



AUDITOR GENERAL
VICTORIA

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Mr A. Cunningham
Inquiry Secretary
Joint Committee of Public
Accounts and Audit
Parliament House
Canberra ACT 2600

Dear Mr Cunningham,

Review of Independent Auditing by Registered Company Auditors

As requested in your letter of 12 April, 2002 my Office offers the following comments in relation to abovementioned JCPAA Review. The views in this submission are also supported by the Auditor-General of Western Australia, the Auditor-General of Queensland and the Auditor-General of the Northern Territory.

Corporate Accountability

We note that the Committee's terms of reference deal with regulation of the auditing profession, and accordingly our comments are restricted to that aspect of corporate accountability. However, we wish to make the point that the audit function is only one aspect of the corporate accountability and governance model, and that there are other aspects of that model and other stakeholders whose role is integral to a consideration of the proper functioning of the capital market. In our view a comprehensive review of issues arising from the recent corporate collapses involves reviewing the role of directors, regulators (for example, ASIC, ASX), financial reporting requirements, analysts, legal requirements etc. Part of the broader concern that we have is that the financial reporting function, and within that the role of the audit function, is not in many cases given the significance it warrants as an essential component of the corporate governance process. The audit function needs to be recognised as a valuable function in its own right. We therefore agree that an examination of the role of the external audit function in the model is critical, and a Review of this nature is appropriate.

Given the diversity of issues covered by this subject matter, and to make our submission manageable, we have limited our response to the matters that we have identified as significant and subject to diverse views. The submission has also not re-iterated all of the debate underlying the matter on which comment is provided. The arguments are summarised in the Report by Professor Ramsay "Independence of Australian Company Auditors" issued in October 2001 which we commend to the Committee as background to the debate, although we do not support all of that Reports conclusions and recommendations. We believe that the enquiry will position the JCPAA to assess the seriousness of contemporary issues surrounding corporate governance and whether a radical corrective response is appropriate, and we would not be surprised if the Committee concluded that significant changes were recommended.

The Audit Function – Providing a Context

Our comments reflect a context and view of the role of the audit function in the corporate accountability and governance process based on historical precedence. That role emanates from the UK *Companies Act* of 1845 which required incorporated companies to have their annual financial reports audited. This reflected the requirements of the market place which saw capital being raised from shareholders who had no part in managing the company. The separation of ownership and management saw the need for managers to report periodically to those who contributed the capital, and as a mitigating factor for the benefit of corporate limited liability. In this context the external audit function can be argued to be a significant regulatory control in the capital market. These underlying principles are evident in the current *Corporations Act* which delegates this legislative role to registered company auditors; that registration itself being a statutory designation.

This view is further reinforced by the legislative requirement for companies to prepare a financial report in accordance with Accounting Standards. These Standards are derived from a model which requires that the resultant general purpose financial report is intended to meet the information needs common to users who are unable to command the preparation of reports tailored to satisfy, specifically, all of their information needs eg shareholders, employees, creditors, suppliers, regulatory agencies etc. The availability of the financial report and audit report as public information is an integral component of the regulated capital market. The current regulatory model, broadened from the historical separation of ownership base, requires, as a statutory requirement, that a registered company auditor be appointed to undertake the audit role. In this context, the audit role can be characterised as a delegated regulatory function. If that view is taken, it follows that the regulation of that function should reflect complementary principles. It may be argued, however, that the audit function has become a commodity/service function which has led to practices that are inconsistent with its antecedent role and underlying principles.

The accounting profession has embraced the audit role and explained it in its professional standards. The audit function is described as an “assurance engagement”.

Auditing Standard AUS 108 “Assurance Engagements” states:

“The objective of an assurance engagement is for a professional accountant to evaluate or measure a subject matter that is the responsibility of another party against identified suitable criteria, and to express a conclusion that provides the intended user with a level of assurance about that subject matter. Assurance engagements performed by professional accountants are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria, thereby improving the likelihood that the information will meet the needs of an intended user. In this regard, the level of assurance provided by the professional accountant’s conclusion conveys the degree of confidence that the intended user may place in the credibility of the subject matter.”

Auditing Standard AUS 202 “Objectives and General Principles Covering an Audit of a Financial Report” states:

“The objective of an audit of a financial report is to enable the auditor to express an opinion whether the financial report is prepared, in all material respects, in accordance with an identified financial reporting framework.”

AUS202 then prescribes the following general principles of an audit:

- independence
- integrity
- objectivity
- professional competence and due care
- confidentiality
- professional behaviour
- technical standards

At the level of broad principles, the professional literature has captured the fundamentals of the role of audit and the necessary general principles relevant to the effective discharge of that role. A combination of statutory regulation of the financial reporting and audit function and professional standards attempts therefore to provide parties external to a company (including shareholders through separation of ownership and management) with independent assurance on the representations of the directors/management about their accountability/governance in terms of financial reporting.

It is our contention however that the fundamental and significant role of audit in the accountability process has been blurred by practice and the lack of prescription in legislative and self-regulatory developments over time. In substance the role of the auditor as registered statutory provider and independent party appointed by statute and given statutory responsibility to report to shareholders and the Australian Securities and Investment Commission (in certain circumstances), has not been given adequate attention in the regulation of the audit function. This has manifested itself in significant debate on the “independence” of auditors, and the need to further regulate in this area. The comments which follow focus on this issue.

Audit Independence

The literature on auditing has for many years recognised that “independence is the cornerstone of the profession”. It is also recognised that independence is in large part on attitude of mind which is difficult to measure and regulate. Much of the regulation, professional and other, also acknowledges that independence must be assessed in terms of actual independence and perception. Lack of independence in fact has the potential for an ineffective audit process in an individual case. Equally, any perception by a report user that an auditor is not independent also potentially renders the function ineffective. If independence is compromised by perception, the report user will not take any assurance from the audit function, irrespective of the actual quality of the audit.

In our view, regulation of independence is therefore as much about creating an environment that avoids auditors being put in a situation where a conflict of interest might arise and that could create perceptions of such conflicts.

The following reflects our views on some of the more significant issues raised in the debate to date.

1. Provision of “other services” by auditors to auditee entities

This is one of the most contentious areas of the current debate over regulation of auditors. It is our view that given the nature and role of the statutory audit function in the corporate accountability model, the provision of non-audit services to a company creates an environment for potential conflicts of interest or, the perception of such a conflict. The nature and credibility of the audit function demands that the statutory provider be and be seen to be free of any other interest. This view recognises that the shareholders are the statutory audit providers “client”, whereas the provision of a non-audit service to a company requires that the statutory provider then view the directors/management of the company as the “client”. Audit becomes one of a range of services and therefore has to be managed as a “client service” rather than a regulatory function on behalf of auditors “client” ie shareholders . It is difficult to see how the auditor can serve two masters.

We are not convinced that the arguments and proposals on this matter to date mitigate the concern; for example:

- Some argue that there is no evidence to suggest that the provision of non-audit services by an audit firm has led to “audit failure”. The arguments and research on this issue are well documented in the Ramsay Report, Part 5 (d) and 8. This Report indicates that the evidence is not conclusive in either direction, and in our view also underestimates the arguments of the impact on the perceptions of financial report users. Part of the difficulty with this research is that it has not to any significant extent examined the impact on auditor attitudes/judgement which are difficult to measure and assess.

“Audit failure” does not need to be entity specific. It can be said to have occurred if the credibility of the function and its role in the corporate accountability process is undermined by perceptions of economic dependency and mutuality of interest because of the well documented increase in the provision of non-audit services. If the audit function is not credible because of this factor, and the debate suggests that this is an issue, “audit failure” has occurred as an essential element of the model is ineffective. The regulatory model approach to the audit function in our view suggests that the provision of non-audit services by an auditor is incompatible with the inherent nature of the role.

There is an argument that if audit firms are prevented from providing non-audit services that they will find it difficult to attract and retain high quality staff and the quality of audit will decline. This argument is fallacious as any proposal to prohibit firms from providing other services to audit clients does not prevent them from providing these services to other entities to which they do not provide audit services. The provision of those services within an audit firm will therefore be ongoing, and should not impact the staffing profiles or viability of audit providers. There is also a view that audit costs will need to increase if other services to audit clients are prohibited. If this is true, then it proves the assertion that audit has been a “loss leader” and supports the concerns about economic dependency.

- It is interesting to observe that several major corporate entities have indicated that as a matter of policy they intend in future to source all or some of their non-audit services from firms other than their auditor. While we support this initiative, we do not see this voluntary practice as reducing the need for regulation in this area. Obviously the extent of such initiatives will vary in their application, but as a matter of principle it is our view that it is not appropriate that regulation of audit independence be undertaken by those whose financial accountability is being attested to by the auditor. This in itself is a conflict of interest. It is our view that regulation of this issue should be legislative in line with the statutory role of the auditor and audit function.
- Another solution that has been advocated is increased disclosure about the dollar amount and nature of non-audit services provided by the auditor, and disclosure of whether the audit committee or the Board of Directors has assessed whether the provision of these services could impact auditor independence. We do not believe that this represents a solution for the following reasons.

If the major concern with the provision of other services is perception, then the disclosure that this impediment exists (depending on its significance) confirms to a report reader that independence is impaired. This renders the audit function ineffective in that the report user will not be able to derive the assurance supposed to be provided by the independent audit function. In this case transparency may in fact have an undesirable impact, other than in cases where no such services are provided or are insignificant in amount and nature. It is our view that it is preferable to avoid the potential impediment being an issue at all.

We also note that an element of the proposals for greater transparency include a company audit committee stating in the annual report whether or not the nature and level of non-audit service provision by the auditor is compatible with maintaining independence. It is a curious notion that the “auditee” entity (albeit its audit committee where such a committee exists) has a role in assessing and providing some assurance about audit independence. It is difficult to understand how this body would do that given that many of the factors influencing audit independence are internal to the auditee/audit firm, issues of attitude, objectivity etc and whether such a body would be objective. In our view audit independence should be regulated from the auditor perspective, not that of the auditee or a group associated with the auditee.

Having said this, we do support proposals for mandatory audit committees with an appropriate charter to enhance the corporate governance structure. An appropriately structured audit committee can play a significant role in supporting the role of the independent auditor within an entity. We support the principles for such Committees set out in “Audit Committees: Best Practice Guide”, 2nd Edition by the Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, the Institute of Company Directors and the Institute of Internal Auditors-Australia.

One of the responsibilities of an audit committee recommended in the abovementioned Best Practice Guide is reviewing auditor remuneration and for the audit committee to be satisfied that an effective, comprehensive and complete audit can be conducted for the agreed fee. We would support a requirement that assurance be provided to the shareholders by the audit committee on this matter.

- A prohibition on the provision of non-audit services to audit clients should encourage recognition from audit practitioners that the audit is a valuable “service” in its own right. If it becomes the only focus of the auditor/audit firm’s relationship with the auditee, it is our view that this will be beneficial to the audit function. We are aware that there is an argument that such a relationship exacerbates the “economic” dependency problem, as the auditor’s fee basis is dependent solely on the audit engagement. We do not support this contention as it would seem that the “economic dependency” and “undue management influence” risk is greater where the volume of fees at risk (audit and non-audit services) is larger.

2. Auditor Rotation

We endorse that principle of mandatory rotation of auditors. The issues to be resolved within this context is whether the rotation should be of the partner or the firm and the rotation period.

We support the principle of rotation on the basis that it should enhance the objectivity and professional scepticism (as required by professional auditing standards) applied to the audit function. We believe that in principle this is best achieved in the corporate sector through rotation of audit firms. We recognise however, that there are pragmatic obstacles (see later comments).

We are aware of the arguments against the proposal that rotation be applied at the audit firm level. These concerns centre on an expectation of higher cost, disruption to the auditee as the new auditor becomes familiar with the auditee entity and the loss of the experience of the incumbent audit team. We acknowledge that there may well be a cost issue, however we believe that in principle the resultant benefits of an independent, robust and quality audit function are significant. The arguments relating to loss of experience are in our view not supportable in principle. Auditing Standards require that an auditor have or obtain knowledge of the business, including general knowledge of the economy and industry within which an entity operates. The Standards also require that the auditor and audit team be appropriately skilled and experienced at a level appropriate to the needs of the audit engagement. It is axiomatic therefore that in principle, and under the requirements of Auditing Standards, a change in audit firm should not cause concern in terms of audit quality and efficiency, beyond the initial cost of the transition phase. As indicated, the benefit is in fact that there is a fresh perspective, current knowledge acquisition process, objectivity and scepticism applied by a new auditor and audit team.

We are, however, conscious of the fact that there are practical constraints within the Australian marketplace that make the introduction of this principle impractical. For example, in the case of large corporates, the audit capability is likely to reside with one of the “Big 5” (now “Big 4”) firms. If a prohibition is introduced on the provision of “other services” by the audit firm to an auditee, those “other services” are likely to be provided by one or more of the “Big 4”. This may see a situation where all potential audit firms would have a conflict of interest because of their association with the auditee, such as auditing their own work where the prior provision of “other services” has resulted in advice etc that has been implemented by the auditee. As indicated above, we acknowledge the disruption and cost issues and in addition the fact that this option has not been broadly applied internationally, and in the limited number of jurisdictions where it has, the practical implementation problems appear to have led to concern that the effectiveness has been problematic.

A more practical alternative is that a requirement be introduced for mandatory rotation of the audit partner and audit manager after a maximum of 7 years. This time period is consistent with US and UK precedent. We have included the audit manager in this recommendation on the basis that the benefits of enhanced objectivity of the partner rotation principle be applied at the more detailed operational and implementation level of the audit process.

3. Auditor Appointment/Removal

We are aware of suggestions that the approach to the appointment of auditors be changed to have such appointments made by the Australian Securities and Investments Commission. In principle we see some merit in this proposal on the basis of our view as to the role of the audit function in the accountability and regulatory process. However, we also recognise that the current model also has merit in that the law recognises the primacy of shareholders in the process of appointment and removal of auditors through the Annual General Meeting, and the involvement of ASIC in having to approve the removal and resignation of an auditor.

We would support those advocating an improvement to the existing process by having the recommendation of auditor appointment at an AGM based on the recommendation of the audit committee or a committee of non-executive directors rather than executive management.

4. Auditor attendance at the Annual General Meeting

The Corporations Act provides that a company’s auditor is entitled to attend a general meeting and be heard at a general meeting on matters that concern the auditor in their capacity as auditor. The Act provides that the chair of the AGM must allow members as a whole a reasonable opportunity to ask the auditor questions relevant to the audit and the auditor’s report.

We believe that the Act should be strengthened to require the auditor to attend the AGM. This would strengthen the role of the auditor and accountability to shareholders.

5. Scope of Audit Reporting

The debate over the “audit expectation gap” has raised many issues. One is the extent to which an auditor can and should be reporting on aspects of corporate governance other than the annual financial report.

Reporting on Internal Control

It is our view that one of the major issues in corporate governance is the existence and operation of an effective internal control structure. Auditing Standard AUS 402 “Risk Assessments and Internal Controls” defines the internal control structure as:

“...management’s philosophy and operating style, and all the policies and procedure adopted by management to assist in achieving the entity’s objectives. The internal control structure extends beyond those matters that relate directly to the financial report and consists of three elements:

- (a) the control environment
- (b) the information system; and
- (c) control procedures”

It would seem appropriate therefore that the management of a company provide a written representation as to the effectiveness of the company’s internal control structure and the auditor provide an audit opinion on that representation.

We believe that the introduction of such a requirement would improve the focus of corporate management on this important area and improve accountability to shareholders.

Auditing Standard AUS 810 “Special Purpose Reports on the Effectiveness of Control Procedures” issued in 1999 provides auditors with professional guidance on the conduct of engagements of this nature.

Reporting Management Discussion and Analysis

The financial reporting framework would be enhanced by a requirement that a financial report be accompanied by a management discussion and analysis report. The information reported in the financial report would be enhanced by discussion and analysis of the main factors affecting the financial performance, financial position and financing and investing activities of a company. This requirement could be introduced by the development of an Accounting Standard by the Australian Accounting Standards Board. The audit role would extend to adding credibility to this information through the normal attest function.

In making recommendations for expanding the scope of the audit function, we acknowledge that this needs to be accompanied by changes in the legal liability regime for auditors. Under present law, co-defendants in a lawsuit have joint and several liability for any damages awarded against them. This means that the plaintiff is able to recover 100 per cent of the damages from any one defendant, irrespective of how that defendant was to blame *vis-à-vis* any other defendants. Auditing firms are perceived to be ‘deep-pocket’ defendants with large professional indemnity insurance coverage, and this may have contributed to the extent of claims against them.

Where a company collapses or suffers a significant loss, action is usually taken against a number of parties. If for example the directors have limited financial resources, the bulk of the damages is usually claimed against the auditor, even though the auditor may be only partially responsible. To address this problem consideration needs to be given to a system of proportionate liability where each defendant bears only the proportion of the loss suffered by the plaintiff that can be equated to his or her level of responsibility.

6. Audit Independence Board

One of the initiatives suggested (Ramsay Report) to improve the regulation of audit independence is the establishment of an Auditor Independence Supervisory Board (AISB). This proposal has drawn mixed reactions in terms of whether it is a worthwhile initiative, and if it is the details of how it would be structured, funded, the nature and extent of its role etc. It is our view that if the recommendations indicated earlier in this submission were adopted, there is no need for an AISB in the form proposed.

We also note that one large audit firm has taken the initiative of establishing its own Audit Standards Oversight Board to oversight that firm's audit standards, quality and independence. While supporting such a self-regulatory initiative, we do not believe that this voluntary initiative of one firm addresses the broader issues. Even if it became a widespread practice and such Boards were established in accordance with an agreed framework to govern their role etc, it is difficult to accept that they will be perceived as an effective "independent" self-regulatory mechanism where the audit function remains as one service integral to the firm/auditee business model.

Please feel free to contact me should you wish to discuss any of these matters further at this time.

Yours sincerely,

J.W. Cameron
Auditor-General