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

Dear Sir

REVIEW OF INDEPENDENT AUDITING BY REGISTERED COMPANY AUDITORS

I refer to your letter dated 5 July requesting our response to a series of supplementary questions and questions which we took on notice and set out our responses below.

Question 1
What is your opinion on a proposal that the Corporations Act be amended to require firms undertaking audits of publicly listed companies to lodge an 'independent performance report' to ASIC every 12 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. 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.

We believe this notion to be a far more "heavy hand" of regulation than is either warranted or advisable. The "details of the outcome" of each audit could include all the things that auditors currently report to the Audit Committee in their Closing Report. This is mostly confidential information. A cornerstone of the relationship between the company and the auditor is one of trust especially regarding access to all the client's information. We would not agree with any detailed reporting to ASIC which would discourage open communication between companies and their auditors.

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We do not support this proposal, as we believe it could reduce the quality of audits. The current requirements in the Corporations Act for the auditor to report breaches of the Act and of accounting standards are sufficient.

Question 2
Will you be making any changes to your independence and quality control policies in light of the release of Professional Independence Statement F1?

Yes, we will require the rotation of audit signing partners every seven years. We have already decided to comply with this recommendation of the Ramsay report. We already apply this policy to our SEC registered clients. We are also already making some other minor amendments to our policies to reflect F1, but for the most part we already comply with the Statement.

Question 3
Should Australia move further towards adopting more principle-based accounting standards rather than using overly prescriptive rule-based standards as a way to improve the reliability of financial reporting? How does the program to harmonise our standards with the international accounting standards impact on this issue? What are the costs and benefits of harmonisation, particularly for companies trading solely within Australia or in the US?

Australia already has principle-based standards. These standards already largely reflect International Accounting Standards (IAS), with some notable exceptions, namely the standards on employee benefits (in respect of post-employment benefits, such as superannuation), financial instruments and internally generated intangible assets. The program to harmonise with IAS does not affect this particular issue, because our standards are already principle-based.

The timeline for harmonisation with IAS (2005 deadline) may pose a practical problem for Australian companies. This is because there are significant changes being proposed to IAS via their IASB Improvements Project, as well as the requirement for Australia to catch up with the outstanding standards referred to above. Companies will be faced with a raft of changes in the next 2 years, many of which will be complex and difficult to implement. Past Australian accounting standards are effectively nullified by the transitional provisions of the IAS, which means that companies which have complied with Australian standards in the past, where those standards were not consistent with IAS, will have to reverse accounting treatments that were permitted under Australian standards. Companies will likely find this difficult to accept. Australian companies that do not report overseas will realise little benefit from harmonisation with IAS compared to the costs of harmonising. Australian SEC Registrants will only really benefit from harmonisation when the SEC accepts IAS – which it has no immediate plans to do. However, Australian companies that report on European and Asian exchanges will benefit from harmonisation with IAS. Another cost is a quality cost – some Australian standards are of higher quality than their IAS equivalents – eg AASB 1017 “Related Party Disclosures”. This standard has been effective as a deterrent to related party

transactions and has had a positive effect on corporate governance in Australia. It would be a loss for Australian corporate governance to substitute AASB 1017 with IAS 24, which, in our opinion, is a weak standard.

Question 4
What do you think of the following suggested changes to enhance the role and independence of auditors?

(a) Impose more serious penalties on companies for obstructing or provide misleading information to the external auditor?

We agree with this proposition and believe that such a change would place accountability where it clearly belongs.

(b) Make ASIC responsible for the allocation of the audits of listed companies and for remunerating auditors using a fund levies on business?

We disagree. This will cause a serious decline in the investments audit firms make in understanding their clients' industries and business. These investments lead to a much better understanding of audit risk and therefore a better quality audit.

On the question of mandatory rotation of audit firms, this is an area where one size does not fit all and boards of directors should rightly have the responsibility of assessing whether or not the tenure of their auditor should be cut short and an alternate firm selected as a replacement. The one size fits all argument on rotation posits that the legally required rotation of auditors every 5 or 7 years will ensure a different methodology might bring a fresh approach and more rigour to the audit and that the auditor would be able to conduct the audit and report frankly, without fear of removal or threat of having the audit put to tender. In Ernst & Young's view, this would result in either a major deterioration or serious risk of deterioration in the average quality of audit and may, in fact, create greater independence problems than perceived at first blush. Specifically:

- there is a great risk of auditors being less informed than they should be in the first 2 years of appointment as auditors of complex or high risk companies;
- by requiring mandatory rotation, there is a serious risk of the loss of corporate memory regarding complex industries or transactions in circumstances where there may be trailing or postponed impact, either contractually, commercially and/or financially;
- an audit firm in the last stage of their tenure might choose not to invest in relevant industry or client knowledge, particularly following a major investment in a new geographical industry sector simply because that might not, in the opinion of the outgoing auditor, be a sensible investment although it clearly would make the audit process more effective;
- the choice of auditor for major corporations is amongst the four major accounting firms. For proper reasons of independence, companies may choose any one or all of the three firms that are not currently their auditor to provide certain services

including acting as part of management, which would be inconsistent with audit independence and, therefore, could not be provided by the auditor. In a mandatory audit firm rotation environment, it is entirely conceivable that when the mandatory rotation time comes, the other three firms may each have carried out work that would, on grounds of loss of independence, make them ineligible to accept the audit appointment. This could leave a major corporate, such as a bank, with no alternative (or an unacceptable alternative) as auditor at the time of mandatory rotation.

Simply put, the fact is that what might be perceived to be an enhancement of auditor independence through mandatory firm rotation firstly is very expensive, very disruptive and is essentially ill-conceived in that greater risks to the quality of the audit are more likely to emerge and there may well be an even greater risk of loss of independence and objectivity in the process.

Finally, we strongly disagree with the concept of using a fund levied on business to remunerate auditors. Audit fees reflect a combination of the appropriate scope necessary to carry out an effective audit and fair commercial rates for the varying skills and experiences required to undertake a quality audit process. The scope will be influenced by such diverse factors as the size, complexity and geographic spread of the company and its industry, the quality of internal controls and the quantum of internal audit. Commercial considerations must acknowledge the need for the audit firm to make a fair profit. Establishing fixed criteria for levies on business and the allocation of proper fees to audit firms would be impossible or unrealistic.

(c) Require public listed companies to have Corporate Governance boards, appointed by their shareholders, to manage the appointment of the auditor and oversee or administer the audit function?

We assume by this question that the proposition is a Corporate Governance Board be appointed additional to the Board of Directors. We disagree with this proposition. This should be the role of the Audit Committee, which in turn is appointed by the Board of Directors. It may be appropriate for the ASX to publish guidelines in respect of the role and function of Audit Committees.

Question 5
What do you think of the following proposals?

(a) All public listed companies are required to have an internal audit function, which is responsible to the Audit Committee?

We agree with this proposal, except where the size or nature of the company and its industry is such that a full internal function may not be warranted (eg smaller mining or biotech companies). It is the responsibility of the company to implement and maintain effective internal controls and procedures designed to protect the company from material

errors, omissions, fraud and poor management reporting. The internal audit function is designed to review and test the quality and effectiveness of these controls.

(b) The internal auditor be a statutory appointment and the scope of internal audit be mandated by legislation?

We disagree. For the reasons set out in our response to Question 5 above, "one size does not fit all" and we would not agree with mandatory internal audit appointments. The internal audit scope is necessarily co-developed by the Board of Directors (usually through the Audit Committee) and management and the company needs to be able to determine what risks need to be addressed by the internal auditor. These cover operational and financial risks. The appropriate management of risk of a company is part of good corporate governance and thus rests with the Board of Directors.

Question 6

Response already emailed to Adam Cunningham.

Question 7
Question on notice from Senator Murray re the process by which directors are elected and selected. Please comment on the suggestion that ASIC and the ASX get together and produce best practice guidance for the election of directors; the best processes for electing directors, how the ballot papers should be worked out and how selection is carried out; what kind of criteria should be met, and what kind of training and experience they should have.

We recommend that the ASX be responsible for developing a guidance note on the processes for the election of directors. We believe there is precedent in the UK Listing Rules.

Question 8
Question on notice from Senator Murray re performance audits. One idea which I would like your reaction that performance audits would be not mandated, but that the ASX and/or ASIC be given the authority to be able to say to companies that, because of market signals, they are concerned and that, as the regulators or the institutions in this area, they want to companies to have a performance audit conducted. A performance audit, as you know, relates to effectiveness, efficiency and practice, the achievement of outcomes relative to the financial statements, strategies and everything else. It is not mandated, but it gives them a trigger to pull if they are getting worried about a company.

While we understand the thrust of this notion, we believe the practical difficulties of successfully implementing it are enormous. We suspect that further detailed analysis of this notion would result in the conclusion that it is not workable either from a cost or benefits perspective. If it were pursued, however, then a clear and fair set of guidelines would need to be developed to ensure that Boards, financiers and investors were aware of

the criteria or market signals (as you put) which might trigger a request for a performance audit, how the scope of such a review would be developed and agreed and who should perform the work.

Question 9
You offered to provide further advice on your recommendation that " a thorough analysis of the current financial reporting, regulatory, oversight and disciplinary framework be undertaken".

We believe this to be an important subject. We are aware of a wide number of views, options and recommendations that have been expressed which, in our opinion, address segments of the broader issue, depending on your perspective. Australia already has a range of oversight and advisory boards responsible for aspects of the oversight in the audit, accounting, reporting and disciplinary area. We believe that later events have superseded Professor Ramsay's brief and that addressing the issue of audit independence alone is an inadequate response to the recent experiences undermining the faith in the capital markets and good corporate governance. We therefore believe that this whole subject needs to be examined in more detail with the role and responsibilities of all of the existing oversight boards being scrutinised in the context of the Australian reporting, regulatory, oversight and disciplinary environment and international experience in this regard.

We therefore recommend that suitably qualified consultants be appointed to undertake this review, that detailed terms of reference be drawn up, that the consultants be required to report within 3 months and that all key stakeholders be given the opportunity to be interviewed and to receive a briefing on the consultants conclusions and recommendations at the time their report is finalised.

Should require further information, please let me know.

Yours sincerely

Brian J Long
Chairman, Board of Partners