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

Our ref AudInd02-JCPAA-L0508-MJC

Contact Lindsay P Maxsted
(Tel: 03 9288 5547)

16 August 2002

Dear Mr Cunningham

Review of Independent Auditing by Registered Company Auditors

We are pleased to provide the following response to the supplementary questions and matters taken on notice, as detailed in your letter dated 12 July 2002.

Matters taken on notice

1 Should legislation be introduced to provide regulatory authorities with the ability to request the conduct of "performance" or "performance type" audits in publicly listed companies?

In considering the merit of this proposal, it is necessary to consider whether the requirement should be imposed on:

- entities in a particular class, eg. all publicly listed companies; or
- entities in certain circumstances eg. due to specific regulatory requirements.

If the performance audit is to be mandated for, say, all publicly listed companies, then a clear framework would need to be developed upon which the performance audit would be based. Performance audits might involve a diverse range of issues. Examples might include the reporting of KPI's in relation to maintenance of control systems, management of risk, governance processes etc.

It would be important to determine whether or not the results of the performance audit would be made public.

If the performance audit is to be undertaken pursuant to a specific regulatory requirement, then it is more appropriate for the scope and framework of such an audit to be agreed between the entity and the regulator. The resulting report would be lodged with the regulator, with careful consideration about whether the report would be made publicly available. Although not technically "performance reports", arrangements currently exist whereby the Australian Prudential Regulation Authority requires deposit taking institutions to engage their auditor to undertake specific work and report to the institution's own board. These reports are then provided to APRA by the institution but they are not publicly available. Reports could be provided on a number of bases, either annually or perhaps triggered by, for example, the regulator becoming aware of financial or governance deficiencies or concerns in respect of specific industries or entities.

Australian Auditing Standards already provide for the conduct of performance type audits, with standards and guidance contained in:

- AUS 108 Assurance Engagements
- AUS 806 Performance Auditing
- AUS 808 Planning Performances Audits
- AUS 810 Special Purpose Reports on the Effectiveness of Control Procedures.

However, the extension of performance auditing beyond the government sector in Australia has effectively been inhibited by the current regime of joint and several liability and unlimited liability under which auditors in Australia operate. Auditors are cautious of extending their reporting responsibilities beyond traditional financial reporting because of the risks that this may entail. We therefore see appropriate liability reform as a key plank in any extension of performance auditing in Australia.

2 Mr Coleman was asked for his views on the issue of the "true and fair" override in the Corporations Law. In particular, the effectiveness of section 297, which includes the sentence "the section does not affect the obligation under section 296 for a financial report to comply with the accounting standards".

The law requires (Section 296) that accounts must comply with accounting standards, ie:

> "account must give "a true and fair view"…. but this does not affect the obligations under section 296 for a financial report to comply with accounting standards".

The practical effect of this is that the accounts must firstly "comply with accounting standards". Then, if directors do not believe that the accounts present a "true and fair view", they must provide additional information in the notes.

In our view, this means that the "true and fair" test is secondary to the requirement to present accounts in the accordance with accounting standards.

In a practical sense, to comply with accounting standards, the primary financial statements, ie. balance sheet (statement of financial performance), profit and loss (statement of financial position) and statement of cash flows must comply with accounting standards. These are the "headline" statements that are included in Australian Stock Exchange and other public announcements. Even if a Board of Directors feels sufficiently strongly that these statements are wrong, they need to mount a very significant communication exercise to ensure that the "additional information in the notes" receives sufficient prominence to ensure the issue is highlighted. They would also need to accept that ASIC might take a very dim view of their position.

There is also a clear presumption by both ASIC and the AASB that because the law requires compliance with accounting standards (S296) and because the standards are only issued after significant "due process", it would only be in extremely rare circumstances that compliance with accounting standards would not give rise to "a true and fair view". It is for this reason that KPMG, and may other commentators, believe that the law should be changed to re-establish the "primacy" of a true and fair view over compliance with accounting standards.

Supplementary questions

1 What do you think of the proposal that firms undertaking audits of publicly listed companies be required to lodge an "independence performance report" to the regulator every twelve months. The report would provide details of the outcome of each audit, including details of mechanisms in place to ensure the independence of the external audit function. ASIC would have the power to investigate any matters arising from the report, and to take action to rectify any deficiencies or concerns.

In answering this question, we assume that the independence performance report would provide details to the regulator on the internal processes and controls within the audit firm that ensure the firm remains independent of its audit clients.

In our view, it is very important that Audit Committees work to enhance or maintain the auditor's independence. Independence reporting, on an engagement-by-engagement basis with the auditor reporting to the client's audit committee is a recognised tool for helping to ensure independence. KPMG policy states that we report to all listed entity audit clients about independence matters, including a formal declaration of independence for the respective financial period.

In addition to this form of independence reporting, we recognise the importance of responding to the expectations of our clients and other market participants in a transparent manner. As a result, KPMG have recently strengthened our internal oversight through:

- the establishment of an Ethics and Conflicts Committee which has broad responsibility for oversight of and application of the firm's ethics, independence and conflicts policies. The Committee is chaired by the firm's national chairman, and includes as a member Professor Ken Trotman, Director of the Centre of Accounting and Assurance Research at the University of New South Wales

- the commissioning of an independent review by Professor Keith Houghton, incoming Chairman of the Australian National Centre for Audit and Assurance Research, and Professor Ken Trotman. The review will focus on the application of KPMG's policies regarding independence, conflicts and quality, and the results of the review will be made publicly available

- the appointment of a senior partner, Michael Coleman, as the firm's dedicated National Managing Partner Risk and Regulation.

In addition, as detailed on our submission to the Commonwealth government on the findings of the Ramsay report on auditor independence, we support the establishment of an appropriately structured and funded audit oversight body.

If some form of annual reporting by the firm is considered necessary, overseas models might be worthy of consideration. Oversight Boards have recently been established in the United Kingdom, Ireland and Canada. In addition, the recently enacted Sarbanes-Oxley Act in the US requires the provision of certain independence and quality information annually to the newly established Public Company Accounting Oversight Board.

2 Do you believe the program to harmonise our accounting standards with the international accounting standards will improve the reliability of financial reporting?

Whether or not the reliability of financial reporting will be improved through harmonisation largely depends on the respective quality and appropriateness of the current Australian financial reporting framework and the international financial reporting framework. It is now generally recognised that International Accounting Standards (IAS's) are becoming sufficiently robust so as to warrant harmonisation. In particular, IAS's cover certain areas of financial reporting not currently included in Australian Accounting Standards, including:

- Recognition and measurement rules for financial instruments
- Intangible assets
- Pension / superannuation accounting.

However, there are instances where current Australian accounting standards are seen to be more robust than their international equivalent, eg. in respect of:

- Related party disclosures
- Extractive industries
- Insurance
- Consolidated accounts.

It is therefore arguable whether harmonisation of itself will increase financial reporting reliability. However, we are of the opinion that the positives outweigh the negatives in this respect. This is, not insignificantly, based on the assumption that requirements of substance over form premise are retained within IAS, thereby avoiding the "black letter law" problems that have recently been the focus of so much attention in the United States. We also note the recent public comments by the Chairman of the Australian Accounting Standards Board, indicating that areas where current Australian Accounting Standards are stronger than the international equivalent would be preserved during the harmonisation process.

Ultimately, financial reporting reliability post harmonisation will be largely dependent on the maintenance of a well-funded, responsive and consultative International Accounting Standards Board, so that future financial reporting developments are reflected within the framework on a timely basis.

3 What are the costs and benefits of harmonisation, particularly for companies trading solely in Australia?

The major costs and benefits of harmonisation are summarised below:

Costs	***Benefits***
■ Significant time and money may be spent by entities in understanding the differences between Australian and international accounting standards, and in properly reflecting those in the entity's financial report and management / reporting systems.	■ The adoption of a single, robust set of accounting standards should be of benefit to entities that trade globally or are involved in cross-border investment. This is primarily because the comparability of financial information between countries / jurisdictions is increased, lowering financial "information risk". This is expected to facilitate more efficient movement of capital, and may also reduce the cost of capital.
■ There may be a detrimental impact on an entity's credit ratings or cost of funding to the extent that harmonisation negatively impacts reported earnings or other financial indicators.	■ Benefits may also arise as entities review and streamline their financial reporting systems as part of the preparation and implementation process.

On face value, the benefits of harmonisation for companies that trade solely in Australia or who solely source capital within Australia, may be less than for multinational entities. This may particularly be so in respect of companies that source capital from private sources.

However, it should be noted that:

- many smaller entities will still not be required to prepare financial statements on the basis that they are "small proprietary" companies under the Corporations Act 2001. Harmonisation will therefore not impact these entities whilst they remain "small proprietary" companies
- many large proprietary companies may continue to report on the basis that they are not "reporting entities" pursuant to Statement of Accounting Concepts SAC1. This will allow these entities to continue to exclude certain items of disclosure from their financial reports, thereby reducing the impact of harmonisation that arise due to changes in disclosures
- it can be argued that public entities that raise funds solely from Australian capital markets may still benefit from harmonisation, on the basis that any perceived improvements in reliability and comparability of financial reporting should make access to domestic funding easier and cheaper.

4 In addition to the issue of legal liability, what changes to the accounting and auditing framework are required to support an increase in the scope of the external audit (and the audit report) to cover, for example, governance issues, risk management and internal controls?

This may require:

- changes to the Corporations Act 2001 surrounding the scope and wording of the auditors report
- changes to the philosophy / operations of the regulators. For example, ASIC generally adopt a black letter approach to enforcement as opposed to broader-based prudential regulation.

It would also be necessary to confirm the intended audience of the expanded audit report. The framework for establishing the scope and form of the report may differ considerably if the report is made publicly available as opposed to being provided solely to the regulator.

As detailed previously, existing Australian Auditing Standards largely accommodate the audit and reporting of matters beyond financial accounts. However, this would require further review to ensure the current standards appropriately accommodate the scope and form of any expanded audit report.

5 Should the role of the auditor and the scope of audits be codified in legislation?

The role of the auditor and the scope of audits are currently codified in the Corporations Act 2001 in a number of ways, including:

- auditor qualifications, including prohibition in respect of financial interests in and indebtedness to the audit client
- the appointment and removal of auditors
- the matters upon which an audit report on a financial report drawn up in accordance with the Act must comment on
- the obligations of the auditor to report certain breaches of the Act by the company to the regulator.

In addition, ASIC regulate the auditing profession through:

- approval and registration of company auditors
- referral of disciplinary matters to the Company and Liquidators Disciplinary Board.

At present, the engagement process between client and auditor, and the framework by which audits are conducted, are primarily governed by Australian Auditing Standards and supplementary guidance issued by the Australian Auditing and Assurance Standards Board (AuASB). As you would be aware these standards, and the operations of the AuASB, are not codified in legislation. We consider this to be appropriate given the inherent difficulties in legislating professional standards that in many ways are driven by matters of concept and professional judgement. We are not aware of any other set of professional rules or standards in Australia that are codified in legislation.

However, as detailed in our submission to the Commonwealth government on the Ramsay Report on Auditor Independence, we welcome a formal review of the place and oversight of the AuASB as part of an overall review of the Australian regulatory framework.

We trust these responses are of value in finalising your deliberations. Please contact me or Michael Coleman if you require any further information.

Yours faithfully

Lindsay P Maxsted
Chief Executive Officer