

GL/ml 95.02

19 July 2002

**Mr Adam Cunningham
Inquiry Secretary
Review of Independent Auditing by Registered Company Auditors
Joint Statutory Committee of Public Accounts and Audit
Department of the House of Representatives
Parliament House
CANBERRA ACT 2600**

Email: jcpa@aph.gov.au

Dear Adam

Re: Supplementary Questions

CPA Australia welcomes the opportunity to provide the attached supplementary information to the Joint Committee of Public Accounts and Audit's (JCPAA) Review of Independent Auditing by Registered Company Auditors.

CPA Australia is actively working to ensure Australia's financial reporting framework continues to support public confidence, and is further pursuing a range of initiatives in this area over coming months.

Please do not hesitate to contact me on phone Tel: (03) 9606 9689 if you would like to discuss further or clarify any of the points raised within this supplementary information

Yours sincerely

**GREG LARSEN, FCPA
Chief Executive
CPA Australia**

Encl.

JCPAA Review of Independent Auditing by Registered Company Auditors

Supplementary Questions to CPA Australia

1 Accountability of Accounting Firms

1.1 ***“The Corporations Act be amended to require that accounting firms undertaking audits of public listed companies be incorporated and publicly listed”***

Based on comments made by the Committee, CPA Australia understands this proposal seeks to simultaneously address the issues of professional indemnity and improved audit firm accountability. CPA Australia does not believe this proposal offers the best solution to either of these issues.

Listing as a public company would not compel the firm to provide extensive information about its corporate governance processes specifically the processes employed to manage the risks to audit integrity and quality. Moreover, investor pressure could, at its worst, encourage financial considerations to override ethical standards.

Incorporation of audit firms would offer legal limitation of liability that does not currently exist. We believe that there is a strong case to support limited and proportionate liability for the audit function but we do not believe this is the best mechanism and instead, refer the committee to the proposals outlined in our submission to the Senate Economics Reference Committee, Inquiry into the Impact of Public Liability and Professional Indemnity Insurance (May 2002).

1.2 ***“The Corporations Act be amended to require firms undertaking audits of publicly listed companies be required to lodge an “independent performance report” to the regulator (ASIC) every twelve months. The report would provide details of the outcome of each audit, including mechanisms in place to ensure the independence of the external audit function. Additionally, ASIC would have the power to investigate any matters arising from the report and to take action to rectify any deficiencies or matters of concern.”***

CPA Australia believes that companies and their audit firms share responsibility for protecting the integrity of the audit function. This principle is clearly outlined in both content and recommendations contained in CPA Australia's paper *The Financial Reporting Framework - The Way Forward*. CPA Australia recommends a revised institutional model that oversees the performance and integrity standards of the entire financial reporting framework. We believe this provides a solution that goes to the heart of public concerns and builds a much stronger and more rigorous framework for the future. CPA Australia suggests that the 'independent performance reports' would be better facilitated through this structure rather than through ASIC.

Implicit in the CPA Australia model is the need for co-regulation which supports greater integrity and competency through professional development coupled with rigorous review and disciplinary processes. CPA Australia strongly believes that it is critical to do as much as possible to prevent inappropriate practices before they occur.

However a blanket call for such reports entails a substantial administrative burden for firms and any review body. The scale of this burden will be influenced by the degree and manner in which firms are required to report on the outcomes of each audit. Nonetheless firms would need to prepare the reports, and the review arm would need to be appropriately resourced to not only review the reports but to also investigate their veracity. CPA Australia supports the current approach where reporting is by exception such that the administration is minimised and the ASIC's

attention is given to areas where non-compliance with the Corporation's Act have been identified by the auditor.

CPA Australia believes a more efficient alternative would be to require a statement in the audit report that the auditor has complied with the independence requirements of relevant the professional body. This approach limits the administrative burden and complements existing requirements under the current Corporations Act whereby an auditor must disclose the outcomes of the audit either in the Auditor's Report or directly to ASIC in accordance with s 311.

2 Financial Reporting Framework

2.1 *In developing your Financial Framework did you consider the UK Accountancy Foundation Model? Are you aware of the model proposed by the National Institute of Accountants (NIA), which advocates a much greater level of independence from the accounting profession?*

CPA Australia reviewed a number of different frameworks around the world including the new UK model. Our proposal builds on this work, and balances findings against our understanding of Australia's local cultural and community expectations.

With respect to the NIA model which was released after the CPA Australia paper and has not been comprehensively reviewed by CPA Australia at this stage. It will be considered together with the ongoing input sought from Government, industry and the profession as we continue to address the challenges to public confidence in Australia's financial reporting framework.

2.2 *What are the advantages and disadvantages of adopting a framework such as the one you are proposing? What exactly is the role of government?*

As outlined in The Financial Reporting Framework - The Way Forward, the rationale supporting the model is

1. The proposed model establishes clear rules of engagement that enable the government and the profession to determine a mutually acceptable, simplified, principles-based approach to the people and processes involved in financial reporting in Australia.
2. The model collapses the existing fragmented system of bodies into one umbrella organisation that sits above three purpose-specific entities. From the public interest perspective, this logical allocation of responsibilities, resources and competencies greatly enhances the simplicity of the system, reduces duplication and provides for more consistent and transparent outcomes. It represents a model that is easily explained to the public and a substantial shift from the current arrangements. This will do much to reassure the public that the profession and government are seriously tackling the problem.
3. The model can be expanded to capture the full range of functions defined as part of the broader financial reporting framework for example company directors, CEOs, CFOs, internal auditors, analysts and professional advisers eg actuaries. The model has the potential to ensure appropriate standards of integrity and competence apply to all. (At present it is described in terms of the accounting and auditing professions.) CPA Australia believes other key stakeholders such as the Australian Institute of Company Directors (AICD) and the Australian Institute of Internal Auditors (AIIA) could become valuable participants.

CPA Australia supports current co-regulation but seeks to improve it through this model. The paper deliberately does not allocate roles to the current participants, including the Government. CPA Australia is instead looking to use the conceptual model to focus discussion within industry and government to develop a solution that is accepted to all participants and most importantly, is acceptable in the minds of the public.

2.3 *Is there scope for the private sector to adopt some of the practices which support the independence of the public sector auditor and which requires them to meet high standards of accountability and transparency?*

Public Sector audits are conducted under a substantially different scope of focus and with considerably stronger legislative protection for the views provided therein. As indicated to the Committee, CPA Australia agrees there is potential for a broadening of the audit function within the private sector to incorporate some of the performance oriented measures in place in the public sector. In developing the recommendations contained within our paper, CPA Australia drew on the thoughts of some of Australia's most senior public sector auditors and accountants. However CPA Australia warns that such moves will need to be accompanied by appropriate review of liability for registered company auditors.

3 The Role of the Auditor

3.1 *Is there a need to enhance the traditional and statutory role of auditing by diluting the growth of commercial/ service provider relationships between an auditor and a client?*

CPA Australia strongly believes that both the company and the audit firm have a fundamental responsibility to preserve the integrity of the audit function. Therefore it is incumbent on both the company and the audit firm to review all possible sources of conflict and to determine whether these represent a real or perceived threat to audit quality. If so, the audit firm may progress with either the audit or the alternative service engagement, but not both.

CPA Australia believes this approach can be enhanced by stronger corporate governance guidelines that demand a more vigilant approach from company directors to protecting audit integrity. CPA Australia's recommendations may see a decline in the simultaneous delivery of audit and non-audit services by audit firms, but will ensure the decisions of directors are fully informed, and are more effectively justified and disclosed to shareholders.

More importantly, the approach advocated by CPA Australia is consistent with our call for consideration of all threats to audit integrity, not just those that may result from service provider relationships.

3.2 *Is there adequate protection for the statutory role?*

No. CPA Australia believes that the current practices of both auditors and company finance teams are constrained by inadequate avenues for raising concerns regarding the company or firm's practices. CPA Australia recommends these be addressed through a number of actions, at the company, audit firm and industry level. CPA Australia is already pursuing the need for stronger whistleblower protection as well as the potential role of an industry ombudsman.

CPA Australia would like to see quarterly reporting mechanism that includes a Management Discussion and Analysis (MD&A) together with a more forward focused opinion on the financial status of the entity. However the unlimited liability of professional firms and the "perceived" depth of potential damages awarded out of professional indemnity insurance constrain the auditor from providing these extra services to the shareholder and public.

CPA Australia has also recommended that much greater disclosure occur when the company decides to appoint or reappoint their audit firm. We consider this increased disclosure to be important in protecting the auditor's role in advising of possible concerns, and believe it provides an important check on company's who may seek to 'remove' an auditor for improper reasons.

4 Provision of Non Audit Services

4.1 *Can the guidance provided in the recently released Professional Independence Statement F1 be relied to ensure firms address the threats to independence arising from the simultaneous provision of audit and non-audit services?*

To the extent that firms comprise members of CPA Australia, then the professional code of conduct applies and can be relied upon to ensure firms address the threats to independence arising from the simultaneous provision of audit and non-audit services. CPA Australia cannot vouch for the application of the standard by auditors who are not members of CPA Australia or in fact not members of a professional body at all.

CPA Australia's suggests a greater level of comfort regarding the integrity of the audit function could result from the equivalent standard being applied to company directors and their audit committees, and in doing so could avoid potential conflicts being put to audit firms to consider . This is consistent with our view that Companies and auditors share responsibility to protect audit integrity.

4.2 *How will the Professional Independence Statement F1 be enforced and the extent of compliance with its guidance be monitored?*

The professional statement F1 is part of CPA Australia's professional code of conduct and is therefore monitored through CPA Australia's existing quality assurance/peer review programs. These programs check member understanding as well as application of the code and in doing so provides important feedback on the standards efficacy and relevance in all circumstances. CPA Australia uses this information to ensure that the standard remains relevant. Non compliance is investigated and disciplinary action taken again consistent with our existing regulations and processes.

End
July 2002