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Sent: Sunday, 11 August 2002 5:42 PM
To: Cunningham, Adam (REPS)
Subject: RE: Indep Audit
11 August 2002

Mr Adam Cunningham
Inquiry Secretary
Review of Independent Auditing by Registered Company Auditors
Joint Committee on Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Mr Cunningham,

Thank you for your letter dated 26 July 2002 in respect of the supplementary questions, which the Inquiry Committee would like me to address.

1. Accountability of Accounting Firms: What is your opinion on the following proposals?

- *The Corporations Act be amended to require accounting firms that undertake audits of publicly listed companies be incorporated and publicly listed.*

Accounting firms have changed in their scale and mode of operation. They no longer conform to community expectations of partnerships. They are large in scale and it would be true to say that in few of the large partnerships is there any prospect of all of the partners (even equity partners) knowing all other partners within the same partnership. Therefore, reverting to incorporation on the basis of scale would seem sensible. Incorporation as a company would also permit limited liability and this too would be welcome particularly by practicing auditors.

An additional advantage of auditors becoming publicly listed companies is that there would be a much greater sense of transparency and accountability of the organisation to the wider community. Publicly listed companies have continuous disclosure requirements and they are also required to publish financial statements. That is to say, there is a great deal more transparency about a company compared to a partnership. One would know how much substance is behind audit company A than audit partnership A.

There are, however, some significant disadvantages or potential costs. Firstly, audit firms are by reputation highly volatile in income streams and if listed on a stock market would be categorised, if my understanding is accurate, as high risk organisations. Is it advantageous for an economy to have high-risk organisations involved in the audit process listed on a stock exchange and subject to bankruptcy?

Perhaps more problematic is the fact that if an auditor is a listed public company then anyone including audit clients are free to buy and own shares of that company. If one is to avoid the obvious conflicts of interests of auditing one's owner this immediately places limitations on who can audit whom. It is theoretically possible for a large Australian listed company to own shares in say four or five audit firms. The potential effect on who might then be their auditor becomes a

serious issue.

To my mind the major advantage of auditors becoming listed public companies would be the greater extent of transparency and accountability available to the wider community. Perhaps this can be achieved via other means.

- *The Corporations Act be amended to require firms undertaking audits be publicly listed companies and be required to lodge an independence performance report to the Regulator (ASIC) every 12 months. The report would provide details of the outcome of each audit including details of mechanisms in place to ensure the independence of the external audit function. Additionally ASIC would have the power to investigate any matters arising from the report and to take action to rectify any deficiencies or matters of concern.*

The above would be a positive step forward and perhaps my answer in the public hearing was flawed because I did not understand the question or properly consider the issue addressed in this matter.

The concept that auditors would be accountable to some external body in respect of issues of independence and conflicts of interest is a necessary part of the way we should proceed in this current crisis. At present there is virtually no transparency or accountability by audit firms with regard to conflicts of interest or independence decisions. Worse, is that the people who make the decisions in respect of conflicts of interest and independence invariably, directly or indirectly, benefit commercially from the outcome of their decisions. Typically accountability occurs where there is a corporate failure and a rigorous investigation of the auditor's role in respect of that business firm. On those occasions evidence is gathered on the quality of the audit and is assessed by a person or persons independent from the audit. However, this is a relatively clumsy method of ensuring transparency and accountability on the quality of the audit.

While an independence performance report supplied to the Regulator is a useful step, I suspect it might be ineffective because it would be compiled in a way not to cause embarrassment or "discomfort" to the audit firm. In addition to be effective as a source of information it would need to be prepared by someone with no commercial interest in the effects that the report might have. Hence I would return to the proposition that audit firms need to appoint independence boards. An independence board might in turn provide such aggregated data to ASIC on an annualized basis and perhaps more frequently if cases occur which cause concern.

If there is to be an annual independence performance report supplied to the regulator, I would suggest as an additional requirement that where independence protocols (as developed possibly by ASIC or by the AuASB or a combination of the two) are developed where there is a breach of those protocols that this would be immediately transmitted to the regulator as a "exception report".

2. Corporate Governance

- *What sort of audit related matters do you believe need to be considered by companies and what framework should companies put in place to support these assessments.*

Audits came into existence as voluntary actions by the management and boards of companies in the latter part of the nineteenth century. They exist because they can add value to the share price

and lower the cost of capital to the company both in respect of equity and debt. Therefore, a company including both the board of directors and the management have incentives for good quality auditing. Management have competing incentives to try and “capture” the audit process so that the performance and position of the company might appear more favourable than would otherwise be the case.

From the perspective of the board of directors and/or audit committee of the board there are several audit related matters that require careful consideration. Specifically three matters need to be considered.

At the outset of an audit engagement the auditor choice decision needs to be carefully considered and it is recommended that best practice for incorporation is (1) the tendering of audit engagements on a competitive basis with criteria for competency, independence and price; (2) that protocols be put in place in respect of communications between management and the audit firm. These protocols would inhibit or preclude excessively “comfortable” relationships being developed between individual audit staff and management of the auditee; (3) that direct communications between the audit committee/board of directors and the audit firm be established (rather than “filtered” through the management of the auditee) so that issues and processes can be discussed directly with the audit committee/board of directors rather than via management.

It would be my suggestion that all publicly listed companies compulsorily have a nominated audit committee. In some circumstances this may well be the full board of directors, however, if a company wishes to be publicly traded and to put itself in the marketplace in such a public way then one of the costs of this benefit is that an audit committee be established. An audit committee may involve those who are entirely outside the board of directors to bring expertise into a case where an auditee is relatively small but at all times the audit committee must comprise a majority of persons who are not executives of the auditee.

- *What more needs to be done to ensure that directors and management take more responsibility for ensuring auditor independence?*

Auditor independence is best guaranteed from within the audit firm. It is and should be their responsibility to ensure that controls are in place such that the audit firm acts independently. Having said that, there are protections a board of directors can put in place to ensure that management has much less opportunity of “capturing” the audit process. These have been suggested and noted above. This, however, is not a sufficient set of conditions to ensure auditor independence and more far reaching solutions from the audit firm perspective are required.

- *Will the currently released professional independence standard (F1) assist and improve the culture of independence in audit firms and to better enable them to recognise potential threats in the process?*

The short answer to this question is yes. F1 is better than what it superseded. However, will it be comprehensive and effective as a much higher standard and the answer to that is perhaps but not with certainty. The real way of ensuring independence is to create a different set of structures where there is both objectivity and transparency in respect of decisions that impinge upon independence. Audit firms by and large are organisations that lack transparency or at least they have lacked transparency in the recent past. We see some signs of change occurring. The extent to which change is effective, ongoing and sustainable will affect culture within the firms. There is still a considerable amount of work to be done.

- *What reforms do you propose so that those auditors are compelled to compete not just on price but also in respect of their governance particularly auditor independence?*

My views on this particular issue have been well documented. Independence is one of the two pillars of auditing. The other pillar being audit competence. To my mind audit independence comes from the presence of structures and processes that are transparent and objective. By transparent I mean that stakeholders need to have access to issues that relate to independence in a timely fashion (having regard for the need to protect client confidentiality) and objectivity means that decisions must be taken by people who receive NO commercial benefit from the outcome of their own decision making. The present structure within audit firms does not guarantee this. Indeed it does not even come close to ensuring that it might happen.

3. The Role of the Auditor

- *Is there a need to enhance the statutory role of auditing by for example introducing changes to dilute the growth of commercial/service provider relationships between an auditor and client? What reforms do you suggest?*

There are significant economic advantages to the joint supply of audit and auditor provided non-audit services. These economic benefits translate to benefits to the shareholders in many cases. For example, if a company needs advice in respect of the calculation of tax liability who else could more efficiently and effectively (and with minimal time lag) provide this information but the auditor. However, there are also taxation consulting opportunities that would represent a threat to independence. For example, if the tax partner of an accounting firm recommends a very aggressive tax position and the audit partner of the same firm having seen the tax policy in place wishes to add a significant provision for the possibility of this tax program being outlawed there is a clear conflict between the two coming from within the accounting firm. This is a threat to independence. The example suggests that there is considerable subtlety in the potential threats to auditor independence so banning a particular type of auditor provided non-audit services is unlikely to be effective. In addition the quality of the audit firm could deteriorate if there is a wholesale ban or dramatic limiting of auditor provided non-audit services. The example I gave in my original submission illustrates this. Consider, for example, an audit firm that to ensure high integrity information hires its own actuarial expertise. However, given the number and type of audit engagements the actuary hired is unable to be used full-time. So to ensure that the actuary is challenged both in quality and quantity auditor provided non-audit services of an actuarial type might well be usefully sold to the audit client.

These are the types of things that suggest that a relatively “crude” set of regulations in respect of joint supply of audit and auditor provided non-audit services is unlikely to be economically efficient and indeed may do more damage than good to the quality of auditing than it does to the independence of the audit.

As I have suggested previously typical in such important yet subtle ways a higher regulatory environment will lead to substantial economic inefficiencies and potential significant damage to the process. This is best illustrated by the remarkably clumsy proposal to enforce auditor rotation.

- *Has the statutory role been given adequate protection in the self-regulatory environment?*

The profession will argue that they do not have a self-regulatory environment but have a co-regulatory environment. By and large the current system can be more reasonably described as

self-regulation. My view is that the profession and in particular the audit firms have brought on their own potential destruction by not protecting the primary service they had provided the audit with enough care and diligence. As indicated elsewhere, auditing only has value, only affects share price, and it only affects the cost of capital if it is both competent and independent and SEEN to be competent and independent. With incentive structures that see audit partners rewarded for selling non-audit services and where non-audit services are seen to be profitable and audits seen as “loss-leaders” the destruction of the integrity and quality of the audit service has been expected and indeed was predicted. The profession needs to regain the confidence of the capital market and other stakeholders. This it must do in large part from itself because of the subtleties and complexities outlined elsewhere. However, there is a public good that needs to be protected and some degree of mandated control needs to be put in place in a way that deals with not just extreme cases or easily measured problems but realistically more subtle and less extreme threats to independence need to be captured and resolved or minimised.

- *What other measures do you see as relevant to closing the expectation gap?*

The accounting profession has generally described the audit expectation gap as a failing of the users of accounting reports. To my mind if we accept the existence of Australia as a market economy I largely reject this assertion. I have used the following example before: “Think of the simple example of a motor vehicle company that produces a three-wheeled car with a top speed of 20 kilometres per hour but tips over when placed under strain. In response to customer complaints about the quality of the car the manufacturer might either (1) say the car is fine and the consumer expectations are unreasonable; or (2) produce a product that fits the consumer needs.” The users of financial services appear not to like the product in the form of the audit opinion when the auditee is under strain typically corporate distress or failure. The nature of audits has changed. If one goes back into the history of audit the major focus of audits in the late nineteenth century was on fraud detection. This has now passed and audits now provide reasonably high levels of assurance that in a materialistic respect the financial statements are in accordance with accounting standards and present a true and fair view. This may not be the product that consumers such as shareholders want. So while it might be described as an expectation gap it might also be described as a product quality gap. There are a number of possible strategies all of which involve some degree of reassessment of whether the “one size fits all” audit product needs to be changed and enhanced with perhaps a range of different audit products with different levels of assurance and possibly different levels of coverage of aspects like fraud or corporate failure prediction. This would involve a significant change to the current role of auditing and is probably outside the scope of the present discussion.

Yours sincerely,

K.A. Houghton
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