

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

31 May 2002

Dear Mr Cunningham

Submission to the Joint Committee of Public Accounts and Audit

Thank you for the opportunity of providing a submission to the Committee for its *Review of Independent Auditing by Registered Company Auditors*.

Introduction

In essence, the issuing of an audit opinion involves the auditor in providing an appropriate level of assurance or confidence to the reader of that opinion.

In the first place, that confidence relates to the way in which the auditee has presented its financial report, and the strength of the internal controls and systems that lead to that report.

However the reader of the opinion must also have confidence in the person or firm carrying out the audit.

I believe that the standard of auditing in Australia is amongst the best in the world, and that there are no systemic failures in auditing. But confidence in the role of the auditor is a growing concern in Australia as it is elsewhere, and it is a concern that must be addressed.

If there is a perception that the auditing profession lacks competence or lacks independence, then the level of confidence in audit will be diminished. It is not sufficient to argue that the perception is misplaced, and hence no action should be taken. That approach risks further damage to the standing of the audit profession and, even more importantly, to confidence in corporate reporting.

I understand that a number of other Auditors-General have made submissions to your Committee's review. Auditors-General and Audit Offices are in a unique situation to observe and comment on the issue of independence. Being part of the audit profession, we understand better than most the importance of professional, independent and competent audit as part of good governance arrangements.

More importantly, we are clearly perceived as not being influenced by factors such as personal reward, the desire to increase market share, the risk that existing audit contracts will not be renewed, and the desire to promote, or benefit from non-audit services. Hence comments or suggestions that we might make in relation to auditor independence are clearly not - and are perceived to be not - influenced by any self interest.

Non-Audit Services

The provision of non-audit services by audit firms is one of the more contentious issues in the current debate about auditor independence.

I acknowledge that there may be no conclusive evidence that non-audit services have lead to systemic corporate or audit failures. However I can understand that many might view it as an unacceptable risk that audit staff, faced with making an adverse audit opinion on marginal grounds, could be swayed by the importance of the client's business to the accounting firm. This risk is heightened if the client has other business dealings with the auditor's firm.

It would be illogical to suggest this risk does not exist. And because it is impossible to prove, in respect of *every* audit opinion, that the risk has not crystallised, then it is impossible to refute the perception of compromise in *any* audit opinion.

A number of major corporations, both in Australia and overseas, have chosen to remove the risk by not awarding non-audit work to their external audit firm. In doing this, they have not ascribed any wrongdoing to their existing auditors, but have simply acted to counter any loss of confidence in the veracity of their financial reports and the independence of their auditors.

While I am the mandated auditor for all New South Wales public sector agencies, I contract out approximately 10 per cent of my auditors to private sector firms. It has long been my Office's practice – well before the current debate on this issue began - that contract audit firms must relinquish their right to provide any other service to the public sector agency for the duration of the contract, except with my approval (which has rarely been given).

For the above reasons, I submit that investor, shareholder and public confidence in auditor independence requires that corporations be prohibited from using firms for both external audit and other, non-audit work.

Role of Audit Committees

The benefits of audit committees to the good governance of corporations and other entities are well supported by a range of inquiries and surveys. There seems little, if any, evidence that there are disadvantages to their establishment and operation. Given this, we fully support the concept of legislative, mandatory establishment of audit committees for listed companies and major private companies.

To be fully effective, this legislation may need to be supported by regulations that cover certain aspects of the committee's composition and functions. The September 2001 edition of "Audit Committees: Best Practice Guide" (published jointly by the Australian Auditing and Assurance Standards Board, the Australian Institute of Company Directors and the Institute of Internal Auditors) and the Ramsay report provide guidance on the ideals for these aspects.

Rotation of Auditors

In principle I see merit in the mandatory rotation of audit firms. However there are a number of reasons why this may not be practical.

Australian subsidiaries of multinational companies and Australian parents of overseas subsidiaries tend to have the same audit firm in all jurisdictions. Having a mandatory rotation requirement would create real difficulties in these situations.

Another difficulty would arise for larger companies (ie clients of one of the "Big 4" auditors) if there were both a prohibition (either legislatively or by the company's own choice) on obtaining non-audit services from their audit firm *and* they were required to rotate audit firms. In this situation, the company would need to ensure that it had no on-going contracts with any of the other "Big 4" firms beyond the term of the existing audit term.

On balance I do not believe that audit firm rotation should be mandated.

However, I strongly support the mandatory rotation of partners after a given period of time. While I would see five years as the preferred maximum before rotation (this is consistent with my Office's policy), I accept that seven years may be a more realistic choice.

As well, I believe that mandatory rotation should also apply to the audit team members, particularly managers. Both for practical and independence reasons, the rotation of managers should not occur at the same time as partners.

On this aspect, and any of areas where legislative backing may be proposed, differential obligations may need to be developed to recognise the circumstances of smaller companies and smaller audit firms. Clearly it is not feasible to mandate audit partner rotation in a practice that has only one audit partner without, in effect, mandating audit firm rotation.

Auditor Appointment

The Australian Securities and Investment Corporation (ASIC) is reported to have stated a preference for it to appoint the auditors to individual corporations.

I think this proposal is misguided. In the absence of any evidence of systemic failure in the auditor appointment process, it represents a substantial degree of over-regulation. To provide ASIC with this role would blur the lines of accountability and, where corporate and audit failures do occur, could expose the regulator to legal liability (unless legislated away).

A far better option is to mandate for audit committees to be responsible for aspects relating to the appointment of external auditors. This would include overseeing the tender process, negotiating contracts and recommending an audit firm to shareholders.

Conclusion

Confidence in the competence and independence of auditors is an essential element of confidence in Australia's corporate sector. Anything that diminishes that confidence in a systemic way could have wide-ranging implications and must be addressed. The Committee's review provides an opportunity for a careful consideration of the issues relevant to auditor independence. I would be happy to expand on my views if the Committee felt that to be useful.

Yours sincerely

R J Sendt
Auditor-General