

# **Deloitte Touche Tohmatsu submission to the Joint Committee of Public Accounts and Audit in response to the request for submissions to its Review of Independent Auditing by Registered Company Auditors.**

**24 May 2002**

## **Introduction**

1. Deloitte Touche Tohmatsu (Deloitte) welcomes the Committee's review and its contribution to the important debate on audit independence presently taking place.
2. Deloitte agrees it is important to take such steps as are necessary to restore the faith of shareholders, directors and all other stakeholders in the financial statements of Australian corporations. However, Deloitte urges caution to ensure that any proposed reform to audit independence does not create new and greater risks or harm, or create un-realistic perceptions. Deloitte believes there are many fundamental issues to be considered. Audit independence is only one aspect.
3. Improvements are needed in corporate governance, including the role and quality of Audit Committees.
4. Deloitte looks forward to discussing this response at the appropriate time.

## **Ramsay Report**

5. Deloitte has responded to the Treasurer on the recommendations made by Professor Ramsay in his report on the *Independence of Australian Company Auditors*. That response substantially covered the issues we believe are appropriate to submit to this Committee.

## **Deloitte Key Recommendations**

6. Deloitte makes the following specific recommendation on key issues regarding audit independence, the audit profession, corporate governance and financial reporting:
7. Deloitte supports the need for an independent audit oversight body and suggests an expanded Financial Reporting Council (FRC) may be the appropriate body for this role.
  - Deloitte supports updating audit independence standards but does not support the Corporations Act being amended to incorporate a requirement that the auditor be independent; and
  - Deloitte believes that all listed companies should have an Audit Committee, that such Committee should comply with international best practice and that the Audit Committee should be responsible for the relationship with the auditor.
  - Deloitte supports Australia's long standing policy of harmonisation with International Accounting Standards;

- Deloitte supports Australia's long-standing policy of harmonisation, thus achieving "world's best practice" with International Auditing Standards;

## **Harmonising Accounting Standards**

8. Deloitte believes that the harmonisation of Australian Accounting Standards with the International Accounting Standards should be a greater priority for the profession, professional associations and standard-setting bodies
9. With the complete interconnection of global financial markets, and the increasing number of Australian corporations either operating or seeking capital in international markets, the harmonisation of Australian Accounting Standards with the International Accounting Standards is an imperative. Improving the efficiency of Australian capital markets requires improvement in the accountability of private and public sector reporting, which leads to increasing demand for high quality, internationally comparable financial information.
10. However, the process of harmonisation of Australian Accounting Standards must also address shortcomings, which have been identified in International Accounting Standards.

## **Audit Committees & Corporate Governance**

11. Whilst recognising that the Board of Directors bears ultimate responsibility for corporate governance, Deloitte supports the view that it should be mandatory for listed companies to have an independent Audit Committee. The Board must fully support the Audit Committee through appropriate governance policies. This recommendation is fundamental to the restoration of confidence in the financial reporting of Australian corporations, and in resolving the perception that the independence of auditors has been compromised.
12. This recommendation replicates one of the accounting profession's key recommendations from the Audit Expectation Gap Reports (1993 & 1996) which argued that requiring such Audit Committees would significantly enhance corporate governance and assist in maintaining audit independence for listed companies. The Expectation Gap Report argued that auditors must be required to formally report to the Audit Committee, a consequence being that the Audit Committee would have the responsibility to recommend to the Board and shareholders on the appointment and remuneration of auditors, and monitor audit independence. The Government Working Party then supported this recommendation in 1997.
13. The challenge of restoring confidence in the financial reporting of Australian corporations is not that of auditors alone. A significant degree of responsibility attaches to Boards and to senior management of Australian corporations.
14. Deloitte was pleased to see in Senator Conroy's recent address to the National Institute of Accountants that the Senator gave particular prominence to the vital role that audit committees must play in improving corporate governance. In particular, his support for properly independent audit committees for all listed companies, the role they should play in appointing auditors and their on-going responsibility in relation to the auditors interaction with the company, its management and shareholders.

## **Legal liability reform would enable more comprehensive reporting**

15. The rising cost of professional indemnity insurance and its diminishing availability in the market place have meant that a party cannot be certain, in the event of a claim against the auditor of a company, that such a claim can be satisfied. The current cost of professional liability risk for the Big 5 firms globally represents conservatively 14% of audit revenues generated, and the ever-increasing size of such claims has resulted in auditors being unable to obtain cover for amounts that are well beyond the capacity of the professional indemnity insurance market. These circumstances threaten the ongoing viability of the large audit firms and, consequently, the best interests of national public welfare.
16. It is also generally accepted that when a loss occurs, it may not be wholly attributable to the auditor's work. Yet, even if the responsibility for a loss is only partially due to the audit, the auditor may be required to meet the entire judgment, in the event of the other parties' inability to pay. There is no justification for the disproportionate burden on auditors of the financial consequences of commercial fraud and failure.
17. Indeed, the fact that auditors are required by their professional bodies to maintain professional indemnity insurance makes firms an immediate target in any litigation.
18. As a consequence of these factors, the establishment of a statutory cap on an auditor's liability and reform of the law on joint and several liability, where financial loss is involved needs to be re-considered;
19. These are complementary reforms and address the problems of uncertainty to the community by providing the auditor access to adequate and certain insurance cover and a solution to the currently inequitable allocation of damages.
20. A view has been expressed that auditors should not be able to limit their liability. This approach will ultimately result in increased uncertainty as to the availability of insurance cover, thus leading to a decline in those wishing to join the profession and a decrease in those firms wishing to undertake the audit role. None of those outcomes will serve any benefit to the community.
21. A scheme exists in New South Wales that caps the liability of ICAA and CPA members in public practice, having regard to the level of the fees charged (up to a maximum of \$20 million). However this is only available in the State and, as State Legislation, may be overridden by Federal Law. Despite its limitation, the scheme does provide benefits by giving greater surety that its members will have adequate cover and resources (as required by the Scheme) to satisfy any claims. In addition, it requires certain professional standards to be met and risk management training to be undertaken, thus leading to the delivery of improved professional services.
22. It is generally true that when a company fails, it is the auditor that comes under scrutiny. Yet, it is not the auditor who makes the daily decisions that may affect a company's strategy, affairs or policies, nor are they the party that appoints the executives or board. However, it is inevitable that the auditor will be sued. On the basis of joint and several liability, it is also likely that the auditor will be sued for the total loss, as the insurance cover and assets are attractive targets for litigants. The result being that the insurance is required to cover not only the auditor for their liability but also that of other impecunious or uninsured parties.
23. The introduction of a reasonable limitation of liability that covers audit work, proportionate liability legislation and abolition of joint and several liability of defendants is required to attract high quality audit professionals.
24. To ensure that there is an acceptable balance between the risks associated with an auditor's role and the public interest in having an independent audit conducted, a capping of liability, proportionate liability legislation and abolition of joint and several liability of

defendants is required.

25. The 1993 report of the Ministerial Council for Corporations Working Party recommended that the 'arbitrary and unfair consequences of the rules regarding joint and several liability of auditors' should be addressed in a review of the law.
26. There has been significant liability reform recently in the northern hemisphere, with the UK introducing Limited Liability Partnerships and Canada implementing proportionate liability. Auditors' reluctance to report more fully is due to the real risk of spurious legal actions. The Australian unlimited liability environment, which is out of step with other countries, encourages a "blame" and litigious culture where auditors with "deep pockets" are targeted. This involves expensive and time-consuming defence of unwarranted actions, which is not in anyone's interests.
27. In our view, there is a strong case for greater disclosure of information, which will be subject to audit or review. This can be more readily accepted under a framework of limitation of liability, some form of proportionate liability and abolition of joint and several liability of defendants.

### **Multi-disciplinary audit teams & the need to maintain skills**

28. There is currently considerable debate as to what, if any, non-audit services it is appropriate for an audit firm to provide to its audit clients.
29. Deloitte submits that an absolute prohibition on the same firm providing audit and non-audit services to the same client, whether regulatory or in practice will seriously undermine the quality of audits in Australia. Deloitte does agree that ensuring the independence of the audit is paramount, and is happy to participate in the debate about consulting services, internal and external audit.
30. The provision of certain non-audit services has ensured a depth of knowledge and access to expertise that has ensured audit professionals deliver more thorough and complete audits. The better the audit, the greater the benefit to the financial system. Audit teams need to include high calibre personnel and experienced technical specialists who can understand business risks, and are able to hold their own against skilled, knowledgeable and articulate business people in evaluating complex business transactions on behalf of the Board.
31. Deloitte has recognised the impact on clients of the perception of audit independence being compromised, and has announced that it will be separating Deloitte Consulting. In a further effort to address public perceptions about auditor independence Deloitte has also announced that globally it would no longer accept new engagements to perform internal audit outsourcing for audit clients.

32. Deloitte notes President Bush's comments endorsing the benefits of the provision of non-audit services if independence is not compromised:

*"Accounting firms' expanded services, including tax planning and the design of information technology systems, are often offered alongside traditional audit services. In fact, the accounting profession is uniquely qualified to offer many services that strengthen corporations' controls, **and the performance of some services can enhance the quality of audits**".(emphasis added)*

*(Specifics of the President's Ten-Point Plan)*

33. Professor Ramsay stated that, whilst "...there is a widespread misconception that firms providing non-audit services are not independent...**such services can benefit shareholders.**" (emphasis added).
34. The Panel on Audit Effectiveness (US) concluded in an independent review in 2000 that there was no evidence that audit quality was compromised because a firm provided consulting services to a client. In fact, the Panel asserted that in many audits it reviewed, audit quality had been improved by the performance of consulting services and none were affected negatively.
35. Professor Stephen Taylor of the University of Technology Sydney this year found that financial accounts were more conservatively compiled if one of the five major accounting firms audited the company and if that firm provided substantial non-audit services.
36. A University of Southern California study also found no significant association between the ratio of audit to non-audit fees and the likelihood of an auditor issuing a going concern opinion.
37. The audit of a complex company requires a multi-disciplinary audit team with a broad array of constantly updated skills and competencies. A strict regulatory or practical prohibition will make it difficult:
- For audit team specialists who participate in the audit to maintain their state-of-the-art skills and competencies if they cannot also provide advisory and consultative services;
  - To attract and retain team specialists within the audit firm in the absence of intellectually challenging and rewarding advisory and consulting mandates;
  - To contract outside technical specialists (to replace audit team members) who may not be willing to provide the needed level of expertise because of the risk of litigation in providing audit-related services, and because the revenues from audit support work would be immaterial to their larger consulting business.
38. To use outside service providers for needed competencies could create new independence concerns, since these providers may not be subject to current auditor independence rules.
39. Deloitte notes that the Institute of Chartered Accountants in Australia and CPA Australia have just issued new regulations on professional independence, which will have effect from 31 December 2003. These rules are based on the International Federation of Accountants independence rules, which were introduced in 2001. Deloitte internal processes are already fully compliant with these rules and Deloitte has therefore stated that it will move to early application of the new independence rules with immediate effect.

## **Enhanced financial and audit reporting**

### **Audit reports and audit scope need to be revisited**

40. The audit report explains what the audit does and provides an opinion on the truth and fairness of the financial report.
41. It is a specific and highly technical report, developed along the lines it has due to legal challenges and liability concerns. As noted in an earlier section, the joint and several liability rules and professional insurance arrangements have been interpreted to imply that auditors are a good target for legal claims and actions. The result is that auditors have, of necessity, become 'risk averse' when reporting.
42. We recognise that there is opportunity to make the audit report a more easily read and understood report, and consider this to be an important priority to address.
43. The assurance the auditor provides at present is limited to the financial report. Shareholders and others recognise that other information provided with the financial report is equally as important to their needs, for example the directors' reports and environmental reports. Both the US and the UK have assurance over other aspects in the annual package.
44. The US has an audit level service for the Management Discussion and Analysis (MD&A), which assures the Board and Audit Committee that "the MD&A presentation is in line with SEC requirements; the historical financial information is accurately derived; and the underlying information provides a reasonable basis for the disclosures made".
45. The UK requires a report to the shareholders on certain of their Combined Code disclosures (which relate to the internal control processes) made by the Board.
46. Subject to liability considerations, we support revisiting the scope of the audit and the audit report. This could take the form of, for example:
  - i. Rewriting the report to more 'plain English' language.
    - Expanding the work and report to cover governance, risk management and internal control aspects of relevance to shareholders' appreciation of their company.
    - Expanding the scope of the audit for other issues of on-going and legitimate relevance to shareholders.
47. We recommend expansion of the scope and format of the audit report, within liability confines, to cover governance, risk management and internal control expressed in plain English.

### **“True and fair override”**

48. In recent times a number of people, including the Chairman of ASIC, David Knott, and Senator Conroy, have called for the reintroduction to the law of an overriding qualitative accounting consideration ( the “true and fair override”). In doing so, they have acknowledged the abuse of the override prior to its removal some years ago but suggest that enforcement sanctions would prevent the repetition of past abuses.
49. The recent experiences in the USA, particularly in relation to Enron where a “tick the

box” approach to accounting standards permitted serious profit mis-statements, are clearly very much in public focus at the moment.

50. Nevertheless, these overseas failures should not cause Australia to change course mindlessly in its commitment to a rationale accounting framework. It should be remembered that Section 297 of the Corporations Act already requires that financial statements must give a true and fair view. If the financial statements prepared in accordance with accounting standards do not give a true and fair view, additional information must be given as per Section 295(3) so as to give a true and fair view.
51. It should also be noted that in overseas jurisdictions which accommodate the true and fair override there are provisions, such as in the UK Companies Act, that only in *special circumstances* may the override be applied so as to depart from compliance with the financial statement reporting requirements of the Act. In such circumstances there is a requirement for a clear and unambiguous statement of the particulars, reasons and effect of the departure (UITF abstract 7). This makes use of the override rare.
52. Deloitte believes that it is appropriate that this matter be once more debated but that past experience be given full weight before any change is made.

## **Continuous reporting**

53. The pace of change in corporate dynamics and earnings capabilities has made timeliness of reliable, information to shareholders more important. Financial reporting must be both informative and reliable and provided to users in a timely fashion. The increase in use of the Internet for economic communications makes possible the disclosure of useful selected financial and non-financial information in virtual real-time.
54. A number of other countries (for instance the US, Germany and a number of Asian countries) already have, or are in the process of mandating, quarterly reporting by listed entities. These reports commonly require review of the financial information contained therein by an independent accountant, although this is not a uniform requirement.
55. The call for more extensive and timely reporting of corporate financial and non-financial information is growing, particularly in the US. In his ten-point plan for improvements to the US regulatory system, President Bush has included two proposals for better information for investors. The first calls for investors to have quarterly access to information needed to judge a firm’s financial performance, noting that today’s disclosure practices have fallen behind the advanced techniques of corporate finance. The second states that ‘each investor should have prompt access to critical information’
56. In his statement to the US Congress on 14 February 2002, the Chairman of the American Institute of Certified Public Accountants, James Castellano, noted, “Changes in business prospects have made quarterly reports outdated.” He went on to say “Investors need more frequent corporate financial and non-financial disclosures (i.e. on-line, real-time) to make informed investment decisions.”
57. The need for a company’s accounting systems to be compared against best practice has been recognised in the 10th proposal of President Bush’s plan. This proposal envisages that the company’s auditor would also be required to compare the quality of the financial controls with best practice, and communicate the findings to the audit committee. This is similar to Mr Castellano’s proposal that “management should be required to make an analysis and assertion (to shareholders) on the effectiveness of the company’s internal control apparatus” and that auditors “should be required to attest to, and report separately, on the effectiveness of the management assertion.”

58. The Secretary of State for Trade and Industry in the UK has recently announced a review into arrangements for financial reporting and auditing.
59. In this environment it is appropriate for Australia to review existing reporting requirements, both for their adequacy and timeliness. As part of this review, the desirability and practicability of financial and non-financial information being reviewed or audited by the company's auditor should also be considered.

## **Shortcomings in the financial reporting framework**

60. The financial reporting model has been questioned in Australia and in other countries due to market valuations of entities relying increasingly less on the annual financial report. There are many reasons for this, including the ability of investors and analysts to obtain other financial and non-financial information related to entities and greater sophistication of computerised analysis techniques.
61. The scope of financial reporting standards also is a relevant part of this. With new business models, some commentators argue that financial reporting standards have not kept up to date, with no scope to include intangible but potentially valuable items, including relevant ratios and analysis within the scope of financial reports.
62. The auditing profession has recognised these issues, and there are a number of projects and individual solutions in the market looking to provide information, and in some instances assurance, on entities' value creators.
63. The perceived or real problems concerning the financial reporting framework are far-reaching and beyond the remit of this submission. Further work needs to be undertaken to ensure the reporting framework continues to deliver credible information going forward
64. We recommend that ways to expand or amend the financial reporting framework to provide a more comprehensive view of the state and value of the company be investigated.

## **Conclusion**

65. Recent events with the accompanying media and policy debates both in Australia and the United States have reinforced the perception that audit independence has been compromised. This perception and the response of all stakeholders continue to drive the reform agenda.
66. Updating of the rules governing audit independence is occurring on a global basis and Deloitte fully supports the need for reform and for globally consistent standards. Deloitte looks forward to playing its part in this important debate.



