related parties in the wholly-owned group not disclosed [AASB 1017.5.1(b)]
- receivables from controlled entities not analysed between [AASB 1017.5.2(c); wholly-owned group and other related parties AASB 1017.6.4(c)]
- dividends and interest received from controlled entities not analysed between related parties in the wholly owned group and other related parties. [AASB 1017.5.2(a)(i),(ii)/.6.4(a)(i),(ii)]
- particulars of transactions with other related parties not disclosed [AASB 1017.6.2]
- particulars of individually material transactions with other related parties (identities of related parties, terms and conditions, aggregate amounts recognised) not disclosed [AASB 1017.6.3]
- aggregate amount of interest revenue in respect of loans to an associate not disclosed [AASB 1017.6.4(a)(i)]
- identity of parent entity not disclosed [AASB 1017.7.1]
- comparative related party information for the preceding year not disclosed [AASB 1017.8.1]

Profit and loss accounts

- disclosure/non-disclosure of items as abnormal questioned [AASB 1018.15]

Inventories

- amounts of inventories carried at cost and at net realisable value not separately disclosed [AASB 1019.10.1(e)]
- aggregate amount of inventory write-downs and other losses not disclosed [AASB 1019.10.1(f)]
- circumstances or events that led to reversal of write-downs of inventories not disclosed [AASB 1019.10.1(h)]

Depreciation

- depreciation methods not disclosed [AASB 1021.11.2(a)]
- useful lives or depreciation rates used for each class of depreciable asset not disclosed [AASB 1021.11.2(b)]
- aggregate amount of depreciation allocated for each class of depreciable asset not disclosed [AASB 1021.11.2(c)]
- accumulated depreciation not presented as a deduction from the class of assets to which it relates [AASB 1021.11.2(d)]
- financial effect of change in depreciation expense because of reassessment of useful lives, revaluation or reappraisal of recoverable amount not disclosed [AASB 1021.11.3]

Consolidated accounts

- identity of ultimate parent entity not disclosed [AASB 1024.39(a)]
- explanation not provided of how control exists when ownership interest in a subsidiary is less than 50% [AASB 1024.39(d)]

Statement of cash flows

- contents of Statement of Cash Flows questioned [AASB 1026]
- aggregate purchase consideration relating to acquisitions of entities not disclosed [AASB 1026.9.2(a)]
- amount of purchase consideration for acquisition of entities discharged in cash not disclosed [AASB 1026.9.2(b)]
- aggregate amount of cash held by acquired entity at date of acquisition not disclosed [AASB 1026.9.2(c)]
- aggregate amounts of assets and liabilities of entities acquired summarised by nature and function not disclosed [AASB 1026.9.2(d)]
- aggregate consideration received relating to disposals of entities not disclosed [AASB 1026.9.4(a)]
- aggregate amounts of assets and liabilities of entities disposed of not disclosed and summarised by nature and function [AASB 1026.9.4(d)]
- incomplete information provided about transactions that did not result in any cash flows [AASB 1026.11.1]
- details of credit standby arrangements not disclosed [AASB 1026.12.2(a)]
- summary of used and unused loan facilities and the extent to which these can be continued or extended not disclosed [AASB 1026.12.2(b)]

Earnings per share

- diluted earnings per share not disclosed and no statement to the effect that it was not materially different from basic earnings per share [AASB 1027.16/.27(a)]

Accounting for employee entitlements

- particulars of ownership-based remuneration [AASB 1028.14(d)] scheme not disclosed:-
  - (i) Nature of scheme including the number of employees/groups of employees eligible to participate, types of shares and exercise date
  - (ii) Prices to be paid
  - (iii) Number and types of shares acquired, shares still available and market price
  - (iv) Number and types of shares issued, total market value, total received from employees
  - (v) Details of accounting policy comparative information not disclosed [AASB 1028.16]

Presentation and disclosure of financial instruments

- general lack of sufficient information about financial instruments [AASB 1033]
- accounting policies and methods adopted for each class of financial asset and financial liability including criteria for recognition and basis of measurement not disclosed [AASB 1033.5.2(a)]
- information about exposure to interest rate risk for each class of financial asset and financial liability not disclosed including
  - contractual repricing or maturity dates [AASB 1033.5.4(a)]
  - effective interest rates/weighted average effective interest rate [AASB 1033.5.4(b)]
- information about exposure to credit risk not disclosed [AASB 1033.5.5]
- concentration of credit risk exposure not disclosed or incomplete [AASB 1033.5.5(b)(ii)]

SURVEY OF PUBLISHED FINANCIAL REPORTS 1999

- aggregate net fair value for each class of financial asset and financial liability not disclosed [AASB 1033.5.6(a)]
- method(s) adopted in determining net fair value for each class of financial asset and financial liability not disclosed [AASB 1033.5.6(b)]
- significant assumptions made in determining net fair value not disclosed [AASB 1033.5.6(c)]
- reason for not reducing carrying amount of financial asset which is in excess of net fair value not disclosed [AASB 1033.5.7(b)]
- comparative information not disclosed [AASB 1033.6.1]

Information to be disclosed in financial reports

- classification of balance sheet items questioned [AASB 1034.4.1]
- accounts payable and borrowings not separately disclosed in the balance sheet [AASB 1034.5.1(b)(i)&(ii)]
- provisions not disclosed as deductions from the classes of assets to which they relate [AASB 1034.6.1(b)]
- basis of the most recent valuations of land and buildings not disclosed [AASB 1034.6.1(h)(ii)]
- net gain or loss on disposal of assets in each of the four categories required not disclosed [AASB 1034.10.1(d)]
- amount of franking credits available not disclosed [AASB 1034.11.1(e)]
- remuneration of executive directors not included in executives' remuneration [AASB 1034.12.1/2]
- aggregate remuneration of executive officers not disclosed [AASB 1034.12.1/2]

Borrowing costs

- capitalisation rate used to determine the amount of borrowing costs not disclosed [AASB 1036.8.1(c)]

Urgent Issues Group Consensus Views

UIG Abstract

4 'Disclosure of Accounting Policies for Restoration Obligations in the extractive industries': accounting method adopted in respect of restoration obligations not disclosed

8 'Accounting for Acquisitions - Recognition of Restructuring Costs as Liabilities': key features of restructuring program not described.

22 'Accounting for the Buy-Back of No Par Value Shares': nature and terms of share buy-back not described.

23 'Accounting for Transaction Costs Arising on the Issue of Equity Instruments': amount of transaction costs arising on the issue of shares and recognised directly in equity not disclosed

Other Reporting Issues

Rounding of Amounts in Financial Reports

- not in accordance with ASIC Class Order 98/0100 for auditors' remuneration, directors' remuneration & executives' remuneration

Directors' Report

- no clear cross references for disclosures transferred from the directors' report to the financial report
- details of each of the elements of each director's remuneration not disclosed
- no mention of compliance with environmental legislation
- nature and amount of options issued to directors not disclosed