31 May 2002

Dr Margot Kerley
Committee Secretary
Joint Statutory Committee of Public Accounts and Audit
Department of the House of Representatives
Parliament House
CANBERRA ACT 2600

Email: jcpa@aph.gov.au

Dear Dr Kerley,

Re: Review of Independent Auditing by Registered Company Auditors

As Australia's largest accounting body we welcome the opportunity to make this submission to the Joint Committee of Public Accounts and Audit's Review of Independent Auditing by Registered Company Auditors on behalf of our membership. Over the course of the current debate following recent corporate collapses, CPA Australia has maintained the view that the Australian financial reporting framework is working well, but it is not above scrutiny, and the profession has a significant role to play to ensure public concerns are addressed effectively.

CPA Australia has actively provided advice to public investigations into the issues of corporate collapse such as the Ramsay Review of Auditor Independence in 2001 and has since endorsed many of the Review's recommendations. We have also put forward many recommendations for change of Australia's financial reporting framework.

CPA Australia recognises that the spate of recent corporate collapses in Australia and overseas have seriously undermined public confidence in the role of auditors, but more broadly in the role and integrity of all participants in the financial reporting framework. We strongly believe that the JCPAA review combined with an assessment of the broader financial framework will lead to positive outcomes for the community, business, and the accounting profession. This is the thinking behind CPA Australia's recently released paper *The Financial Reporting Framework - The Way Forward,* which is attached for your reference.

CPA Australia looks forward to further discussing these issues with the Committee. If you have any questions or require clarification on any issues raised in the attached submission, please do not hesitate to contact me on phone (03) 9606 9655.

Mr Greg Larsen
CEO
CPA Australia

Submission to Joint Statutory Committee of Public Accounts and Audit

Review of Independent Auditing by Registered Company Auditors

May 2002

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1. Executive Summary and Recommendations

CPA Australia is Australia's largest professional association with more than 97,000 members across finance, accounting and business sectors. Of these members:

- 19 percent are in public practice,
- 11 percent in the public sector, and
- 49 percent are employed in commerce and industry – a grouping that includes chief financial and executive officers of some of Australia's largest reporting entities.

Of the remaining membership the key groups include academia and not for profit organisations[1].

Approximately 1500 CPAs identify auditing as their primary job function. This group includes registered company auditors as well as members of audit teams and individuals who undertake audits for entities not required to engage a registered company auditor. More than 13,000 CPAs identify the roles of CEO, CFO or Financial Controller as their primary job function. CPA Australia has drawn on the breadth and depth of expertise represented by our diverse membership to develop this submission.

The audit function is an important component of Australia's financial reporting framework, and has a critical role in the efficient operation of capital markets by adding credibility to the financial reports prepared and signed off by the company.

CPA Australia believes the current focus on auditors and their clients provides a unique opportunity for the profession, Government and industry to show leadership in developing a financial reporting framework more capable of fulfilling today's public accountability expectations.

The inquiry focus on independent auditors will address a very important component of the financial reporting framework, and one that has come under considerable public scrutiny. However, CPA Australia is also advocating the need for a comprehensive overhaul of the financial reporting framework and has captured this thinking in the landmark paper *The Financial Reporting Framework – The Way Forward*.

This paper outlines a series of reform principles with the potential to call a halt to the ad hoc evolution of the financial reporting framework and ensure future reforms build towards clear and common goals.

In addition, CPA Australia has identified a series of supplementary reform options to address specific issues that have come under considerable public scrutiny. In particular, CPA Australia is advocating an increased level of vigilance, as well as disclosure from all participants, in respect to audit integrity and specifically auditor independence.

CPA Australia's proposed reforms directly address the need for increased transparency and credibility in financial reporting in Australia. They will also enhance public accountability and confidence.

CPA Australia supports retention of the current co-regulation model, but believes it requires a considerable review if it is to meet public interest going forward. Again, CPA Australia's proposed reforms provide an opportunity to more effectively recognise the strengths of Government and professional regulation, and in doing so, build a framework that is superior to that based on either in isolation.

Along with the strong commitment to reform and recognition of the vital role provided by auditors, CPA Australia also recommends stronger public support for the audit function. Specifically through improved whistleblower protections and the introduction of an industry ombudsman, but also by addressing the need for appropriate professional indemnity measures to be in place.

[1] CPA Australia Annual Report 2001

2. Introduction

2.1. CPA Australia

CPA Australia is Australia's largest professional association with more than 97,000 members across finance, accounting and business sectors. Of these members:

- 19 percent are in public practice,
- 11 percent in the public sector, and
- 49 percent are employed in commerce and industry – a grouping that includes chief financial and executive officers of some of Australia's largest reporting entities.

Of the remaining membership the key groups include academia and not for profit organisations[2].

2.2. CPAs as Auditors

CPA Australia's membership records identify 1,500 members who list audit as their primary job function with a further 5000 indicating a professional interest. Most recent data provided by ASIC indicates that there is a total of 7,000 registered company auditors. Membership of a recognised professional association such as CPA Australia or Institute of Chartered Accountants in Australia (ICAA) is not the only criteria for registration by Australian Securities and Investments Commission (ASIC). (The criteria is outlined in Attachment 2)

Not all entities require a registered company auditor. CPAs also provide auditing services to non-listed entities, and in this capacity provide services to community groups and sports clubs through to large private holdings, superannuation funds and trusts.

2.3. CPAs as Managers and Directors

CPA Australia's membership records identify more than 3,220 who list audit as Chief Executive Officer as their primary job function, 4,021 list Chief Financial Officer and a further 6266 members list Financial Controller.

3. Audit Role in Context

3.1. Role of Audit

Under the Corporations Act, publicly listed companies, a range of other disclosing entities, registered schemes as well as large and certain small proprietary companies are required to lodge an audited statutory financial report. Disclosing entities are commonly described as entities that issue a prospectus for example managed funds, superannuation funds and some trusts.

According to the Corporations Act, an Auditor is appointed by shareholders. In practice, however, the audit firm is often appointed by the Board of Directors of an entity, on behalf of the shareholders, with shareholders confirming the appointment through the Annual General Meeting. The auditor's role is to add credibility to the financial reports prepared and signed off by the entity and provide a high level of assurance that the financial reports are free from material misstatement.

The criteria for an individual to be an effective auditor is an appropriate level of competence, based on appropriate skills and experience, coupled with the appropriate real and perceived degree of independence. An effective audit is achieved where an effective auditor is guided by appropriate standards and where the business and the auditor adhere to appropriate rules of engagement.

[2] CPA Australia Annual Report 2001

3.2. Value of Audit

Unfortunately some entities view the external audit as primarily a function of compliance, leading to a focus on cost and meeting minimum compliance requirements.

The external audit is, however, able to provide management and the Board with increased confidence in the integrity of both the information and the processes by which it is generated. This confidence should be an important consideration in their business and strategic decision making. We see more recognition of this where entities voluntarily undertake audits separate to the annual statutory financial report audit. However, these are often at the insistence of external parties for example bankers, financiers, potential business partners or buyers rather than the entity.

The external audit of an entity's financial reports should lead to greater confidence in the information provided, hence increased certainty for the investor and resulting in a value premium over unaudited reports of competitor or equivalent firms. However, there is no statistical research that is able to quantify this assertion.

This potential premium is also particularly difficult to assess in the Australian context because of the statutory financial report audit is part of the compliance requirements for companies listed on the ASX.. This is further complicated by research that suggests (eg Craswell, Francis and Taylor, 1995) an audit undertaken by an auditor perceived to be of high quality will achieve a premium over less 'credible or quality' auditors. This research implies that there is more value to the company in the 'brand' of auditor rather than the rigor of the audit itself.

CPA Australia strongly supports the obligation for annual external audits to be undertaken of companies . Our view is that this is a key factor in protecting credibility of information available to investors as well as other stakeholders such as employees, suppliers and financiers. It is a key factor in maintaining effective capital markets in Australia and in other nations with similar auditing requirements. It also imposes a minimum standard for all listed companies, and other disclosing entities The challenge is to ensure that the standard of the compliance audit is adequate, and also whether there is a need to pursue increased appreciation of the 'value adding' results of the audit to the companies themselves as well as to other stakeholders.

3.3. Corporate Failure

There is no perfect financial system, in the public or private sectors, which will ever be able to rule out the risk of corporate failure or provide stakeholders with perfect information. An increasingly global business environment may in fact amplify these risks even further. For this reason, public interest will only be served by ensuring effective and transparent accountability processes are in place.

3.4. Inherent Limitations of Audit

The external audit function is designed to provide a high level of assurance but cannot provide absolute assurance. This reflects the fact that in undertaking an audit, the auditor is required to use judgement in providing his/her professional opinion, and that this judgement is based on a sample of the business activity – not every transaction. The audit also relies on estimates and valuations provided by management and 'other professionals' e.g. actuaries. The auditor is required to form an opinion on the reasonableness of these valuations. There will always be a risk that the audit will not uncover or detect process issues or fraud.

AUS 106, Para 10 describes the situation as, "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"

3.5. Audit Dependencies

The above section (3.1) clearly identifies the broader range of functions that can impact on the audit and its outcomes. A sound audit will only result from a situation where those responsible for standard setting, monitoring and policing as well as the audit-client take steps to manage, and where required, minimise risks with the potential to detract from the audit.

According to the OECD Principles of Corporate Governance, a key function of the board is to ensure the integrity of the corporation's accounting and financial reporting systems. This includes independent audit and appropriate systems of control; in particular systems for monitoring risk, financial control and compliance with the law. The potential for the business to detect inappropriate practices is greatly enhanced by the company's own commitment to their corporate governance responsibilities.

The auditor is required to follow auditing and professional standards in undertaking the audit, during which the auditor is required to assess whether the company has complied with accounting standards appropriately. The auditor's reliance on clear and relevant standards for auditing and accounting as well as for managing ethical challenges is significant and a critical consideration in assessing audit performance.

3.6. Regulation and Registration of Auditors

3.6.1. Current Co-regulation Model

In 1993 the Ministerial Council for Corporations (MINCO) opened a review of regulation of company auditors with the purpose of ensuring that an appropriate legal framework was in place for the registration, appointment, supervision and disciplining of company auditors in relation to their functions under the Corporations Law and to ensure their independence[3].

The Working Party established under MINCO, considered three issues in relation to the requirements for registration, i.e.

- educational qualifications
- professional qualifications, and
- the appropriate level of practical experience in auditing (competencies).

With regard to the latter issue, the Working Party concluded that competency standards should ultimately be adopted as the principal basis for determining whether a person has sufficient practical experience in company auditing to be registered as a company auditor.

It further recommended that where an authorised accounting body, such as CPA Australia, has in place a competency standard in auditing that has been approved by ASIC, an applicant for registration as a company auditor must satisfy the audit component of the competency standard in order to be registered.

The two professional accounting bodies (CPA Australia and ICAA) have determined that persons who are members of these bodies, and who wish to be registered as company auditors should satisfy certain competency standards relating to registered company auditors (RCAs). The standards describe the necessary skills required by RCAs that are relevant to audit tasks in the various audit contexts.

However, pending the introduction of Competency Standards by authorised accounting bodies (refer Glossary of terms, MINCO Working Party Report, July 1997) the Working Party concluded that an hours-based regime should be maintained.

[3] Report of a Working Party of the Ministerial Council for Corporations, July 1997.

The Working Party further recommended that RCAs should not be required to undertake a specified level of audit work in any one year, but should be required to maintain their competence in audit work. Where an RCA has not undertaken any substantive audit work during a period of not less than five years or has failed to maintain competency in audit work, the supervisory body may require the RCA to show cause why his or her registration should not be cancelled (Recommendation 6.6 MINCO Report 1997).

In 1992 the ASCPA (now CPA Australia), the ICAA and the Institute of Chartered Accountants of New Zealand established the Competency Standards Steering Committee, under the chairmanship of Professor W P Birkett, Professor of Accounting of UNSW, to carry out an extensive study into the development of competency-based standards for the accounting profession. The research results have been extensively accepted across the profession and have been used as the basis for the development of a single unit of competency, being the competency standards relevant to the level of competence expected of RCAs. The standards have been developed consistent within the Australian National Training Authority (ANTA) guidelines.

The final resolution of this matter has been deferred indeterminably. Correspondence received in late 2000 from the Federal Minister responsible advised that, while the recommendations of the MINCO Report of 1997 were supported the matter would be deferred pending the outcome of deliberations on matters relevant to those issues contained therein. The matter has not progressed.

3.6.2. CPA Australia's Approach to the Regulation and Registration of Auditors

CPA Australia's regulation of public practitioners ensures they must hold minimum levels of professional indemnity insurance, undertake continuing professional development and quality assurance reviews in order to retain their public practice certificate. A breach of this requirement can result in the imposition of penalties through CPA Australia's disciplinary process.

The range of penalties includes a restriction on the ability to utilise CPA Australia intellectual capital in the course of business or to offer services to the public as a CPA Australia member. The ultimate sanction is forfeiture of membership.

The form of regulation of public practitioners by CPA Australia is to help ensure that the quality of services offered by them is maintained. It is also paramount to CPA Australia that the protection of the interests of the persons who rely on the services of members by requiring members to hold professional indemnity insurance. These initiatives by CPA Australia are seen to be clearly in the public interest.

All CPAs, regardless of their professional role, must adhere to CPA Australia's professional code of conduct, as well as the additional specific miscellaneous standards produced by CPA Australia but not included in the code. The code and standards outline the principles of acceptable conduct, and provide guidelines and illustrations of how the statement or standard should be applied in practice. For example, the recently agreed Professional Statement F1 on Professional Independence is part of the CPA Australia's code of conduct and is therefore mandatory for members. Each statement and standard is intended to provide CPAs with guidelines as to what is considered appropriate behavior in contrast with the law that details the acceptable limits of behavior.

3.6.2.1. Professional Independence Standard – F1

CPA Australia's Professional Independence Standard (F1) guides all CPAs and specifically those undertaking assurance engagements including auditing. This standard provides specific instruction on the identification, assessment and adoption of safeguards to manage risks to independence.

In May 2002 CPA Australia and the ICAA agreed to a revised professional independence standard, based on the same standard issued by IFAC in November 2001. The decision followed the issue of the exposure draft for public comment, and the consideration of subsequent feedback.

The revised F1 replaces the existing Professional Standard in CPA Australia's Code of Conduct. The new F1 also represents a significant step forward for the accounting profession. Firstly, because it is based on the IFAC standard, it brings Australia in line with international practice. Secondly the standard incorporates a conceptual framework for auditor independence, therefore requiring members to adhere to the spirit of the statement, as much as the guidelines.

The new standard does not come into effect until 31 December 2003. However, CPA Australia is encouraging all members to adopt the new standard immediately and specifically in relation to new engagements.

CPA Australia has agreed to F1 while recognising that it has not been revised to capture lessons that are and will emerge from the ongoing investigations and reviews of recent corporate collapses. CPA Australia will adapt F1 to reflect future outcomes as well as the recommendations contained *The Financial Reporting Framework – The Way Forward*.

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3.7. Defining and Meeting Community Expectations – Audit Expectations Gap

A gap remains between what auditors deliver and what stakeholders expect auditors to deliver - the audit expectations gap. Considerable work has been done internationally and in Australia to identify the true extent to which the gap exists and possible options for addressing it.

The audit expectation gap can be seen to have three components, the performance gap, standards gap and the unreasonable expectations gap, as outlined in the diagram below.

Audit Expectations

Performance Gap
potential for audit performance to fall below required professional standards and legal standards

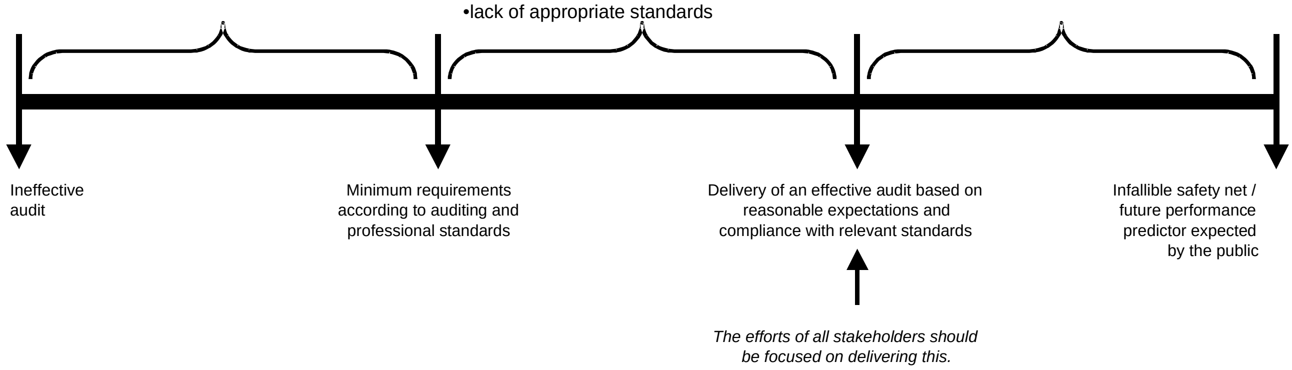
Impacting issues
•ineffective monitoring
•ineffective QA
•ineffective disciplinary procedures
•lack of independence
•lack of competency

Standards Gap
potential for audit performance to meet required standards but still fall short of 'reasonable' public expectations

Impacting issues
•public interest not appropriately reflected in standards
•push for international harmonisation can dilute standards below local expectations
•evolution of audit responsibilities eg accepting a greater responsibility for fraud over time
•lack of appropriate standards

'Unreasonable Expectations' Gap
potential for audit performance to fall short of public expectations eg provide an infallible safety net

Impacting issues
•Shareholder/stakeholder awareness
•inappropriate and inconsistent explanation and response by the profession



The profession, government, regulators and business have an obligation to address the first two areas– the standards and performance gaps - to ensure best practice is consistently delivered. CPA Australia's recent tailoring of the IFAC Professional Independence Standard to create its version for CPAs is an example of the ongoing work required to ensure standards remain relevant to community expectations. The third component requires broader participation to ensure the balance between community expectations and the underlying purpose of the audit is not lost.

In 1993 CPA Australia and ICAA jointly commissioned a report into the 'expectations gap'[4]. The report identified opportunities to address the entire expectations gap issue, defined as "…the difference between the expectations of users of financial reports and the perceived quality of financial reporting and auditing services delivered by the Accounting Profession."

The 'unreasonable expectations gap' reflects a frequently occurring difference between what the public believes an audit should be able to provide and what is required under regulatory and professional guidelines. It is often reflected in the expectation that the audit report should be able to provide a future indicator of performance. The Expectations Gap report provided a number of recommendations on this issue. For example the Expectations Gap suggested that the forward-looking projections prepared by the company for the ASX could be brought within the audit scope. CPA Australia argues that many of these recommendations should be revisited as part of an industry wide focus on improving the quality, integrity and usefulness of financial reports. Moreover, CPA Australia contends that the audit function will only be substantially enhanced by addressing the broader range of interdependent processes.

In 1996 a Taskforce was established to progress the Expectations Gap Report's recommendations. As a result the profession has made considerable progress on recommendations resulting in their revision and adoption. In some instances new thinking or initiatives from outside the profession have superseded the proposals. In other instances the successful adoption of recommendations required action on a broad front and was beyond the profession's mandate.

3.8. Independence of Australian Company Auditors – The Ramsay Report

In 2001, the Federal Government commissioned the Ramsay Review into Auditor Independence in Australia[5]. The Review represented Government's initial response to concerns about auditor independence highlighted by, but not confined to, the collapse of HIH. It took place against a backdrop of public concern about the efficacy of the auditing profession.

CPA Australia has confirmed its support for many of the recommendations contained in the report released in October 2001 but questioned the proposal for an Auditor Independence Supervisory Board (AISB). CPA Australia strongly endorses the objectives behind the concept of the AISB, but we question whether creating yet another board is the most effective means by which to achieve them. Implicit in this concern, is the suggestion that the very bodies that the AISB is meant to police, are in fact recommended as its source of funding.

Of the seven functions nominated for the new AISB, CPA Australia believes all can be delivered through existing bodies including the professional associations, the Auditing Assurance Standards Board (AuASB), Company Auditors and Liquidators' Disciplinary Board (CALDB) as well as ASIC. More importantly by taking this approach, reforms can be enacted quickly.

3.9. CPA Australia's The Financial Reporting Framework – The Way Forward

In April 2002 CPA Australia launched its position paper *The Financial Reporting Framework – The Way Forward* which outlined the challenges that lie before the profession as well as a range of recommendations. The paper builds on the work undertaken through the Expectations Gap project, as well as the recent Ramsay Report. However its real focus is on recognising the breadth of involvement that is required to raise public confidence in the financial reporting in Australia.

[4] A Research Study on Financial Reporting and Auditing – Bridging the Expectations Gap, December 1993
[5] Independence of Australian Company Auditors – Review of Current Australian Requirements and Proposals for Reform by Professor Ian Ramsay October 2001.

CPA Australia's paper addressed the full gambit of concerns from the public perspective, directly responding to the concerns raised by the broader public and their representatives.

CPA Australia argues that good financial reporting and a framework worthy of public confidence requires good accountants, auditors, directors, management, professional bodies and especially entities that facilitate and police this process. CPA Australia's paper concludes that this broader group of professionals can do much to enhance the performance and perception of our financial reporting framework, but this cannot occur unilaterally. All participants with responsibilities under the financial reporting framework must acknowledge the need to improve standards and come to the table with constructive ways forward.

Since the launch of the paper, CPA Australia has received considerable feedback. While some participants and their representatives do not all agree with the proposals, the paper has been acknowledged as a constructive platform from which to address the significant and immediate challenges.

CPA Australia is continuing to work with industry, Government and other stakeholders to progress the range of possible initiatives. CPA Australia also recognises the importance of initiatives such as the JCPAA enquiry in providing an open and credible vehicle for further discussion.

3.9.1. CPA Model Impact on Current Framework

CPA Australia's paper outlined a model able to support a more effective financial reporting framework. Discussion has focused on the potential implications of this model for existing bodies, such as the FRC, AuASB etc.

CPA Australia's model was not designed by referring to these existing structures and their potential fit. Instead our model was created by defining:

- what functions are required by and to support an efficient reporting framework;
- to what degree the functions should be separated from each other or integrated;
- how and where the strengths of government and professional regulation can be incorporated to further enhance the outcomes of the model.

For this reason there is no simple correlation between the existing institutions and the new model. CPA Australia's proposed model can facilitate a more efficient operational framework that is worthy of increased public confidence but we acknowledge that in the short term, at least, the proposed model represents the aspirational benchmark for reform.

3.9.2. Principles of Reform

To move forward in line with CPA Australia's recommendations, it is more constructive to focus on the principles upon which the model is based. These principles ensure appropriate consideration is given to balancing the interests of the market with the need to sustain public confidence.

This form of active, public interest guardianship can be sustained over time if evolution of the framework and its bodies is guided by the following principles:

3.9.2.1. Simple and transparent design

Public confidence will always be rocked by high profile failures, and the public will rarely seek to understand the framework until such collapses occur. In such an environment, a complex and less than transparent framework exacerbates public concerns and encourages a lack of faith in the integrity and competence of all participants. By minimising the complexity of the framework, which includes minimising the number of bodies involved, the industry is able to more effectively explain what went wrong, how and who is doing something about it.

3.9.2.2. Consistent application and outcomes

No framework will ever eliminate the risk of corporate collapse, but a good framework will ensure appropriate and effective mechanisms are in place to trace the origin of the collapse and ensure those responsible are and are seen to be appropriately penalised - in all cases. This principle implies that the framework must have adequate scope to assess the activities of all participants, beginning with the three pillars of financial reporting framework – management, governance and auditors. It also implies the need to minimise the number (and broaden the scope) of bodies involved in standard setting, monitoring, investigation and disciplinary processes.

3.9.2.3. Efficient operation

An efficient framework achieves the right degree of tension between oversight and what is economically effective. In the current environment it is important to keep in mind that the vast majority of managers, directors, and auditors fulfill their responsibilities properly. It is essential that in shaping a new framework, operational efficiency is not lost to excessive oversight that may lead to further unintended consequences such as a reduced focus on prevention. To do so, would penalise positive elements of Australia's financial reporting framework in the hope that individuals could not and would not circumvent the tighter controls.

3.9.2.4. Balanced responsibility

In addition to balancing the public and industry interests, it is also essential that the responsibility for good financial reporting is balanced amongst the full range of participants, again beginning with the three pillars of financial reporting framework – management, governance and auditors. This approach encourages a mutually supportive framework that can deliver performance superior to that of bolstering functions in isolation. It also provides industry with a broader range of options to improve the performance and efficiency of the framework. And finally, a willingness and ability to clearly communicate the scope and relevance of participants' responsibilities enhances public understanding and with that public confidence.

4. Auditor Accountability

An auditor is held accountable in two key respects; that he/she is appropriately competent to undertake the audit, and that he/she is appropriately independent of the company to ensure the audit and opinion provided in the audit report is free of management influence.

Ensuring auditors are accountable for their professional role, is a responsibility shared by the company, the profession and Government. Public accountability requires that appropriate professional accountability processes be in place and that these are delivering outcomes in line with public expectations.

4.1. Professional Accountability

Under the current Corporations Act, the entity's Board of Directors is responsible for ensuring all reasonable care is taken to ensure the integrity and quality of its financial reports. To this end, the audit is to provide stakeholders with improved confidence in these financial reports and financial reporting processes of the entity, then there is clear need for the entity to ensure all reasonable care is taken to facilitate, protect and ensure the integrity of the audit function.

In accepting the audit engagement, the audit firm undertakes to provide an independent and competent high level assurance on the integrity of the financial reports - to shareholders in the first instance, but also to the broader range of stakeholders. This represents a significant real and also perceived duty of care for the audit firm that is in no way diminished by the responsibilities of the company. This duty is enshrined in both the profession's regulations and those caught by the Corporations Act and regulations.

The audit function is dependent upon appropriate guidelines being in place, and that these are effectively monitored with disciplinary action taken as necessary. To this end, the responsibility for protecting audit quality is shared by the participants of the broader financial reporting framework and includes the Government, its' agencies and the professional associations. Amongst them, these bodies set the reporting requirements and the standards or guidelines for their preparation. They monitor the relevance and adequacy of the standards as well as the performance of the individuals involved. Where necessary, the professional bodies and the ASIC can undertake investigation and disciplinary action.

In addition to participation in the review of its members and the standards that guide them, professional bodies such as CPA Australia also develop individuals to more effectively deal with the challenges of their role. Development takes the form of continuous professional development, as well as regular peer and quality assurance reviews that provide members with feedback on their application of standards in the 'real world'. These mechanisms are particularly effective in developing members' ability to manage ethical and professional issues for example the identification and management of threats to independence. Challenging members' application of the relevant standards in a learning environment, provides a level of practical knowledge that supports them in the field and assists them to appropriately identify and respond to these concerns. Coupled with in the field reviews, CPA Australia is working to prevent inappropriate practices.

4.2. Public Accountability

Over recent decades there has been a substantial reduction in the trust members of the public are willing to automatically vest in professionals. This is evident in the medical, legal and also the accounting professions. It may reflect a more highly educated public who seek a more active involvement, but it may also be considered a consequence of unfavorable experiences that have received significant media coverage.

For the accounting profession the shift has been accelerated by the increasing involvement of individuals in the management of their financial affairs. There is an expanding number of shareholders in Australia. Some are a passive consequence of de-mutualisation and mandatory superannuation, but many reflect the growing interest of Australians in shares and the share market. These shareholders are increasingly independent of professional advisors (a situation facilitated by, for example, the growth of online share trading) and have a level of financial knowledge that is superior to past generations.

As a result, the public is shifting its confidence away from trusting Government and industry to act in their best interests and are demanding a more direct level of accountability. Not only do the public expect the participants of the financial reporting framework to be acting in the public interest, they want clear evidence that this is the case. These factors mean business, Government and the profession must deliver a more robust level of confidence to an increasingly questioning, if not cynical, public.

CPA Australia argues that confidence in the current financial reporting framework is undermined by its limited ability to prevent corporate collapse, to provide signals for investors regarding performance and the failure to deliver simple and consistent answers when 'something goes wrong'.

This does not suggest that the current professional accountability system cannot tackle such events. It instead, draws a clear line under the need for the guardians of the financial reporting framework to reconsider whether effective public communication processes are in place to meet the challenges of increased and more questioning public interest.

4.3. Factors Impacting on Auditor Accountability

4.3.1. Auditors

Threats to the independence of the audit can arise from a wide range of actions and relationships, and CPA Australia's professional standard F1 provides a clear outline for members on how to manage these risks. Amongst these are specific threats that have received considerable public attention because of their potential misrepresentation and lack of awareness of the risk management processes have been put in place. For this reason CPA Australia has opted to address them specifically in this paper, and have provided clear recommendations in the attached policy paper.

4.3.1.1. Simultaneous provision of audit and non-audit services

Unfortunately, anecdotal evidence suggests that many businesses see limited value in statutory compliance audits. Instead, they have opted to engage the audit firm to provide audit and non-audit services in the belief that the audit exposure provides the firm with opportunity to build its knowledge of the audit-client and so deliver more effective non-audit services.

There is much support for the belief that an auditor's in-depth knowledge of the business does facilitate an improved audit as well as more appropriate non-audit service responses.Simultaneous provision does present opportunities to compromise the audit that require careful management by the business and by the auditors. CPAs are able to refer to the current professional standard for guidance in these circumstances. To date there has been little effort by auditors or their clients to disclose the full extent of their relationship with the client, nor have they sought to provide stakeholders with clear outline of the range of safeguards put in place.

4.3.1.2. Length of audit engagement – auditor rotation

CPA Australia recommends a vigilant, active and transparent management of the client-audit relationship, by both parties, and especially by the client who is ultimately responsible to the shareholders for the engagement. We have outlined many recommendations to support this approach in our recently released paper, *The Financial Reporting Framework – The Way Forward*.

CPA Australia supports the rotation of the audit firm **where there is an unacceptable level of risk to the integrity of the audit**. Specifically, CPA Australia recommends [point 2.3.7] *" companies be required to publicly disclose their reasons for reappointment, appointment or otherwise of an auditor, and for a **comprehensive review to be undertaken and publicly disclosed every five to seven years to assess the need for audit firm rotation**;"*

CPA Australia's position recognises the need for the business to achieve an appropriate balance between developing adequate business knowledge within the external audit team and the perception and potential 'capture' of the audit team. CPA Australia is also conscious of the fact that mandatory rotation has not been implemented internationally and there are practical and operations issues involved.

CPA Australia believes there are alternative options that can substantially reduce the perception of and potential 'capture' of the audit team over the life of the relationship, without requiring a complete rotation of the audit firm. Specifically, "..*where the company elects to reappoint an audit firm, it does so on the basis that the audit partner and senior audit manager are rotated within the audit firm."*

These measures coupled with more vigilant and active management of the relationship offer constructive and cost effective improvements for Australian business and their shareholders.

4.3.2. Company

4.3.2.1. Vigilance in managing the audit relationship

From the company's perspective, an audit that fails to display appropriate independence will not only diminish the value of the audit, but also has the potential to significantly detract from the company's value as stakeholders become wary of the official financial reports and uncertain of the company's true financial position and results.

Therefore, the business should to take a very active involvement in ensuring the audit relationship is managed appropriately to protect its integrity and at the same time ensure full and frank disclosure takes place. At present, anecdotal evidence suggests that companies have tended to rely on the auditors' to fulfill their professional requirements rather than undertake a more active management of the relationship.

4.3.2.2. Competency of boards of directors

While Boards of Directors bear ultimate responsibility for the corporate governance policies of the entity as well as the overall integrity and quality of a firms financial reports, no professional or competency requirements apply to individuals seeking to become a director. This situation can facilitate a board comprising little financial expertise, or reliant on the opinions of a limited number of members.

Limited professional guidance also calls into question the ability of the board to assess and ensure members are independent of factors that may distort their ability to act in the best interest of the company, including the company's shareholders, creditors and employees.

4.3.2.3. Audit committees

Audit committees though not mandated by ASIC are common amongst listed companies. These committees have a vital role to play in providing comfort to directors on areas of financial significance, as well as providing a link between internal and external audit functions, and the Board. CPA Australia endorses recommendations for audit committees to be established in all publicly listed companies and for other disclosing entities, and especially those recommendations outlined in the recent Ramsay Report.

However, recent events clearly indicate that the value of an Audit Committee is not achieved through its existence alone. The Board, through appropriate corporate governance policies, must support the audit committee in its activities, by ensuring it remains independent of management and that it is appropriately resourced.

4.3.2.4. Internal audit

A vigorous and competent internal audit function can help by not only policing the ongoing adherence to business procedures and controls, but by providing management with feedback on opportunities to improve the business systems, processes and internal controls.

The internal audit team also has the potential to provide a strong preventative influence simply by being seen to exist and be supported by the highest levels of management and the audit committee. Moreover, the internal audit function provides a mechanism to continuously check whether individuals within the firm are circumventing the control processes.

The competence of the internal audit team is a critical consideration. Its members must undertake continuous professional development and be subject to regular quality assurance reviews.

4.3.3. Standards

4.3.3.1. Fragmented approach to setting standards

Under the existing financial reporting framework, accounting standards are set by the Australian Accounting Standards Board (AASB) which operates under the guidance of the Financial Reporting Council (FRC). A second part of the FRC, the Urgent Issues Group (UIG) as the name suggests investigates, interprets and reports on issues and concerns impacting on standards. It submits recommendations to the AASB for approval.

Auditing and Assurance standards are developed by the Auditing & Assurance Standards Board (AuASB). The AuASB forms part of the Australian Accounting Research Foundation (AARF) which is jointly funded by CPA Australia and the ICAA through their Joint Standing Committee (JSC). AARF is also responsible for the Legislative Review Board (LRB) which is responsible for reviewing legislative developments and assessing their impact on existing standards.

Until 2000, the profession was responsible for developing all standards (accounting and auditing). The AuASB and AASB were subgroups of AARF that provided, amongst other functions, a single research secretariat. The current arrangements have enhanced accounting standards by providing them with the support of law. The trade off has been a separation of the development processes for accounting and auditing standards and with that, a loss of synergy between the two. A re-examination of the relationship, possibly involving structural changes, may be required to regain these synergies and thus improve the outcomes of both standard setters. This is suggested in CPA Australia's Model in which we recommend both standard-setting functions be the responsibility of one umbrella body.

4.3.3.2. Existence and appropriateness of standards

The complexity of business activity in Australia and internationally has increased rapidly and is continuing to evolve. In this environment, ensuring that appropriately framed standards are in place is an ongoing challenge that continues to strain the resources of the AASB, AuASB and the bodies that contribute to this process

Without appropriate accounting standards, professionals are forced to increasingly rely on alternative accounting practices that cannot provide the same level of detailed guidance and hence ensure consistency across the profession. At present the issues of valuation, accounting for financial instruments, reporting director and executive remuneration, involving options and revenue recognition for specialist instruments, are yet to be comprehensively addressed.

Auditors' ability to adequately review the company's treatment of these activities is therefore limited by the absence of the appropriate standards.

4.3.3.3. Harmonisation versus leadership and best practice

The push for increased international harmonisation is about establishing a common platform for standards around the globe. Adopting the international standards can mean Australia accepts lower standards Therefore, it is essential that such standards be reviewed in line with Australian public expectations.

In this latter function the profession, regulators and business have the opportunity to promote options for world's best practice, that support Australia's position within world financial markets and provides a sound basis for public confidence.

Tempering this opportunity is the concerns of business who perceive additional regulatory and reporting requirements as potentially increasing costs and therefore placing Australian business at a competitive disadvantage.

The ideal result would be accounting and auditing standards that capture the benefits of international harmonisation but facilitate best practice. Such as system would have the potential to attract investment into entities bound by Australian guidelines enabling business to capture a premium in shareholder value that reflects their sound accounting policies and processes.

4.3.3.4. Adoption of international standards requires resourcing

International harmonisation draws on the national standard setting resources of member nations through its ‘cooperative model’. Australians are well represented within the international bodies, a situation that reflects Australia’s active standard setting process as well as our desire to achieve a balance between international harmonisation and local expectations. While CPA Australia is eager to capture the advantages of international harmonisation, it is firm in its view that Australia must retain its standard setting culture that continues to generate individuals able to take on roles within international bodies.

Any moves to reduce the role and resourcing of local bodies must be considered against the need to ensure Australia’s representation and input into the standard setting process is not diminished by either the availability or caliber of individuals.

4.3.4. Enforcement of Standards

4.3.4.1. Difficulties in regulating / prosecuting ethical issues

Professional standards, and especially those covering ‘ethical standards’, that attempt to regulate intangible concepts such as independence will always challenge standard setters. Such concepts do not lend themselves to black and white definitions, and require extreme vigilance to ensure they are appropriately applied. Investigative and disciplinary procedures need to be appropriately and consistently interpret what falls within the ‘spirit’ of the rules.

4.3.4.2. Need for prevention as well as penalties

Given the difficulties in regulating professional standards, preventative measures must exist to ensure professionals are equipped to assess and respond to the professional and especially ethical challenges, and that these skills are regularly and rigorously assessed. The professional bodies (CPAA and ICAA) currently undertake this function. However ongoing professional development and peer or quality assurance reviews are not a prerequisite of maintaining one’s ASIC Company auditor registration. CPA Australia recommends the profession and ASIC seek opportunities to integrate development and assessment regimes to more effectively support and regulate performance of individuals and to deliver consistency of outcomes

4.3.4.3. Resourcing of investigation and disciplinary bodies

Just as business complexity has increased the demands on standards setters, it has also increased the demands on the bodies responsible for monitoring the application of standards and the investigation and disciplining of individuals. Implicit in this is the need for staff within these bodies to be appropriately familiar with these changing business practices.

There is anecdotal evidence to suggest that these bodies are inadequately resourced to monitor and investigate entities and accounting professionals on the scale required today. CPA Australia’s proposed model sees the investigation and disciplinary functions collapsed into two bodies, thereby consolidating existing resource commitments into a streamlined process and removing the current duplication of monitoring and inconsistency of outcomes.

4.3.4.4. Limited scope and duplication of disciplinary bodies

Under current regulatory arrangements, the process to obtain registration as a company auditor is based on the need to have completed more than 2,000 hours over five years in a relevant role. However, having achieved this hurdle, subsequent annual reviews of registration are less rigorous.

There are cases where auditors found wanting can escape or significantly reduce the punishment by either leaving the profession or ceasing their registration as an auditor. While they are punished to the extent that they can no longer practice as an auditor, they often can use their skills and experience in earning a living from associated activities. Hence, as constituted, the Companies Auditors' and Liquidators' Disciplinary Board (CALDB) and the disciplinary processes of the leading accounting bodies are limited in their ability to deliver just and equitable outcomes to all those that deserve to be punished. Furthermore, all three of these bodies need greater transparency in their processes.

4.3.4.5. Disclosure of professional accountability processes and outcomes

The current system also encourages a veil of secrecy around investigative and disciplinary processes. Under current arrangements, investigations are not disclosed, unless they result in disciplinary action. While CPA Australia respects the privacy rights of individuals, as well as the need for commercially sensitive information regarding third parties to be protected, it is keen to explore new options that disclose outcomes of public interest and impact. This may see progress on options that encourage public participation in, or access to, disciplinary hearings provided appropriate third party privacy protection is achieved.

The current method of disclosure also requires review as the arrangements for disclosing information through professional journals is inadequate due to the complexity and technical language employed.

4.3.4.6. Public interest reveals inconsistency and duplication of professional accountability processes.

At present the professional bodies and ASIC/CALDB share responsibility for monitoring and investigating entities and the professionals. It is a complex system with considerable overlap and no single body responsible for enforcing all relevant standards.

ASIC's role is confined to specific areas of Corporations Act but spreads across the accounting and auditing professions as well as the role of directors, and management. Each professional body is responsible for its members adhering to professional, auditing and financial reporting standards.

The current fragmentation and in some areas duplication of the monitoring and investigative functions undermines public confidence because it fails to provide a transparent, consistent process that is simple for the public to understand.

As the public seeks an increased level of direct accountability, the complexity of the system becomes a significant barrier. It encourages the public to believe the profession and Government are attempting to hide or obstruct their right to information which further undermines their willingness to trust the profession.

CPA Australia argues that our proposed model directly addresses this issue and provides improved clarity and definition for both the participants and the public. In the short term, application of CPA Australia's reform principles points to opportunities for bodies such as ASIC and CPA Australia to take steps towards further integrating their disciplinary functions, with due regard to their fundamentally different mandates

5. An Appropriate Regulation Model

5.1. Australia's regulation model v international alternatives

Please see attachment 2.

5.2. Achieving balance in regulation

Australia's regulatory model has evolved over time and many of the issues we currently face reflect this ad hoc growth. Under current arrangements there is obvious duplication of activity, a situation that implies participants are not confident of other's ability to fulfill their responsibilities.

There is no evidence to suggest the principles of the current model are incapable of providing appropriate regulatory control, but there is much to recommend a comprehensive overhaul of the existing range, scope and number of bodies involved. Moreover greater simplicity will go a long way to assisting the industry to provide a framework that can and is seen to deliver improved public accountability. CPA Australia argues that such an overhaul is required across the entire financial reporting framework, a recommendation outlined in *The Financial Reporting Framework – The Way Forward*.

Effective co-regulation focuses on a model that draws on the strengths of both the Government and the profession. While the range of models in place around the globe supports the fact that there is no perfect model, co-regulation has the potential to achieve a model that is far superior to either full government or full professional regulation.

Increased Government regulation cannot be achieved rapidly. It requires the development of a significant volume of legislation and regulations. Once in place these would require considerable additional resources to police and enforce. A further consideration is the ability to attract and recruit staff of appropriate experience and caliber. The professional bodies currently draw on fellow members to assist in the review and assessment of members. In doing so there is a depth of knowledge that is motivated by the desire to preserve the integrity and quality of the professional designation.

Increased self-regulation enhances the credibility of the professional body(ies) by increasing their significance within the framework. This enhanced credibility reflects across the entire operations of the professional body, supporting its mandate for discipline and increasing its ability to encourage member development. As a regulatory body's authority is whittled away by the demands of increased Government regulation, its relevance and hence authority declines. While Government may be able to replace the disciplinary functions, the voluntary participation in development activities is more difficult to replicate and encourage. Since development activities can prevent inappropriate practices, their value is significant and no less important than the model's ability to catch individuals once the transgression has occurred.

Regardless of how well a profession may regulate itself, it will always face the challenge of balancing member needs against the potential perception of 'protecting one's own'. This is where the transparency and openness of Government involvement provides critical support.

6. CPA Australia Recommendations

6.1. Adopt reforms outlined in CPA Australia's paper, The Financial Reporting Framework – the Way Forward.

CPA Australia's broad range of recommendations to improve public confidence and public accountability of the financial reporting framework are detailed *The Financial Reporting Framework – The Way Forward* – a copy is attached.

The following section (6.1) is an **extract** *The Financial Reporting Framework – The Way Forward*. The numbering is consistent with *The Financial Reporting Framework – The Way Forward*.

2.1 **Improved guidance and support for individuals involved in the preparation of financial reports**

The integrity of a company's financial reports is enhanced when they are prepared in a timely manner by competent staff applying financial reporting standards appropriately and according to robust and effective internal procedures.

CPA Australia proposes:

2.1.1 companies be encouraged to upgrade their corporate governance policies to more effectively support sound financial reporting, to specifically:

- encourage the right mix of competencies within the finance team;
- ensure clear and transparent internal procedures exist that clearly define the entity's:
  - attitude to risk
  - expectations regarding the integrity of data and specifically provide guidelines for appropriate accuracy, completeness and authorisation requirements
  - approach to safeguarding assets and the prevention and detection of irregularities
  - publish a code of ethics guiding staff, the business and their interaction with other parties.
- facilitate clear and consistent application of principled accounting standards.

2.2 **Improved guidance for and monitoring of a company's financial reporting processes and people**

Well-defined corporate governance guidelines supported by rigorous internal monitoring procedures encourage good financial reporting and would improve public confidence in a company and its financial reports. To sustain public confidence the company must adhere to the policies and the processes and also display a commitment to review and refine these over time.

CPA Australia proposes that:

2.2.1 The competency mix, financial skills and independence of Board members be subject to stronger guidelines and standards;

2.2.2 The recommendations pertaining to audit committees outlined in the Ramsay Report be adopted immediately, specifically:

- comprise a sub-committee of the full board made up of non-executive directors, that appropriately represents the breadth of activity undertaken by the business;
- is responsible for recommending the Board approve the financial reports;
- actively reviews the accounting standards that may affect the financial reporting processes or requirements of the entity;
- actively reviews the operations and recommendations generated by the internal and external audit functions;
- appoint and advise the Board on the adequacy of remuneration of external auditors.

2.2.3 The internal audit function be harnessed as vital to sustaining public confidence in a company's financial reporting system. To this end entities ensure their internal audit team members be subject to regular quality assurance reviews and undertake professional development.

2.2.4 he recommendations pertaining to internal audit outlined in the Ramsay Report be endorsed but more specifically, that an effective internal audit function should:

- report directly to the Audit Committee or, in its absence, the full Board of Directors of the company;
- work with the business's risk management arm to appropriately manage these concerns;
- have a clearly scoped charter that provides feedback to the audit committee or board and which clearly defines: the authority of access; the required interface with external auditors; the scope to recommend corrective actions and importantly, defines any specific limitations put on the operations or investigative authority of the internal audit function;

2.2.5 auditors and the profession review current practices and effectiveness of the management letter to provide companies with greater feedback on how to improve report preparation processes;

2.2.6 entities consider options for providing stakeholders with an appropriate assessment of their business and industry risks;

2.2.7 entities be encouraged to combine initiatives already in place with improving technology to develop their competitive advantage through more regular reports to stakeholders, specifically:

- quarterly reporting of results by publicly listed companies and other disclosing entities to stakeholders within 30 days of the reporting dates;
- that these additional reports be provided in an unaudited format, with the option for review or audit at the discretion of the entity;
- that the audit of the annual reports continue but that the results be made available within 60 days of the reporting date;
- that the half yearly report be provided in an unaudited format, with the option for review or audit at the discretion of the entity and it to be made available within 60 days of the reporting date;
- that all listed public companies and other disclosing entities be required to prepare a Management Discussion & Analysis Report (MD&A) to be included in the financial report along with the Directors' report; and

- publicly listed companies and other disclosing entities be required to maintain an up to date website with a designated minimum level of disclosures.

2.3 Improved external auditing of financial reports

The requirements for an individual to be a good auditor is an appropriate level of competence coupled with the appropriate real or perceived degree of independence. An effective audit is achieved where a good auditor is guided by appropriate standards and where the business and the auditor adhere to appropriate rules of engagement.

CPA Australia proposes that:

2.3.1 auditor competencies to be subject to more rigorous and regular assessment;

2.3.2 entities be required to more actively manage and report on their management of the risks to auditor independence;

2.3.3 the simultaneous provision of audit and non-audit services should be avoided where there is a perceived or real conflict;

2.3.4 where an audit firm has been engaged to provide non-audit services and audit services simultaneously, the audit firm must disclose in detail to the Board/audit committee:

- the engagement
- the risks
- their processes for managing risks to independence
- the benefits that are expected to result from the dual engagement

The Board must report these facts for all non-audit service engagements by the audit firm in the proposed quarterly report to stakeholders.

2.3.5 the complexities of the issues surrounding the provision of audit and non-audit services by the same firm be addressed on a principles basis through a specific professional standard and implemented by 31 December 2003;

2.3.6 audit committees to sign off audit engagement letter and be encouraged to publicly disclose its content including auditor remuneration;

2.3.7 companies be required to publicly disclose their reasons for reappointment, appointment or otherwise of an auditor, and for a comprehensive review to be undertaken and publicly disclosed every five to seven years to assess the need for audit firm rotation. This recommendation builds on the existing requirements under the Corporations Act designed to protect the position of the auditor. Under the Corporations Act the presumption is that an auditor, once appointed, is in fact appointed for life. The removal of an auditor of a public company requires application with disclosures to ASIC, who may then grant approval for the removal of the existing auditor;

2.3.8 where the company elects to reappoint an audit firm, it does so on the basis that the audit partner and senior audit manager are rotated within the audit firm;

2.3.9 the management letter be redirected to the Audit Committee in the first instance, to review and champion its implementation, and

2.3.10 stakeholders investigate an appropriate level of disclosure for the content of the management letter or an equivalent risk report generated by the company and independently reviewed/audited.

2.4 Improving performance through better development, application and monitoring of standards

The financial reporting system requires appropriate standards, guidelines and legislation that are constantly monitored, and where necessary revised, to ensure all remain relevant, efficient and effective. The system for developing these standards must facilitate an appropriate balance between the operational needs of participants and the public interest.

CPA Australia proposes that:

2.4.1 relevant bodies review and revise existing practice standards (eg accounting, auditing, corporate governance) to ensure they are relevant, reliable, effective and capable of providing guidance on evolving business practices;

2.4.2 the AuASB and AASB investigate opportunities to capture synergies in the development of standards and to provide standards that reflect the responsibilities of each;

2.4.3 international harmonisation be integrated into Australia's pursuit of best practice with respect to accounting, auditing and corporate governance standards;

2.4.4 the standards setters' focus on the decision-useful objective of financial reporting and give immediate attention to issues relating to measurement, in particular of financial instruments, prospective financial reporting, developing standards for Management Discussion & Analysis (MD&A) as well as improving the reporting of performance.

2.5 Improving performance through better professional support

An effective system must sustain the competency of and public confidence in the people involved. This requires ongoing, relevant development backed up by transparent, rigorous and independent processes that lead to consistent and appropriate disciplinary outcomes.

CPA Australia proposes that:

2.5.1 the profession and ASIC integrate development and assessment regimes to more effectively support and regulate the performance of individuals and to deliver greater consistency of outcomes;

2.5.2 whistleblower protection be expedited to provide greater support to professionals.

The following recommendations are specific to the terms of reference provided by the JCPAA.

6.2. Capture and Build on the Strengths of the Current Co-Regulation Model

As outlined in CPA Australia paper, the proposed model recognises the synergies between Government and the profession. In particular the credibility that comes from legislative support and enforcement of standards, coupled with the preventative and developmental focus of the professional associations.

The new model provides a clear option for the profession and Government to capture these strengths and to look to embrace further representative bodies in a similar relationship, for example the AICD and AIIA. The CPA Model is designed to accommodate any professional body able to provide appropriate rigor to its membership and willing to participate in a common standard setting, monitoring and disciplinary framework.

CPA Australia acknowledges that the new model is an aspirational but nonetheless achievable benchmark we can strive towards. In the immediate future, CPA Australia recommends the adoption of the identified principles. When applied to the current framework, they clearly indicate a number of opportunities for immediate reform such as stronger integration of standard setting, monitoring and disciplinary processes that are consistent with the longer term benchmark model.

6.3. Community Support for Better Auditing - Professional Indemnity

CPA Australia has long advocated the introduction of uniform legislation that will result in professionals only bearing the risk in a claim clearly resulting from their actions.

A source of increased professional indemnity premiums for accountants has resulted in numerous instances from the accountant becoming liable to pay the whole of a judgement debt because of the notion of joint and several liability of defendants. This has been of particular importance in large corporate claims where the accountant/auditor has been the defendant with insurance.

In two states of Australia, namely New South Wales and Western Australia, occupational limitation of liability legislation exists in Professional Standard Acts. The effect of such schemes is to cap levels of liability to amounts set out in the particular scheme registered by an occupational association such as CPA Australia. However such schemes may themselves be of limited value given that they do not address the previously mentioned notion of joint and several liability, nor the effect of Commonwealth legislation such as the Trade Practices Act. A member could have a limited liability under the New South Wales Act whilst having an unlimited liability arising from the plaintiff pleading a breach of the Trade Practices Act.

Uniform legislation with the States and the Commonwealth is required to overcome these difficulties.

Likewise proportionate liability linked to the abolition of joint and several liability of defendants seems to CPA Australia to be a major reform which could lead to a return to a reasonable market for professional indemnity insurance, whilst continuing to afford a plaintiff a reasonable expectation of recovery. Like any profession, accountants are willing to shoulder their responsibilities for what their action may have caused by way of damages. However, on the basis of equity, CPA does not see that its members should bear inequitable liabilities for others failures simply on the basis of an outdated doctrine of joint and several liability of defendants. It is imperative that the current insurance market failure be addressed by such an initiative. Indeed, insurers would, in our understanding, see such as a positive step to restoration of the market. Without such reform business and the public interest will suffer further.[6]

[6] Inquiry into the Impact of Public Liability and Professional Indemnity Insurance, CPA Australia Submission May 2002

7. Conclusion

CPA Australia believes the current focus on auditors and their clients provides a unique opportunity for the profession, Government and industry to show leadership in developing a financial reporting framework more capable of fulfilling today's public accountability expectations.

CPA Australia welcomes the JCPAA inquiry and the opportunity it provides to raise, discuss and progress initiatives that can make a lasting and positive impact on the performance of this framework. CPA Australia has identified a range of issues in *The Financial Reporting Framework – The Way Forward* which are impeding the performance of the current framework. This paper outlines a series of reform principles with the potential to call a halt to the ad hoc evolution of the financial reporting framework and ensure future reforms build towards a clear and shared goal.

In addition, CPA Australia has identified a series of supplementary reform options to address specific issues that have come under considerable public scrutiny. In particular, CPA Australia is advocating an increased level of vigilance as well as disclosure from all participants in respect to audit integrity and specifically auditor independence.

CPA Australia's proposed reforms directly address the need for increased transparency and credibility in financial reporting in Australia. They will also enhance public accountability and confidence.

CPA Australia believes the current co-regulation model should be retained, but also that it requires a considerable overhaul if it is to meet public interest going forward. Again, CPA Australia's proposed reforms provide an opportunity to more effectively recognise the strengths of Government and professional regulation and in doing so build a framework that is superior to that based on either in isolation.

8. References

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9. Glossary of Terms and Acronyms

Acronym	Name	Function /body of….
FRC	Financial Reporting Council	Gov't
AASB	Australian Accounting Standards Board	Gov't
PSC	Professional Standards Committee	CPAA
AuASB	Auditing and Assurance Standards Board	Professional bodies
UIG	Urgent Issues Group	FRC
AARF	Australian Accounting Research Foundation	Professional Bodies
LRB	Legislative Review Board	AARF
ASIC	Australian Securities and Investments Commission	Gov't
CALDB	Company Auditors and Liquidators' Disciplinary Board	Part of ASIC
CPAA	CPA Australia	
ICAA	Institute of Chartered Accountants in Australia	
JSC	Joint Standing Committee	Professional bodies
APRA	Australia Prudential Regulation Authority	Gov't
ASX	Australian Stock Exchange	Listed
CoEs	Centres of Excellence	Member think tanks within CPA
Big 4	Ernst & Young PricewaterhouseCoopers Deloitte Touche Tomatsu KPMG	
ANAO	Australian National Audit Office	Gov't
QA	Quality Assurance	Reviews of CPAs
CPD	Continuing Professional Development	CPAs are required to undertake 120 hours per triennium

10. Attachments

10.1. Attachment 1 – Terms of Reference

Review of Independent Auditing by Registered Company Auditors

With the spate of recent noteworthy corporate collapses both within Australia and overseas, the JCPAA wishes to explore the extent to which it may be necessary to enhance the accountability of the public and private sector auditing.

In particular the Committee is keen to determine where the balance lies between the need for external controls through government regulation, and the freedom for the industry to regulate itself.

10.2. Attachment 2 – Australia's Regulation Model Compared with International Alternatives

Extract from SUBMISSION TO THE TREASURY COMMITTEE' S INQUIRY INTO THE FINANCIAL REGULATION OF PUBLIC LIMITED COMPANIES BY THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES - Appendix 4: Overview of the audit framework for listed companies in the USA and the UK
Description of Australian practice provided by CPA Australia.

	U.S. Practice	*U.K. Practice*	*Australian Practice*
Where does the authority come from?	The requirement for an audit for listed companies derives from the rules of the SEC, with which all companies listed on U.S. stock exchanges must be listed. The SEC has various rules governing the auditors (e.g. the independence rules) and the companies. These effectively sit on top of (and do not replace) those of the AICPA[7]. While not all auditors are required to be members of the AICPA they are required to be licensed by a State Board of Accountancy. US ethics standards are more rules based than in the UK.	The Companies Acts require all non-small companies, private and public, to be subject to audit. The DTI has the power to regulate auditors, but delegates it to particular accountancy bodies (the Recognised Supervisory Bodies). These report to the DTI annually on their activities The FSA's Listing rules, which apply to listed companies, do not have provision for any direct oversight or interaction with auditors. UK ethics standards are more principles/ framework based than in the UK.	Under the Companies Act, a Company, registered scheme or disclosing entity must have the financial report for the financial year audited and obtain an auditor's report. A small proprietary company may gain relief from an audit in certain circumstances. A disclosing entity must prepare a half-yearly report, which can either be audited or reviewed.

[7] American Institute of Certified Public Accountants

Requirements to practice as an auditor	Individuals who wish to practice as public accountants, which includes auditing, must be qualified CPAs and be licensed with the relevant State Board. These have varying education, CPE and experience requirements If an AICPA member or firm audits an SEC client, the individual or firm must join the AICPA's SEC Practice Section. In addition, auditors of companies listed on the main stock exchanges have to be enrolled in a peer review program compliant with AICPA standards and subject to oversight by an independent body.	To be able to sign an audit report, an individual must be a qualified member of one of the RSBs (the ICAEW and four others) and have a practising certificate with one of those bodies. These have various experience and CPE requirements Firms must be registered with one of the RSBs Registered audit firms must, by UK and EU law, be majority owned by individuals qualified to be auditors	To gain registration as a Registered Company Auditor, the person must be a member of the ICAA, CPA Australia or any other prescribed body, hold a prescribed qualification, have prescribed practical experience and be able to satisfy ASIC that the person is capable of performing the duties of an auditor and otherwise be a fit and proper person
Accounting standards	The SEC has authority to establish standards for listed companies, but in fact relies on the FASB (which took over the role from the AICPA in 1973). This is a private body, run by trustees appointed from a variety of stakeholders, and paid for by companies, banks, etc and the AICPA's Research Association. Through various Bulletins, the SEC has informed the accounting profession of its opinions on accounting and reporting issues. In addition, SEC staff attend meetings of the FASB (including the EITF[8]) and technical committees of the AICPA.	The Companies Acts include certain accounting requirements derived from EU law. They also recognise accounting standards issued by the ASB (which took over the role from the ASC[9], set up by the profession, in 1990). The ASB is a private body, run by a board appointed by the FRC, and funded by the FRC. The FRC itself has a board consisting of various stakeholders and is funded by the profession, companies, banks, etc and the government. ASB's Urgent Issues Task Force issues non-mandatory Abstracts on urgent issues.	Accounting Standards are set by the AASB, which is responsible to the FRC. The FRC is a statutory authority reporting to the Federal Treasurer. Accounting Standards have the force of Law under the Corporations Act. The Urgent Issues Group, which is responsible to the FRC issues Abstracts known as Consensus Views which are mandatory for members of the profession to follow.

[8] Emerging Issues Task Force
[9] Accounting Standards Committee

	Accounting standards are more rules based than in the UK. US reporting timetables are generally faster than in the UK.	Accounting standards are more principles and "substance over form" based than in the US. UK reporting timetables are generally slower than in the US.	
<u>Auditing Standards</u>	Standards are issued by the Auditing Standards Board of the AICPA. The ASB is a senior technical committee of the AICPA. Audit reports state, inter alia; "We conducted our audits in accordance with auditing standards generally accepted in the United States of America" and that the financial statements "fairly present". The AICPA's Code of Professional Conduct requires an auditor to follow these statements in conducting an audit. Auditors, whether members or not members of the AICPA, are also required to follow these auditing standards by their State Board of Accountancy.	Standards are issued by the Auditing Practices Board. This was originally set up by the accountancy profession but its successor body is now part of the new independent regulatory framework under the Accountancy Foundation. Audit reports state, inter alia, "We conducted our audits in accordance with auditing standards issued by the Auditing Practices Board" and that the financial statements give a "true and fair view".. Audit Regulations issued by the RSBs require that auditors adhere to auditing standards.	Accounting standards are more principles and "substance over form" based than in US. Auditing Standards and Guidance Releases are issued by the Auditing & Assurance Standards Board, which is a responsibility of AARF, which is a joint venture of CPA Australia and the ICAA Auditing Standards are mandatory for members of the professional bodies but they do not have legal status. Audit Reports must state that the auditor has formed an opinion that the financial report is in accordance with the Law including compliance with accounting standards and providing a true and fair view. If 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. Further the auditor must report on any defect or irregularity in the financial report and any deficiency, failure or shortcoming in respect of the conduct of the audit, sufficiency of records and whether the entity has kept other records and registers as required by Law.

Quality review of accounts	The financial statements of all first-time share issuers receive a thorough review by the staff of the SEC. Repeat share issuers are reviewed on a selective basis. If selected, reviews of registration statements usually trigger a simultaneous review of annual and quarterly reports. SEC staff also performs periodic reviews of accounts filings.	The FRRP[10] is a private body, run by a board appointed by the FRC, and funded by the FRC (see above). The FRRP does not proactively review accounts but will investigate complaints about accounts of public and large private companies. It has, by law, the power to require revisions to accounts.	ASIC conducts annual reviews of a sample of financial reports with a focus on a limited range of issues.
Quality review of auditors	The SEC Practice Section of the AICPA has a peer review programme, mandatory for AICPA members that audit SEC registrants. However, the SEC does not mandate that a firm join the SECPS. The SECPS requires member firms to adhere to quality control standards established by the AICPA.	All registered auditors are monitored by the JMU[11], an independent body of full time inspectors employed by the ICAEW, ICAS and ICAI. The Audit Regulations, to which all registered auditors must adhere, require arrangements to be set up to ensure that quality is maintained.	All members in public practice are subject to a regular Quality Review Process conducted by the professional bodies, namely CPA Australia and the ICAA.

[10] Financial Reporting Review Panel.
[11] Joint Monitoring Unit

Disciplinary arrangements	The SEC can instigate legal action or administrative action (e.g. prohibition for a period). Member firms of the SECPS are required to report litigation alleging deficiencies in the conduct of an audit of an SEC client to the Section's Quality Control Inquiry Committee (QCIC). The activities of the QCIC are overseen by the Public Oversight Board and the SEC. During the period 1991 to 2001, 261 SEC related cases involving AICPA members were opened. Of those 112 are in process, 105 were closed with violation findings, and 44 were closed with no violation. These cases involve auditors and company personnel.	The initial complaints, either direct or from the committees overseeing the JMU's monitoring work, are investigated by the Institute, though in the case of public interest cases, they can be referred to the Joint Disciplinary Scheme (separately constituted but funded by the ICAEW and ICAS). The government, through the DTI, will investigate separately where there are suggestions of breach of law (these investigations are usually of the company, but the auditors or individual accountants may be covered by the enquiry). Typically, around 2000 complaints per annum (about all aspects of a member's behaviour) are dealt with by the ICAEW. Approximately 65% are dismissed or there is no prima facie case, 10 % are settled through, typically, cautions, fines, or exclusions and the rest are settled through conciliation.	ASIC investigates complaints received from any source and where the evidence is compelling that an auditor may have transgressed the Corporations Act, the case is referred to the Companies Auditors & Liquidators' Disciplinary Board (CALDB) Breaches of Professional Standards and adverse findings of the CALDB are referred to the internal disciplinary procedures of the professional accounting bodies. The outcomes of these disciplinary hearings are published in the monthly journals of the professional bodies.