

Dear Bob,

The question posed by the terms of reference of your inquiry is where the balance lies between the regulation of auditors and the audit function by legislation and by industry self-regulation. This question is certainly fundamental and is worthy of exploration, but for the terms of reference to focus merely on inquiring into the potential enhancements that can be made to the accountability of public and private sector auditors is inadequate. There are grounds to argue that the focus on audit accountability distracts from another significant issue that has been the subject of little discussion during the vigorous debates that have been propelled by the handful of corporate calamities.

Companies and their advisers must fear detection if they apply an aggressive accounting treatment to a transaction. There needs to be a heightening of regulatory risk for companies and their advisers through the use of a broader strategy of financial reporting surveillance by the corporate regulator, the Australian Securities and Investments Commission. By 'financial reporting surveillance' I mean the active review of financial statements by a team of specialists from within a corporate regulator or an outsourced party that has the objective of verifying whether the accounts of a company comply with requirements set down within the Corporations Act and the current set of applicable accounting pronouncements. There is currently a surveillance program that is undertaken by the ASIC every six months that looks at specific issues rather than taking a holistic view of the financial statements and determining whether an entity is in compliance with the accounting rules. That program consists of ASIC staff reviewing a relatively small random sample of listed company accounts. It is a good initiative that enables the Commission to see what practices are prevalent in the market place and where its enforcement resources could be deployed to clean up poor reporting. Increasing the scope of such reviews and the number of entities subject to a review would increase the odds of companies adopting aggressive accounting practices or not complying with standards being detected.

Companies would see that it would not be in their interests to be picked up and potentially prosecuted for the failure to follow the Corporations Act, which includes compliance with accounting standards. They would be forced to discipline themselves to comply with the accounting pronouncements that are presently in effect. Auditors and their firms would have no choice but to ensure clients are sticking to the acceptable accounting principles set down by the Australian Accounting Standards Board (AASB). Self-regulation from within the firms would be much tighter if it is known that all listed companies, for example, will be reviewed at least once over, say, a five-year period. Transactions such as complex leasing deals that are not picked up in the year they are initially accounted for would be examined and enforcement action taken if the issue was found to have been inappropriately dealt with. Companies should be forced to restate their financial statements as a minimum and substantial penalties such as fines and jail terms should apply to those that are found to have broken the law. It may be appropriate to think of relevant penalties for audit firms responsible for signing off on the financial statements of a company that has failed to comply with financial reporting requirements as set down in the Corporations Act and accounting standards.

The Australian market place has wasted its time with the independence debate over the past 12 months. It has veered off the main road and onto some wild goose chase relating to other services. Appropriate behavior is not just ensured by setting better independence requirements, altering the functions of audit committees to enable them to make better judgments or establishing oversight boards for the accounting profession. Those are excellent initiatives to improve governance, transparency and accountability. A critical element has to be the enforcement of accounting standards and compliance with the Corporations Act. If the risk of detection and punishment for inappropriate reporting was heightened then it is likely most of the issues to do with independence and audit committees will fade into the shadows. Auditors, directors and company management will need to comply with the Corporations Act irrespective of the relationships between auditors and management or the provision of non-audit services. The need to behave appropriately because of the increased likelihood of detection will be an additional driver ensuring the maintenance of confidence in the Australian capital market.

I would be only too pleased to expand further on my views on this and other audit quality related matters before the committee. If committee members would like to talk through some of the ideas expressed above I am happy to take any calls.

Kind Regards

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