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20 May 2002

Mr Bob Charles MP - Chairman
Review of Independent Auditing by RCAs
Joint Statutory Committee of Public Accounts and Audit
Department of the House of Representatives
Parliament House
CANBERRA ACT 2600
AUSTRALIA

Dear Mr Charles

Review of Independent Auditing by Registered Company Auditors

We appreciate the decision taken by the JCPAA to seek wider consultation in their review of independent auditing by registered company auditors. This letter provides our response to your call for submissions. Pitcher Partners is a large accounting firm of approximately 350 staff and partners and provides accounting, audit and advisory services to medium and large *Australian* based businesses. Our comments reflect the issues arising when considering independence issues in this segment of the market place, in contrast to those primarily concerned with capital markets.

We have a number of concerns regarding the context for your inquiry and these are discussed further below. However, our primary concern is that the auditors of large family-owned proprietary companies do not become bound by the same stringent independence rules that may be applied to the auditors of listed companies.

In respect of this submission, we believe that proprietary companies that are subsidiaries of listed entities should be governed by the same independence rules as those applied to their holding company.

Auditors of large proprietary companies

Independence rules designed to address 'perceptions of independence' or the 'appearance of independence' should not be applied to auditors of any family-owned proprietary company, regardless of the size of its operations. These rules largely relate to the provision of other services by audit firms and employment relationships. Proposals put forward in the public arena so far only exempt small proprietary companies from these rules.

Listed companies (and their subsidiaries) are likely to have a wide range of unidentified stakeholders including existing and potential future investors. Therefore there is justification in enforcing rules that address *perceptions* of independence regarding the auditors of listed companies, on the basis that there may be potential conflict of interests between owners and management and the views of stakeholders may not easily be determined.

By definition, the shareholders in any family-owned proprietary company are a smaller closed group. The owners of family-owned proprietary companies can closely control or monitor management decisions, and transparency exists as to the nature of relationships and transactions with auditors. The scope for *perceptions* is considerably lessened, if not eliminated, as the actual relationship is clearly discernible and known to interested parties. In contrast to shareholders' interests in listed companies, there are no external equity interests for family-owned proprietary companies.

We believe that any rules that prevent family-owned proprietary companies from seeking a range of services from the same accounting firm, are likely to stifle the provision of timely financial expertise to local family businesses, and will add significantly to their costs in obtaining those services. This outcome can only be detrimental to the prosperity of family businesses, which have been acknowledged as the backbone of the Australian economy. There is a need to provide this "middle market" with free access to financial advice, as there is often a lack of financial expertise within the entity. Large family-owned businesses already have onerous reporting requirements, and this will be further exasperated by stringent independence rules which restrict access to a preferred source for professional services.

Other Matters

We also draw your attention to the following matters:

- Any action taken to revise auditor independence issues is unlikely to resolve the underlying problems surrounding corporate collapses.
- To provide early warning of corporate collapses the whole area of corporate governance needs to be considered. This includes consideration of business risk, management policies, accountability relationships and financial reporting. Many of these issues are beyond the scope of a statutory financial statement audit.
- ***If*** audit failures are found to be a factor contributing to corporate collapse (and this is not yet proven), then it is more likely that it is the firm's audit *process* rather than auditor independence that will be the cause of any problem.

- Perceptions of auditor independence vary significantly depending on the context for the company-auditor relationship. In particular there are significant differences in context for family-owned proprietary companies and listed companies. The Ramsay Report made an inappropriate arbitrary distinction between small proprietary companies and all other entities *without* consultation with stakeholders from local business.
- Large family-owned businesses require *objective* professional services, including audit, from trusted business professionals. Due to differences in ownership, expectations, and nature of relationships, listed companies need to apply independence rules so that owners are assured that the professional services obtained by management are objectively, rather than commercially based.
- Issues relating to the durability of the financial reporting framework are discussed below.

Response to comments made by JCPAA in announcing the review

We acknowledge your comments regarding community expectations that auditors report *accurately and fairly* on the financial state of the companies they are auditing. Also, that as the audit function provides independent assurance on the operations and accounts of entities in the private and public sectors, it is very significant in maintaining business confidence, which is vital to Australia's economic performance as a nation. We would like to draw your attention to certain preconceptions that underlie your comments.

Firstly, there is a clear lack of understanding that the auditor's opinion is given within the context of the accounting framework referred to in the audit report. It does not mean that the numbers are factually right or wrong but only that they are reasonable within the specified framework.

Secondly there is a clear lack of understanding of the accounting framework used for preparation of the financial report. The nature of accounting standards means that there is rarely only 'one right way' to measure and report numbers. Also, increasingly, accounting standards require that the method of measuring and reporting accounting numbers depends on management expectations and future plans. Therefore although an auditor can determine whether or not the financial report has been prepared in accordance with a specified accounting framework, it less feasible for an auditor to disprove management plans to contest the way numbers are represented.

Finally, given that accounting standards are increasingly driven by management judgments, and due to the nature of the audit process, an auditor is **not** able to report on accuracy. The audit process is based on assessments of risk, analysis of reported results and test checking of transactions and calculations and therefore cannot provide a "guarantee" that numbers are "correct" or "accurate". This is further compounded by the fact that the numbers are driven by management judgments and cannot be viewed as factually correct but only that the methods fall within the accounting framework.

These preconceptions are discussed further in attachment 1 to this letter, which also provides an example of how different measurement rules can arise. Having regard to

the factors discussed in attachment 1, it is possible that deficiencies in the accounting framework are a major contributing factor to the corporate collapses, which have attracted public attention and comment, rather than audit failure.

We are concerned that the “middle market” has not been represented in the independence reviews conducted by the Accounting Bodies and by Professor Ramsay. Their focus appears to be on the needs of capital markets without recognising any differentiation for large family-owned businesses. Therefore we would welcome an opportunity to discuss with you matters arising from this submission. We would also welcome the opportunity to address the JCPAA directly on these issues during the public hearings.

Yours sincerely

Terry Benfold
Partner

S. Dianne Azoor Hughes
Technical Director

Attachment 1
Preconceptions regarding the scope of an audit

There is an unachievable expectation that auditors report on accuracy and a lack of understanding of the audit process.

- The nature of the audit function is such that auditors are not able to report on "accuracy" but can only provide "reasonable assurance" that the financial report is presented fairly in accordance with the reporting framework.
- The scope of work carried out in an audit would need to be increased dramatically for an auditor to report on accuracy, but even then, for many large operations it would be impracticable (if not impossible) to check all transactions to ensure accuracy.
- The accounting process is such that "accuracy' is *not* a term that can be used to describe the outcome. (See discussion under below).
- The concept of "reasonable assurance" and the inherent limitations of an audit are described in Australian Auditing Standard AUS 202 "Objective and General Principles Governing an Audit of a Financial Report" paragraphs .08 to .13.
- Limitations in the audit process include limitation arising through the use of testing, inherent limitations in the internal control structure, the possibility of collusion and the fact that most audit evidence is persuasive rather than conclusive.

There is a lack of understanding regarding the measurement and presentation of accounting numbers:

- The complexity of accounting standards for the measurement and presentation of accounting numbers is such that there is often more than one way of determining how results should be reported.
- Increasingly, accounting standards require that management expectations are brought to account to determine the way numbers should be calculated and reported. As such it is not possible to determine "a right" or "a wrong" method of valuation as it depends on the combination of circumstances and management's future expectations or plans.
- The auditor is only able to determine whether the basis of valuation selected by the entity is within the accounting framework and that management's expectations are not contrary to other evidence gathered during the course of the audit. Therefore the auditor cannot report on accuracy but only on reasonableness.
- For example, consider the carrying amount of say one class of buildings owned by an entity to be reported in the financial report:
  - The relevant Australian Accounting Standards are AASB 1010 "Recoverable Amount of Non-Current Assets", AASB 1015 "Acquisition of Assets", AASB 1020 "Income Taxes", AASB 1021 "Depreciation" and AASB 1041 "Revaluation of Non-Current Assets";
  - Depending on the circumstances of the acquisition of that asset and its intended future use, there are at least four ways to determine the carrying amount, even before considering depreciation charges or the tax consequences of the valuation method chosen.
  - The gross carrying value of this class of buildings might be purchase cost, fair value based on acquisition cost if purchased as part of a business acquisition, recoverable amount if the entity does not plan to

continue to use that building and recoverable amount is less than its carrying value, or fair value represented by a current value for exchange with knowledgeable willing parties in an arm's length transaction;
- ‘Purchase cost’ is the only value that can be supported by conclusive evidence to support the amount recorded. All the other valuations require judgments to be made.

There is a lack of understanding that the auditor reports “true and fair” in relation to a specified accounting framework. This accounting framework is not perfect and requires continuous improvement through the issue of new accounting standards and regulation.

- The auditor reports “true and fair *in accordance* with” the accounting framework detailed in the audit report (such as Corporations Act 2001 and Australian Accounting Standards).
- Having regard to the comments above, the auditor's report determines whether the financial report is “true and fair” within the context of the accounting framework referred to in the audit report. The use of different accounting frameworks may give *different measures* or performance and operating results and these different results that might be deemed “true and fair” by the auditor, within the context of each particular accounting framework.
- From the users' perspective, what seems true and fair to an investor with a short-term investment horizon might be quite different to what seems true and fair to an investor with a long-term investment horizon. Both perspectives might be quite different to what is true and fair in accordance with the specified accounting framework.