

INDEPENDENCE OF COMPANY AUDITORS

*ACCI SUBMISSION
TO THE
JOINT STANDING COMMITTEE ON
PUBLIC ACCOUNTS AND AUDIT*

MAY 2002

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The Australian Chamber of Commerce and Industry

The Australian Chamber of Commerce and Industry (ACCI) is the peak council of Australian business associations.

Our member network has over 350,000 businesses represented through Chambers of Commerce in each State and Territory, and a nationwide network of industry associations. This makes ACCI the largest and most representative business association in Australia.

The role of ACCI is to represent the interests of business at a national level as well as internationally. Through its network of businesses, each ACCI member organisation identifies the concerns of its members and plans united action.

In this way business policies are developed and strategies for change are implemented. ACCI operates at a national and international level, making sure the concerns of business are represented to government at the federal level, and to the community at large.

The Chamber takes a lead role in representing the views of business to government. Our objective is to ensure legislation or proposed policy approaches at a national level address the needs of Australian businesses, whether they are one of the top 100 Australian companies or a small sole trader.

Summary of Recommendations

The Australian Chamber of Commerce and Industry recommends:

. the Australian Government and its corporate regulatory agencies continue to adopt as a matter of broad policy and implement in practice a 'light-handed' approach to regulatory interventions in the market place;

. any regulatory interventions should only take place where market-based approaches have proven to be substantially inadequate, and then be proportional in substance, and administration and compliance costs to the problem being specifically addressed;

. the current industry self-regulation model remain the foundation for corporate auditing policy and practice, although some useful changes could be made.

In this regard, we support mandatory rotation of audit provider-firms at least every five years, or failing that, a similar program of rotation of audit partners/ senior managers/ functional staff at the same frequency where audit firm-rotation would be impractical (such as where there is a limited supply of audit firms capable of undertaking large scale and/or complex audits for larger/specialised enterprises);

. professional service firms not be prohibited from providing both audit and non-audit (for example, broader business consulting) services to individual enterprises, but higher standards be adopted and enhanced disciplinary measures be implemented by relevant industry/professional associations for dealing with conflict of interest matters.

. serious consideration be given to including within the Corporations Law a general statement on auditor independence, along the lines proposed by the Ramsay Report. That is, the auditor must be capable of exercising objective and impartial judgement on all issues encompassed within the auditor's engagement.

. greater efforts be made to promote through investor and public education the essential principle underlying AUS 106.11 and 202.03. That is, an audit report is not an absolute assurance on accountability, the future viability of the company, and or the business judgement with which management is conducting the affairs of the company.

The Chamber is open to discussion as to whether the essence of these principles should be included in the Corporations Law.

Terms of Reference

The Joint Standing Committee of Public Accounts and Audit (JSCPA) has adopted fairly concise Terms of Reference for its Review of Independent Auditing by Registered Company Auditors.

The Terms of Reference state: “With the spate of recent noteworthy corporate collapses both within Australia and overseas, the Joint Committee of Public Accounts and Audit wishes to explore the extent to which it may be necessary to enhance the accountability of public and private sector auditing.”

“In particular, the Committee is keen to determine where the balance lies between the need for external control through government regulation, and the freedom for industry to self-regulate.”

While only short in word-length, such Terms of Reference are quite broad in their reach and in the issues they raise.

The Chamber notes the essential issue for the Committee in this inquiry is, to quote the Chairman: “... to determine precisely where the balance lies between the need for external controls through government regulation, and the freedom for industry to self-regulate.”¹

¹ Mr Bob Charles, MP, “Review of Independent Auditing”, Media Release, 8 April 2002.

Commerce and industry would expect the Committee to approach these important issues in an analytical and thoughtful manner, and would be reluctant to see the Committee move quickly, without good reason, to any presumption that greater government intervention and regulation is automatically 'the solution'.

Any substantive shift in the regulatory balance would bring with it enhanced 'moral hazard' – that is, the onus of responsibility would inevitably shift from the accounting sector to the government to ensure regulatory requirements are met.

Looked at another, any pervasive regulatory regime would see the attribution of responsibility for any shortcomings in audit performance laid squarely at the feet of government and its regulatory agencies, either for poor regulatory design, inadequate implementation and/or deficient administration.

In effect, were government and its regulatory agencies exercising sufficient diligence in their job of 'checking the checkers', or being a performance auditor of financial auditors?

The Business Law Framework

The business law framework covering the role, function and conduct of an audit/auditor is currently spread across several areas: the Australian Corporations Law; jurisprudence; Australian Accounting Standards; and, the rules of professional associations, such as the Institute of Chartered Accountants in Australia (ICAA) and/or the Australian Society of Certified Practising Accountants (ASCPA).

Jurisprudence

Jurisprudence, rather than statute, sets out the mindset with which the auditor should approach his/her work.

From the British Courts: “It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances in each case... He is a watchdog, but not a bloodhound.”²

Elsewhere: “To perform this task properly, he must come to it with an inquiring mind – not suspicious of dishonesty, I agree – but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.”³

And, from the Australian Courts: “An auditor pays due regard to the possibility of fraud or error by framing and carrying out his procedures, having in mind the general and particular possibilities that exist, to the intent that if a substantial or material error or fraud has crept into the affairs of the company he has a reasonable expectation that it will be revealed ...”⁴

Australian Accounting Standards

The objectives and functions of an audit/auditor are set down in auditing standards issued by professional accounting bodies (namely, the ICAA and the ASCPA). These standards are given force through legislation (namely, s 296 of the Australian Corporations Law).

² *Re Kingston Cotton Mill Co (No 2) (1896) 2 Ch 279, Lopes LJ*

³ *Fomento (Sterling Area) Ltd vs Selsdon Fountain Pen Co Ltd (1958) 1 All ER 11, Denning LJ*

⁴ *Pacific Acceptance Corp Ltd vs Forsyth (1970) 92 WN (NSW) 29, Moffitt J*

The “*Objective and General Principles Governing an Audit of a Financial Report*” (AUS 202) sets down the objective of an audit:

“The objective of an audit of a financial report is to enable the auditor to express an opinion whether the financial report is prepared, in all material respects, in accordance with an identified financial reporting framework.” (AUS 202.02).

“Although the auditor’s opinion enhances the credibility of the financial report, the user cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.” (AUS 202.03).

These statements are reflected in the “*Explanatory Framework for Standards on an Audit and Audit Related Services*” (AUS 106), dealing with the level of assurance provided by an audit:

“An audit engagement is designed to provide a high but not absolute level of assurance on an accountability matter. The auditor expresses this as reasonable assurance in recognition of the fact that absolute assurance is rarely attainable due to such factors as the need for judgement, the use of testing, the inherent limitations on internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.” (AUS 106.11).

Furthermore, the “*Irregularities including Fraud, Illegal Acts and Error*” statement (AUS 210) sets out the professional standards required of auditors:

“(An auditor)... has a legal and professional duty to exercise reasonable skill and care in the planning and conduct of the audit so as to have a reasonable expectation of detecting material misstatements arising as a result of irregularities.” (AUS 210.10).

The Corporations Law

The Australian Corporations Law deals with a number of dimensions of the role and function of auditors in corporate governance.

These authorities, powers and responsibilities include: compliance with accounting standards and regulations; the need for the auditor to form an opinion as to whether financial statements provide a fair and true view of the company's financial position; the conduct of the auditor and the auditor's report; the power to obtain information; reporting to ASIC on contraventions of the Corporations Law; and, appointment and removal of auditors.

The main provisions deal with:

- . compliance with accounting standards and regulations (s 296): "The financial report for a financial year must comply with the accounting standards." (s 296(1)).

- . "true and fair view" (s 297): "The financial statements and notes for a financial year must give a true and fair view of: (a) the financial position and performance of the company ...";

- . audit and auditor's report (ss 307 – 308): which require the auditor to form an opinion whether the financial report of the company is in accordance with the Corporations Law, including compliance with the accounting standards (s 296) and true and fair view (s 297) provisions.

"If the auditor is of the opinion that the financial report does not comply with an accounting standard, the auditor's report must, to the extent it is practicable to do so, quantify the effect that non-compliance has on the financial report. If it is not practicable to quantify the effect fully, the report must say why." (s 308(2)).

. power to obtain information (s 310): The auditor has a right of access at reasonable times to the financial records of the company, and may require any officer to provide the auditor with information, explanations or other assistance for the purpose of conducting the audit.

. reporting to ASIC (s 311): “The auditor conducting an audit or review must, as soon as possible, notify ASIC in writing if the auditor: (a) has reasonable grounds to suspect that a contravention of this Law has occurred; and, (b) believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor’s report or bringing it to the attention of the directors.”

. appointment and removal of auditors (Part 2M.4; ss 324 – 331): which deal with qualifications of auditors (s 324), appointment of an auditor by a proprietary company (s 325), appointment of auditors (s 327), nomination of auditors (s 328), removal of an auditor (s 329), effect of winding up on office of auditor (s 330), and fees and expenses of auditors (s 331).

. The Australian Securities and Investments Commission

The Australian Securities and Investments Commission (ASIC) has made a number of public statements on the role of auditors, and their independence, within Australia’s system of corporate governance.

While the ASIC, quite properly, stresses it is important not to be complacent about corporate governance issues, it also usefully points out: there is a perception amongst the public that each time a company collapses there has been a breach of the law (that is, either company failures are illegal, or the result of illegal activities); there are approximately 7000 company collapses each year; and, these collapses do not indicate a systemic failure of governance.

Indeed, ASIC has observed: “ASIC has repeatedly acknowledged that the best governed companies can still succumb to competitive and economic forces, and that corporate failure does not *necessarily* (emphasis in original) imply poor standards of governance. In fact, our standards of corporate governance have been regarded as a benchmark by many of our trading partners.”⁵

ASIC has also usefully noted⁶ corporate failure does not necessarily warrant regulatory intervention, and it is inherent in the free enterprise system which underpins the Australian economy and society that directors may cause the company to assume risks which, in hindsight, were unwise.

Indeed, the law takes such matters into account in the ‘business judgement rule’ (s 180 of the Corporations Law), which provides a defence to directors where they have made a reasonable decision which they rationally believe to be in the best interests of the company.

That is, in effect, the law recognises the inherently risky nature of commerce and industry, and does not wish to expose to liability and/or unnecessarily punish those who reasonably take such risks.

⁵ Deputy Chair Jillian Segal, Address to the 18th Annual Company Secretaries Conference, Surfers Paradise, Queensland, 19 November 2001, at page 2

⁶ Professor Berna Collier, Commissioner, ASIC, Address to the Institute of Chartered Accountants in Australia Conference, Surfers Paradise, Queensland, 27 April 2002, at page 2

**The Chamber on Corporate
Governance and on Business
Regulation**

The Australian Chamber of Commerce and Industry (ACCI) has developed a broad suite of policy statements on priority issues for business.

These policy statements range across, but are not limited to: corporate governance; economics; education; immigration; industrial relations; population; regulation reform; and, trade and international affairs. (A complete listing, and indeed full set, of the Chamber's policies can be obtained from our website: www.acci.asn.au).

Two of these Policy Statements –Corporate Governance and Responsibility, and Regulatory Reform – are especially relevant to the JSCPAA Inquiry into auditor independence.

The Chamber's Policy Statement on Corporate Governance and Responsibility sets down a number of core policy principles.

To quote from the Policy Statement: “Strong and effective systems of corporate governance are essential to the sustained competitive advantage of commerce and industry, and consequently the nation as a whole.”

“At the same time, optimising corporate performance, and through this shareholder value, requires business environments driven by market forces and robust commercial rivalry....”

“Corporate law and regulation have an important role to play in facilitating effective and efficient systems of corporate governance by, inter alia, setting minimum standards of accountability, disclosure, responsibility and transparency.”

The Policy Statement also sets down a number of Policy Objectives in corporate governance and responsibility, those relevant to this Inquiry being, to quote:

“(T)he promotion of best achievable practice in the governance of Australian enterprises to maximise shareholder value and the competitiveness of the firm and the economy (and) emphasising that effective competition and market forces will deliver the optimum outcomes in corporate governance, ahead of regulatory impositions and third party interventions...”

The Chamber has also adopted a substantive Policy Statement on Regulatory Reform. The essential thrust of this Policy Statement is effective regulatory reform can significantly improve government and economic performance.

However, the failure to correctly identify the implications of regulatory activity can result in reduced economic efficiency, investment and opportunities for growth.

Furthermore, even if regulation is the most appropriate way to achieve a goal of Government, the substantial impact on the business sector needs to be recognised when considering new regulations and should drive efforts to reduce the unnecessary impacts of current regulation.

The Chamber's Policy Statement on Regulatory Reform also sets down a number of core principles designed to ensure existing and any new regulations are minimal, yet effective. These include:

- The program of reform should proceed on the assumption regulation is the least appropriate way in which to address issues of concern to the Government. It should be the last resort after all other options (education, publicity, moral persuasion, industry self-regulation and other approaches) have been fully assessed and judged to be ineffective;
- No new business regulation should be contemplated without a thorough and independent cost benefit analysis (including the full cost of the proposed regulation to business), and no regulation should be introduced without full consultation with the business sector; and,
- The cost benefit analysis will be in the form of a regulation impact statement that assesses the total cost to business of compliance, fees and paperwork and compares this total cost to business with the estimated benefits of the proposed regulation.

Taken as whole, the Chamber considers an effective and productive regulatory environment to be one which involves an outcome-oriented approach integrated with other relevant policy areas to avoid unnecessary hindrances to commerce and industry.

Issues and Policy Options

A number of issues and policy options have been identified by corporate regulators and corporate law academics which could usefully inform those interested in further enhancing Australia's already high standards of corporate governance.

ASIC Survey of Audit Independence

Commerce and industry notes the report of a survey of auditor independence released by ASIC earlier this year⁷. The Chamber concurs with ASIC when it said it regarded the survey results as a useful addition to available data on this important matter.

The survey was distributed to Australia's 100 largest companies, with 67 per cent of these firms responding, an outstanding response rate for a business-oriented survey in this country.

According to the ASIC, key findings of the survey include: the provision of non-audit services by audit firms to their Australian corporate clients is widespread; audit firms are earning substantial fees from non-audit services; processes for dealing with potential conflicts of interest require attention; rotation of audit partners remains inconsistent; and, the vast majority of those who responded had an audit committee in place with appropriate operating guidelines.

The ASIC, in its media release publicising the survey, concluded: "Although some findings from this survey indicate a recognition of this problem by both companies and their auditors, there appears to be a lack of rigour in processes to manage conflicts and continuing reluctance to adopt robust audit rotation as an anti-conflicts measure."

⁷ ASIC, "ASIC Announces Findings of Auditor Independence Survey", Media Release, 16 January 2002.

The Chamber's assessment of the survey's results are not as negative as those of ASIC, and as such do not lead us to the same conclusion(s).

To our reading, the key messages from the survey are: there appears to be clear and demonstrable arm's-length relationships between corporate boards and senior executives, and audit providers; Audit Committees are common place, pointing to a high degree of corporate commitment to transparency and compliance; and, where audit firms provide non-audit services, there appear sound commercial reasons/synergies for doing so (particularly where it relates to taxation) and/or more may be 'one-off's' (such as with the introduction of the Goods and Services Tax).

In particular, we contest ASIC's interpretation of the results of the question (10a) concerning the rotation of audit partner and senior staff. Given that 43 per cent of respondents engaged in such a practice, and 54 per cent do not, we consider their evaluation of such practices as being "inconsistent" to be inappropriate. The better interpretation to our mind being there is a substantial practice of audit partner/senior manager rotation amongst Australia's largest firms.

Importantly, commerce and industry does not accept a priori the provision of different professional services by a single provider demonstrates conflict of interest. As any statistician will attest, correlation does not mean causation. To reiterate the point made earlier, there may well be sound and commonsense commercial reasons to buy related services from a single provider, where doing otherwise may be inefficient and/or sub-optimal.

Ramsay Report – In Overview

The Australian Government commissioned and received in 2001 a major academic report on issues and policy options for strengthening auditor independence in this country; the so-called ‘Ramsay Report’⁸.

Without revisiting or reporting in detail the main conclusions of this substantial report (both in substance and in length; nearly 240 pages), the Chamber notes the core messages of the Ramsay Report as being: Australia currently lags behind what he considers international best practice; and, certain elements of the corporations law in this country, in particular on certain employment and financial relationships, are out of date.

Importantly, the Ramsay Report distinguishes itself from topical events in corporate governance and audit practice, when it states at page 6: “The actions of the auditors involved in the recent corporate collapses, and the questions whether any failings in this area of audit independence contributed to those collapses are outside the scope of this report.”

Looked at another way, the Ramsay Report is implicitly raising the very important question of whether different (presumably enhanced) auditor independence would have had any (positive) impact on those corporate collapses. Or in plain terms, would stronger audit independent arrangements have prevented, obviated or reduced the probability/magnitude of those collapses?

⁸ Ian Ramsay, “Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform”, October 2001 – available from the Australian Treasury per www.treasury.gov.au

Ramsay Report – Current Status of Auditor Independence

The Ramsay Report makes a number of interesting observations regarding the independence of auditors, the most notable of which is Australian corporations law (beyond certain employment and financial relationships) does not contain a general statement requiring an auditor to be independent.

Ramsay regards this as a substantial deficiency in the corporations law (which the Chamber attributes to government failure), and proposes a provision to fill this anomaly, which he summarises thus:

“This provision of the Corporations Act would also provide that an auditor is not independent with respect to an audit client, if the auditor is not, or a reasonable investor with full knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgement on all issues encompassed within the auditor’s engagement.”

“It is also recommended that the auditor must make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the Corporations Act and rules of the professional accounting bodies.⁹”

Commerce and industry appreciates the objectives and reasoning behind this proposal, which we would endorse-in-principle. Furthermore, we note the Ramsay Report (at pp 7 – 10) provides proposed draft text for legislative amendment to the Corporations Act, in particular Section 324 dealing with employment and financial relationships.

⁹ Ramsay Report, Part 2 A, at page 7

The Ramsay Report also usefully addresses the issue of the delivery of non-audit services by audit providers, proposing (at pp 10 - 11) initiatives based on strengthening professional ethical rules and the role of audit committees, as well as mandatory disclosure of non-audit services and the fees paid for those services to audit provider-firms.

Again, commerce and industry appreciates the reasoning behind these proposals, which we would endorse-in-principle.

Summary and Conclusion

The Australian Chamber of Commerce and Industry regards the ethical and legal underpinnings of Australia's system of corporate governance as amongst the highest in the world.

While there are transgressions by individuals from time-to-time, the Chamber considers these actions to be the conduct of outliers and certainly not systemic. Similarly, while there may be gaps in the corporations law, these do not reflect any unsoundness in its foundations and are remedial by modest legislative amendments.

Commerce and industry concurs with, and welcomes the statements of the corporate regulator – ASIC – when it said:

“... the collapses which took place last year do not appear to represent a systemic failure of corporate governance in Australia. It is the nature of our free enterprise system that businesses will fail, for reasons not necessarily associated with culpable behaviour of the board or the management.”¹⁰

¹⁰ supra note 6 at pp 5 – 6.

In its deliberations on the role, function and independence of auditors, and the provision of audit services, the Chamber encourages the Committee to clearly distinguish between the systemic and the atypical or outlier.