SUBMISSION TO THE AUSTRALIAN PARLIAMENT'S JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

1. TERMS OF REFERENCE

1.1 *With the spate of recent noteworthy corporate collapses both within Australia and overseas, the Joint Committee of Public Accounts and Audit wishes to explore the extent to which it may be necessary to enhance the accountability of public and private sector auditing. In particular, the Committee is keen to determine where the balance lies between the need for external controls through government regulation, and the freedom for industry to self-regulate.*

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2. INTRODUCTION

2.1 The Enron affair has triggered an enormously wide-ranging debate and has raised questions about many aspects of the operation of capital markets, as well as concerns about financial reporting and auditing standards, regulatory arrangements and the quality of the corporate governance in major corporations. Media comment has focused heavily on the issue of auditor independence. Some national regulators have announced that they are considering options such as placing a limit on the time for which auditors may hold appointment or banning them from undertaking consulting work. These reactions raise two issues.

- First, leaving aside the substantive merits or otherwise of these proposals, ACCA is concerned that such national developments will lead to a fragmentation of rules. Instead, a global solution should be pursued. The global adoption of the independence provisions of the IFAC Code of Ethics will be a major milestone in promoting consistency.

- Secondly, however, it is not clear that the two measures which have been most widely reported are the appropriate responses. The general issue of 'auditor independence' covers a number of separate matters including:

  - over-dependence of an auditor on a particular client, either
    because of the size of fee income relative to the total fees of the firm's region or office, or because of the existence of fees from non-audit work such as consultancy

  - the employment of staff recruited from the audit firm

  - the process of appointing and re-appointing auditors

- the rotation of audit partners

  and

- the process of monitoring and regulating auditors.

2.2 It is not clear that all, or indeed any, of these were major factors in the Enron case and there is a danger that a knee-jerk reaction which misses the target may do more harm than good. Nevertheless, it is the case that public perceptions have shifted as a result of the Enron collapse and the issue of independence does require further consideration. This consideration must take account of all the different aspects of the matter and indicate a careful consideration of the potential benefits and possible costs of any changes.

2.3 Enron, and all the other cases which have attracted attention, have demonstrated the need for greater transparency and trust. This needs to be addressed as a matter of urgency by the global financial community. No single measure is likely to deal with the questions which have been raised and a range of ideas must be considered. These could include:

- making the appointment of the external auditors less dependent on the executive directors and involving the non-executive directors, the audit committee and institutional shareholders; in turn, this would have far-reaching implications for the corporate governance mechanism

- limitations on the ability of audit firms to offer consulting services to listed company audit clients (although not necessarily a ban on the provision of such services to non-audit clients)

- fuller disclosure of audit and consulting fees in the annual report and accounts

- a mandatory review by a company's audit committee of the independent status of the external auditors and the publication of a statement that it is satisfied with the results

- a prohibition on audit firms providing audit services in instances where senior audit staff have moved to senior executive roles in client companies: this could take the form of a moratorium prohibiting audit staff from moving to audit clients for an appropriate period after they have been personally involved with the audit.

2.4 One matter which is not easily addressed by prescriptive regulation but which requires sensitivity on the part of auditors themselves is the issue of the size of the audit fee relative to the local office providing the service and the fee generation target(s) imposed on the engagement partner. When assessing the independence and objectivity of those tasked with providing the assurance activity, it is not appropriate simply to look at individual audit fees relative to gross partnership income. They need to be considered in the context of the income of the office in which the partner concerned works and the expectations which the firm has of him or her. It follows that audit monitoring should focus on the culture within audit practices and the pressures on individual engagement partners.

2.5 ACCA also believes that the process of audit appointment should be reviewed. Although in theory this is a matter for shareholders, in practice the appointment is controlled by management. It may be time to see if this can be changed. One possibility is that private sector or even governmental bodies might fulfil the role of appointing auditors but for multi-national companies a global, not national, approach would be necessary. This approach would require the full backing of regulatory authorities worldwide. An alternative strategy, which we fully support, would be for non-executive directors and corporate audit committees to have a much higher profile role in the auditor appointment process.

3. REGULATION

3.1 In a speech on 17 January 2002, the Chairman of the US Securities and Exchange Commission said of the regulation of the accounting profession:

We cannot afford a system, like the present one, that facilitates failure rather than success. Accounting firms have important public responsibilities.

3.2 He went on to set out his vision:

…this system must at heart be a tough, no-nonsense, fully transparent disciplinary system, subject to independent leadership and governance. In addition, there must be regular monitoring of the ways in which accounting firms perform their responsibilities, and the areas in which either individual firms or the profession as a whole, can improve.

3.3 ACCA shares this view. Indeed, as an organisation which is domiciled in the United Kingdom, it has actively participated in the setting up of an oversight body, which is dominated by public membership, and is involved in a system of quality control which avoids firm-on-firm review and instead utilises, through professional bodies, permanent monitoring staff who are not connected with individual accounting firms. This sort of system, which can both operate on a national basis and cover transnational audit firms, is demonstrably more effective and independent than the widely used and much criticised system of 'peer review'.

3.4 In ACCA's view, it is essential that the process of regulating accountants should have access to the expertise of practising accountants. It is, however, no longer credible or acceptable for the process to be controlled by practitioners or by the professional bodies to which they belong. Over the last few years, ACCA has transformed its own disciplinary and regulatory machinery to comply with developing Human Rights legislation. The committees which take decisions on licensing, discipline and appeals, which only a few years ago exclusively comprised members of the governing Council, now exclude Council members entirely: the committees are composed entirely of lay members, with a lawyer chairman. Proceedings are also typically held in open session.

3.5 In most cases, such arrangements are sufficient to ensure that professional bodies are seen to act in the public interest and to take firm and transparent action against members who fail in their fundamental responsibilities, whether as executives or as auditors. In certain circumstances, however, a case may raise significant public concern with the potential to damage confidence in the profession and it may be appropriate for this to be handled by disciplinary machinery which is even further removed from the professional bodies.

3.6 The new system of non-statutory independent regulation of the accountancy profession provides for such an eventuality. The overall aims of the new system are to ensure that the profession operates in the public interest and to secure public confidence in the impartiality and effectiveness of the accountancy bodies' systems of regulation and discipline.

3.7 At the head of the system is the Accountancy Foundation, an independent body comprising representatives of City and consumer organisations, which acts as the key point of contact with Government, appoints members of the subsidiary bodies (all of which have guaranteed majorities of non-accountants) and ensures that the new system is adequately funded. Under the Foundation are two standards bodies - the Auditing Practices Board, with a remit to establish auditing standards which will enhance public confidence in the quality and relevance of audit; and the Ethics Standards Board, which will set the agenda for, and review, ethical standards issued by the bodies to their members.

3.8 Alongside these bodies is the Investigation and Discipline Board, another subsidiary of the Foundation, which takes over the responsibilities of the accountancy bodes for investigating and prosecuting cases of particular public concern or complexity.

3.9 Finally, the Review Board oversees the operation of the new system and, in particular, the activities of the APB, ESB, IDB and the bodies themselves to ensure that they serve the public interest in maintaining and enhancing the standards of work and conduct of accountants. The Review Board has published its initial work programme, which includes studies of complaints handling, regulation and monitoring and a number of areas relating to auditor independence.

3.10 Although the system is very new, ACCA has supported it as providing an appropriate balance between the need for external, government led control and the efficiency and proportionality of delegated non-statutory regulation. In our submission on the report of the Ramsay Committee, we expressed the view that it was inefficient merely to establish an Auditor Independence Supervisory Board (AISB). We argued that auditor independence is too narrow a remit for a board of this nature. Auditor independence should be integrated into, and monitored by, the regular quality assurance review processes. A board, similarly constituted to the proposed AISB but with a much wider remit, should be charged with the task of overseeing, and reporting publicly on, the standard setting, quality assurance and disciplinary systems to which the accounting profession is subject and the extent to which these serve the public interest. This would include, but not be limited to, matters of auditor independence.

3.11 Furthermore, ACCA believes that it is critical for the board's credibility that it should be demonstrably independent of the accounting profession and its structures. For this reason, while accountants should not be excluded from membership by virtue of their qualification (which may well be an advantage), they should not form the majority of the members of the board nor should they represent , or participate in the governance of, any particular accounting body.

3.12 The best way to ensure that such a board is clearly free of any influence from the profession is for it to be funded by government. If, however, this is not seen as as politically achievable, ACCA supports the concept for "no strings attached" funding, safeguarded by means of a largely non-professional board and fixed sum funding to which the profession is committed for a fixed period.

3.13 One of the key features of the new UK arrangements is the prominent expectation that the professional bodies will normally implement the recommendations of the Review Board and, in the exceptional circumstances that they do not, will make public statements of their reasons. This requirement does not appear to be explicit in the proposals for the AISB. Its absence serves to undermine the powers of the board, such as that to advise the professional accounting bodies on whether standards on auditor independence have been adequately implemented, to serve the public interest.