

6 May 2002

Mr Bob Charles
Chair
Joint Committee of Public Accounts and Audit
House of Representatives
Parliament House
CANBERRA ACT 2600

Dear Mr Charles

Company Auditor Independence

The Commercial Law Committee of the Law Society of South Australia has noted that the issue of the independence of company auditors is again being considered by the Joint Committee of Public Accounts and Audit.

The issue is of particular poignancy given that despite all the attention given to the applicable standards of Audit Independence in a number of reviews over the years, spectacular corporate collapses accompanied by alleged audit failures seem to be occurring undiminished. Whilst the Law Society accepts that audits are no absolute guarantee of propriety, in providing "reasonable assurance" they are an important independent check on companies for investors and creditors alike.

It is sometimes forgotten that each such collapse not only causes many Australians to lose their jobs and often their accrued entitlements, but also thousands of shareholders lose what may be a significant portion of their life savings. These shareholders are increasingly ordinary Australians saving for their retirement.

Assurances

These alleged audit failures are occurring against the backdrop of assurances having been regularly given by members of the accounting and other professions over the years on many committees and on behalf of many interested groups and industry bodies that the present rules concerning audit independence applied by the Corporations Act and Australian Auditing Standards are adequate.

For example, in 1997 the *Review of Requirements for the Registration and Regulation of Company Auditors Report of a Working Party of the Ministerial Council for Corporations July 1997* reported:

- (g) 'In principle there is no objection to providing a client with services additional to audit services. However care should be taken to ensure that:

- [a] actual independence is not at risk by the auditor performing management functions or making management decisions; and
- [b] perceived independence is not at risk because of a perception that the auditor is too closely aligned with the entity's management' (AUP 32).
741. Submissions provided little support for a legislative prohibition on other services. One submission proposed that internal audit not be performed by the external auditor but the overwhelming view was that no restrictions should apply, save that in accepting an undertaking to provide other services, the auditor should comply with the ethical requirements and audit standards referred to in paragraph 740 above.
742. Submissions generally supported the right of a company to engage whoever they considered most appropriate for non-audit work and stressed that the auditor may well be the most appropriate person to do that work.
743. The Working Party is of the view that additional services provided by an external auditor in the areas of accounting services, internal audit and special-purpose reviews of internal control involve a higher degree of risk of impairment of the independence of the work of the external auditor. Even if there is no actual impairment, these services could well give rise to an appearance of impairment of independence. Therefore it seems appropriate that additional procedures apply to help to eliminate any difficulties in this area.
744. For accounting services, REC 4 already specifies precautionary procedures that should be followed and limits the extent of involvement of the external auditor. It is the view of the Working Party that where the principal role of the accounting firm is in the provision of external audit services, then another partner should take responsibility for any accounting services. The general rules applicable to acceptance of such additional work will of course remain in place.
745. Regarding internal audit services, these services are an extension of the role of the internal controls of the enterprise being audited, being quite separate in their nature from external audit work. Therefore, to help ensure that the different roles are not confused, it would seem essential that the partner handling the internal audit work be not the same as the partner handling the audit engagement.
746. Internal control reviews and assessments are a vital part of the work of the external auditor. As a by-product of the audit, the external auditor will bring to the attention of management and the directors issues of concern which have been noted.
747. Particular care needs to be taken where the external auditor has a formal responsibility to report to third parties on aspects of internal controls; sufficient work needs to be performed on the internal controls to be able to make the necessary report.

748. In this situation it would seem inappropriate for the auditor to undertake a specific and separate assignment to review internal controls, for the benefit of management and/or the directors.

Working Party's Position

749. Having regard to the significant legal and professional sanctions when there is a failure by an auditor to maintain his or her independence and the emphasis on disclosure referred to in the next paragraph, the Working Party is not inclined to the view that any specific restrictions should be placed on non-audit services being performed by the auditor or his or her firm.
750. However, the Working Party believes there are good reasons to require the current disclosure requirements relating to non-audit services to be extended to provide a broad breakdown of the nature of those services.
751. Non-audit services provided to a company by its auditor or his or her firm should be reviewed annually by the company's audit committee or, if there is no audit committee, by another committee of non-executive directors.

Position Inadequate

This organisation believes that this type of position, reflected as it is in the present Corporations Law and Auditing Standards, is quite inadequate and fails to adequately appreciate both the conceptual nature of the conflicts at work and the real difficulties and pressures faced by auditors where other non-audit work is performed by the same firm for the audit client.

More recently a review has been undertaken and submitted for the Minister for Financial Services and Regulation by Ian Ramsay entitled *Independence of Australian Company Auditors (October 2001)* which recommends increased disclosure of non-audit work, updated ethical rules, strengthened audit committees and a supervisory board. In our view these recommendations whilst a step in the right direction do not go far enough. The Ramsay proposals still allow room for the audit firm and the corporation to decide for themselves in the first instance that it is all OK for the audit and non-audit work to be done by the same firm. There is an obvious weakness in allowing the potentially conflicted persons to themselves make this call. The fundamental flaw in the present system would remain.

Conflict of Interest

The reality is that the moment an accounting firm has an advisory or an accounting role in a business then that role is potentially subject to audit and there is accordingly a fundamental conflict of interest where the same accounting firm conducts the audit. Business advisory work in particular will often concern financial transactions and structures which will have significant effect on the financial position of the client and will be a potential subject of the annual audit. The stark reality is that there will be enormous pressure express or implicit for the audit not to criticise the accounting work or the business or financial structures or deals the subject of the business advisory work done by the auditor's own firm.

The present requirements that provide admonitions of audit independence while at the same time allowing non-audit work to be performed by the audit firm are conceptually flawed in that the performance of any non-audit work at all creates this potential conflict of interest. The essence of the conflict is that whatever else may be done, the auditor will have an interest in not criticising the other work of his own firm, which interest conflicts with his duty to audit objectively.

The fact that the non-audit work may be small, or that the audit work is only a small percentage of the accounting firm's work does not cure the conflict. Apart from the economic risk of losing one or other category of work, an auditor may well perceive that to criticise his own firm's advisory or accounting work could cause the auditor all manner of grief within his own firm. The auditor is thus fundamentally conflicted, apart from any economic issues.

The Law Society believes that the sorry trail of corporate collapses accompanied by allegedly inadequate audits in recent times calls for a considerably more robust attitude to audit independence. In our view audit firms should be completely independent from the corporations they audit. There would be no difficulty and little cost in prescribing that a firm that provides audit services to a corporation may do no other work whatsoever for that corporation and that their employees may not be seconded to the corporation.

Legislation Required

Given the importance of this issue it is essential that the prohibition against firms doing both audit and non-audit work for a corporation have legislative force rather than be simply a matter of professional conduct rules. A legislative prohibition is significantly harder to ignore, misunderstand or misinterpret. It has the force of law and would carry obvious and tangible sanctions. The Corporations Act should accordingly be amended to impose the prohibition.

The only real consequence is that accounting firms which presently do both audit and other work for a particular client would have to choose which they would continue to do for that client. Given that the total amount of work available to accounting firms would be undiminished, the accounting profession could face some potential client re-organisation but in the bigger picture suffer no actual loss.

This is an important reform, will cost the Government and the Community nothing, but will significantly improve audit independence in Australia. We believe it should be implemented immediately.

Recommendation

The Law Society recommends to the Joint Committee of Public Accounts and Audit that for the above reasons the Corporations Act 2001 should be amended to provide that a firm auditing a corporation may provide no other services of any nature to that corporation, and may not second any staff to that corporation.

The Chairperson of the Law Society's Commercial Law Committee, Simon Stretton, would be happy to appear before the Joint Committee if that would be of assistance.

Yours sincerely

Chris Kourakis QC
PRESIDENT