17 June 2002

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

Dear Secretary

Review of independent auditing by registered company accountants

I refer to the review being conducted by the Joint Committee of Public Accounts and Audit on the subject of independent auditing by registered company auditors. ASIC intends to give evidence at the Joint Committee's hearing on Friday, 21 June 2002 and it may be useful for the Committee to have a summary of ASIC's views on this topic.

ASIC's approach generally

In ASIC's view, there has been a failure of accounting and auditing processes to deliver acceptable outcomes and there is a pressing need for measures which will restore confidence and credibility to accounting and audit.

The issues are complex: some going to the content and style of accounting standards and the manner in which they are set; and others to the quality and rigour of the audit process, raising questions about auditor independence and conflict. In ASIC's analysis, tension arises from the fact that auditors are expected to reconcile a commercial service provider-client relationship with a watchdog-whistleblowing responsibility. Commercial incentives support their service provider-client relationship; but there is very little legislative or other incentive to support their public responsibility role. A regulator could not function properly in such circumstances, but auditors are expected to perform as ‘contracted regulators’ of financial reporting.

Audit standards and their application are almost entirely self-regulatory, and do not have the force of law. The disciplinary and enforcement avenues available to ASIC as the official regulator are limited and complex. At the same time, the audit market for listed entities is dominated by a small number of major firms; and where the disciplinary and enforcement avenues available to the official regulator are limited and complex.

In this context, ASIC notes that in the USA – and indeed in most developed capital markets – audit issues are high on the agenda. Meanwhile, momentum is building for the convergence towards upgraded international accounting standards aiming to cover risks that are inadequately dealt with and adopting a ‘principles’ approach in place of currently overly complicated rules.

ASIC cautions against knee-jerk responses to this set of current issues and considers that time is needed to consider these issues from a 'first principles' perspective; to carefully restate the objectives and expectations of audit, and to ensure a process of consultation and counsel in the formulation of amended policy.

Ten measures: suggestions for debate

ASIC proposes ten measures for discussion as a contribution to the debate on accounting and audit issues:

International accounting standards

1. Australia should remain committed to the development and adoption of a complete and consistent package of international accounting standards.

   In ASIC's view, those standards should address key areas of current international disparity and plug holes that currently exist. Examples include: accounting for acquisitions and the resulting goodwill; accounting for other intangibles; accounting for executive and other stock options; recognition of off-balance sheet commitments resulting from leasing and similar arrangements; accounting for financial instruments including derivatives; and accounting for debt/equity instruments.

2. The international accounting standards should redress the current dominance in some jurisdictions of form over substance.

   International standards should reintroduce to the law an overriding qualitative accounting consideration and audit opinion that the accounts truly and fairly report the financial condition of the corporation. The ‘true and fair override’ was removed in Australia some years ago because of perceptions that that it was abused by some preparers, who used it to avoid standards they did not agree with. If it were to be reintroduced in Australia through the international harmonisation process, it should be accompanied by enforcement sanctions to prevent repetition of past abuses.

3. Australia should commit to the *wholesale* adoption of these updated international accounting standards.

   The efficacy of international standards should not be undermined by selective fine-tuning by user countries. Australian commitment to adoption should be unconditional and, by the end of the process, the AASB should be almost entirely concerned with providing input into the international accounting standard setting process and only in extremely rare circumstances be issuing national standards that deal with uniquely Australian situations.

Rotation of audit firms

4. The principle of rotating audit firms should be embraced to underpin the independence of auditors and to counter-balance the influence of any long-term service provider/client relationship.

   In ASIC's view partner rotation, while useful during the life of an audit engagement, will not achieve the same result as firm rotation. It is not credible that one partner will seriously challenge the established audit practice and advice previously provided by his firm through another partner. Rotation of firms, as encouraged by CPA Australia, is the more credible process.

   There are, however, significant pragmatic obstacles that confront firm rotation, particularly in light of increased concentration of the profession. This is a worldwide issue and Australia's interests would not be served by adopting a unilateral reform. In ASIC's view, therefore, this is a 'first principle' issue requiring serious discussion and consultations.

   The final position need not necessarily be all or nothing. For example, there might be firm rotation every seven years for listed companies as a ‘default’ position, but one which could be deferred by shareholder vote at the annual general meeting in the year preceding rotation. If directors persuade their shareholders that compulsory rotation might do more harm than good – taking account of the company's particular circumstances – the shareholders' view could prevail. At least a default position of rotation would ensure active shareholder participation in the decision. In ASIC's view, that is something that should be put to shareholders at each AGM after the rotation period has expired until a replacement firm is appointed.

Consultancy services

5. Audit and consultancy services should not be provided to the same clients.

   This is not the same as saying that audit firms should be banned from being engaged in consultancy. There is a strong argument that diversity of service is desirable in order to maintain the attractiveness of firms to future generations of accountants. An ability to generate revenue streams across different business lines should not be readily dismissed.

   However, it is undeniable that conflict arises when audit and consultancy services are provided to the *same* clients. In such circumstances, it is natural and predictable that the firm will seek to optimise its overall financial return from the relationship. In ASIC's view, disclosure or Chinese walls will not alter the dynamic of that commercial relationship, and the rigour and independence of audit will suffer.

   For these reasons, ASIC considers that firms should be precluded from providing consultancy services to their *audit* clients, but should be permitted to consult to other clients.

Whistleblowing

6. The law needs more clearly to set out its expectations for corporate whistleblowing.

   Consideration should be given not only to strengthening current reporting obligations of auditors to the regulator, but extending those obligations to a nominated officer of the corporation itself. Financial misconduct within corporations usually requires the transactional assistance of staff who know that things are wrong, but who feel unable to influence the outcome. The law should encourage, even oblige, such people to make known their concerns to the Board, the auditor and even directly to the regulator. One possibility is to impose such a reporting obligation on the most senior line financial manager of the corporation who is not a board member.

   ASIC notes that in the insurance sector direct reporting obligations by the auditor to the regulator and by the in-house actuary already exist, and are being extended under general insurance reforms.

   Such obligations should be accompanied by adequate statutory indemnity to ensure full protection against recrimination by the corporation or other parties.

Audit standards and practices

7. Existing auditing standards need to be reviewed to increase the rigour of audit. Those standards should have the force of law (as with accounting standards) and ASIC should have effective powers to police them.

8. At least for the listed sector, it should be compulsory for the board (in the absence of full-time management representatives where the company structure permits) to agree to the audit mandate and to review audit issues with the auditors at least six monthly.

   The key imperative is to reinforce the need for active dialogue between the board and auditors, independent of management sanitisation. In most cases an audit committee may well be the best way to manage that dialogue.

9. It should be compulsory for auditors to attend annual general meetings of listed companies and for them to be available to answer questions from shareholders.

   In the absence of valid excuse by reason of ill-health or other indisposition, auditors (and directors) should be present to account to shareholders. When the issue of mandating auditors' presence at annual general meetings was last considered, objections were raised on the grounds that directors are not obliged to attend meetings. In ASIC's view, those arguments do not hold good. This is an anomalous situation which should be rectified for both auditors and directors.

Continuous disclosure

10. The current continuous disclosure regime should be reviewed to ensure that it captures the timely publication of relevant information to shareholders and the broader market.

    Rather than mandating quarterly reporting, as recommended by CPA Australia, the suggested review should examine any difficulties with the current ASX rules; and the sanctions available to the regulator.

    A robust regime of continuous disclosure, supported by proportionate and timely sanctions, remains the best means of sustaining a well-informed and transparent market.

Finally, ASIC notes the proposal advanced by CPA Australia that a new umbrella body be established which, through an appointed committee, would investigate, monitor and provide discipline in relation to professional conduct.

In ASIC's view, it is important that ultimate enforcement of the law should continue to reside with the government regulator, and that powers of intervention and available sanctions need to be flexible enough to ensure that the enforcement is effective.

ASIC's roles in policing disclosure across a wide range of business sectors and in a variety of transactions, makes it impractical to treat financial reporting differently. For example, ASIC is responsible for the continuous disclosure regime; for disclosure in prospectuses, schemes of arrangement and takeover documents. All of these involve considering financial statements and working directly with accountants and auditors as well as directors and officers.

The direct connection with ASIC's enforcement work is also obvious. While some review of the current arrangements may be desirable it would not in ASIC's opinion, be sensible, or publicly acceptable, to seek to reduce the role of the independent regulator. Instead, consideration should be given to enhancing the regulator's oversight in some areas.

If you have any questions, please contact me on (02) 9911-2680 or by email on malcolm.rodgers@asic.gov.au.

Yours sincerely

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