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Mr Bob Charles, MP
Chairman
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA, ACT, 2600.

22 May 2002

Dear Mr Charles,

Review of Independent Auditing by Registered Company Auditors

The Auditing & Assurance Standards Board (AuASB) of the Australian Accounting Research Foundation (AARF) welcomes the opportunity to provide a submission to the Joint Committee of Public Accounts and Audit (JCPAA) 'Review of Independent Auditing by Registered Company Auditors'.

A primary role of the AuASB is to develop high quality professional standards and related guidance for auditors and providers of other assurance services, as a means to enhance the relevance and reliability of information provided to users of audit and assurance services. As such, the AuASB has a continuing interest in matters relating to auditor independence in both the public and private sectors.

The AuASB believes that Australian Auditing and Assurance Standards are amongst the best in the world. The Board has had a commitment to harmonisation with international auditing and assurance standards since 1995. As a result, Auditing and Assurance Standards in Australia are at least equal to and in a number of cases more rigorous than the equivalent International Standard on Auditing (ISA). Additionally, Australia has taken a lead role in many International Auditing & Assurance Standards Board (IAASB) projects, including research projects.

Representation on the AuASB comes from both the private and public sectors, together with from academia and from financial report users more generally, so that the perspectives of a wide range of constituents are able to inform the activities of the Board.

In the view of the AuASB, the focus on auditor independence that has emerged from concern over recent corporate collapses in Australia needs to be widened to include the corporate reporting framework more generally, and the responsibilities of those

charged with the governance of the entity. There is a need to consider all aspects of the corporate governance framework and a wider reporting model incorporating a broader range of information than is currently the case, together with the provision of assurance on such information. There is a need to address communication and education of financial reporting and auditing issues to users of financial reports and to improve current consultative processes.

Many of these issues are within the AuASB's mandate and are in various stages of progress within the AuASB's work program. In addition, a major project on audit risk is soon to be undertaken internationally, which will flow through to Australia, with a consequential further improvement in various Auditing Standards and guidance. The AuASB is monitoring this and other international developments closely, through its involvement with the IAASB.

These and other issues are pursued in more detail in the following Attachment. However we would like to emphasise the following points:

- In our view, there is no systemic evidence from recent or previous corporate failures or research that a problem exists with audit quality. We would welcome further research and believe that it is important that the findings of investigations into current corporate collapses are considered carefully in any proposed changes to the financial reporting and auditing frameworks.
- The AuASB believes the existence of active and effective audit committees provides an excellent market-based mechanism to strengthen corporate governance and to oversee the audit function in companies. Other mechanisms to strengthen corporate governance exist, some of which are discussed in the Attachment to this letter, and are worthy of consideration.

Please do not hesitate to contact either myself or Mr Richard Mifsud at the Australian Accounting Research Foundation if you have any queries in relation to this response, or if there are any matters arising which you would like to discuss further. We would be pleased to provide more information on these matters should you be interested.

Yours sincerely,

W.R. Edge

Chairman

Auditing & Assurance Standards Board

ATTACHMENT

Submission to the Joint Committee of Public Accounts and Audit (JCPAA) on the 'Review of Independent Auditing by Registered Company Auditors'

Prepared by the Auditing & Assurance Standards Board (AuASB) of the Australian Accounting Research Foundation (AARF)

1. THE ROLE OF AUDIT

The AuASB feels it is important to gain perspective on the events associated with the announcement of the Review by the JCPAA. The Terms of Reference acknowledge recent corporate collapses as being part of the motivation for the Review. However, it is important to note that company collapses have many causes and there is no evidence from either prior failures or from research, that a lack of auditor independence or audit quality is systemically involved. Informed investors are cognisant of the risk of their investment and investment strategy and seek and use information from many sources. Many parties play a direct or indirect role in the external reporting of corporate performance and there is a real risk that more is expected of auditors than they can be reasonably expected to deliver.

The risk of poor corporate performance, including failure, is an element of the commercial risk/return relationship. Investors and lenders choose the level of risk to which they subject themselves and it is their responsibility to manage that risk as appropriate. Sound investment principles through diversification and other strategies are well documented and available to investors and potential investors. Auditors cannot and should not be held accountable for investment and lending decisions subsequently proving to have been inopportune, merely by virtue of their association with a particular entity.

2. THE CORPORATE REPORTING FRAMEWORK

Audited financial reports, whilst an important accountability mechanism, are only a subset of the information available to existing and potential investors and debt holders in their decision-making. Too often, misunderstanding and unrealistic expectations of the auditor's role within the corporate reporting framework occurs. There is a danger that the role of others, for instance management and the Board of Directors, audit committees, bankers, analysts, regulators and accounting standard setters, is overlooked in too quickly identifying corporate failure as audit failure. Even in the few cases where audit failure is determined to have occurred, it does not necessarily mean that corporate failure follows.

3. WHAT AN AUDIT CAN AND CANNOT ACHIEVE

An audit engagement is designed to provide a high but not absolute level of assurance on a financial report. 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 of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. Further, the audit is largely retrospective, concentrating on past information, and it does not provide assurance regarding future financial position or results of performance.

Too often, more is expected of the auditor than can be reasonably be expected. The opinion an auditor provides is based on knowledge at his or her disposal at the time. Judging situations with the benefit of hindsight can make it on occasions very difficult to evaluate whether the opinion was justified at the time it was formulated. Fraud, particularly if perpetrated by management, is one area that is particularly difficult for the auditor to detect and report upon. The auditor's responsibility in this area needs to be balanced against management's responsibility to provide an appropriate culture and put in place internal control mechanisms to prevent and detect fraud. The AuASB has on its work program for 2002 the second part of a high priority project to further consider the Auditing Standard dealing with fraud and error, in tandem with international developments in this area. The first part of the project was completed earlier this year when AUS 210 "The Auditor's Responsibility to Consider Fraud and Error in an Audit of a Financial Report", and AUS 218 "Consideration of Laws and Regulations in an Audit of a Financial Report", were issued.

4. AUDIT QUALITY

Many thousands of audits of financial reports are conducted annually, with further audits or reviews of interim financial statements for disclosing entities. Of these, an extremely low proportion has ever given reason to question the quality of the assurance provided. This is in no small part due to the strength of both the auditing profession and Auditing and Assurance Standards. Inquiries currently in process into recent high profile corporate collapses in Australia and any ensuing litigation will determine whether or not audit quality was a factor in these cases.

The merit of allowing market-based mechanisms within the market for audit services to work actively to induce desired behaviour should not be underestimated. Imposing rules tends to create rule-based behaviour that encourages economic inefficiency, adding to the costs to be borne by all shareholders and eventually by consumers of goods and services. Carefully enunciating the costs and benefits of proposed legislative or regulatory change is important to evaluating any case for change, in the AuASB's view.

5 Public and Private Sector Standard Setting

In many areas, the AuASB has issued Standards and guidance on specific audit and assurance related matters that have later become the basis for an international auditing standard or guidance. For instance providing guidance on moderate assurance is a project for which Australia has taken the lead and, although not completed, the project at international level is well on its way to achieving issuance of an International Standard on Assurance Engagements. Developing guidance on the audit implications of electronic commerce, a document recently adapted from the Australian version (AGS 1056 “Electronic Commerce: Audit Risk Assessments and Control Consideration”) and issued by the IAASB as an International Auditing Practice Statement, is another example. These and many other examples that could be cited, cumulatively demonstrate in the setting of Auditing and Assurance Standards the leadership role taken and contribution made by Australian representatives connected with the peak International standard setting body.

Further, all Australian Auditing and Assurance Standards and Auditing Guidance Statements are for use by audit and assurance providers engaged in both the public and private sectors. Within the body of the AuASB pronouncements more generally, two Auditing and Assurance Standards relate primarily, but not solely, to engagements typically carried out by auditors in the public sector. AUS 806 “Performance Auditing” and AUS 808 “Planning Performance Audits”, as their titles suggest, deal specifically with performance audits. Additionally a project on “Compliance Auditing”, dealing with assurance of probity, particularly in a public sector setting, is on the AuASB’s work program for 2002.

In addition to globally oriented Auditing and Assurance Standards, the AuASB is active in recognising and understanding the Australian business and regulatory environment and providing guidance to auditing and assurance service providers on specific industry and regulatory issues that arise. The Auditing Guidance Statement for auditors of authorised deposit-taking institutions that was issued in connection with the introduction of the Australian Prudential Regulation Authority (APRA) Prudential Standards is an example of such industry-specific guidance. Guidance for auditors under the reporting requirements of the Prudential Standards for General Insurers will be issued later this year.

The AuASB is also active in issuing timely material in relation to corporate governance matters generally. In 2001, it revised the *Audit Committees Best Practice Guide*², a publication drawn on heavily by Professor Ramsay in his

2 Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, issued jointly with the Australian Institute of Company Directors and the Institute of Internal Auditors - Australia, *Audit Committees: Best Practice Guide* (2nd edition, 2001).

3 Auditing & Assurance Standards Board of the Australian Accounting Research Foundation with the support of the Institute of Internal Auditors-Australia, and the Australian Institute of Company

October 2001 Report, *Review of the Independence of Australian Company Auditors*. Professor Ramsay endorsed many of the practices described in this Guide and recommended that several be required of listed companies in relation to their audit committees. This Guide has been well received in the market place and provides an excellent source of reference for audit committee members and others in achieving sound governance of companies in which they have an interest.

A similar publication for use in the public sector *Best Practice Guide: Local Government Entity Audit Committees and Internal Audit*³ has been similarly well received. The AuASB is of the view that appropriately constituted audit committees are an effective auditee corporate governance mechanism that will enhance audit quality and provide internal oversight of audit related issues. The AuASB concurs also with the desirability of most audit committee members being conversant with financial and accounting matters.

6. CO-REGULATION AND EXTERNAL REGULATION

In the current debate on auditor independence, one suggestion is to regulate the accounting/auditing industry externally rather than permit the co-regulation model that has been in existence for so long to continue. It is interesting that this was not a preferred option for Professor Ramsay in his recent review of the Independence of Australian Company Auditors, nor is it the way in which most countries choose to regulate the profession.

One of the major disadvantages of bureaucratic arrangements requiring prescriptive legislation is that they may hinder the development of market-based solutions to issues that arise, since amendments to legislation are not a simple matter and may not keep pace with changes in the business environment. The AuASB is not convinced that external regulation of the profession in the form of legislative change is likely to produce superior outcomes and believes the existing self or co-regulation model remains the best way to proceed.

7. EXTERNAL OVERSIGHT BOARD

Another suggestion in the current debate has been the formation of an oversight board for monitoring the activities of the profession. The AuASB welcomes debate on the notion of an oversight board but believes such a Board needs to be broad in its focus. The AuASB is keenly observing the activities of such oversight Boards in the UK and elsewhere.

Directors for the Department of Infrastructure (DoI) and endorsed by the Municipal Association of Victoria (MAV) and Local Government Professionals (LGPro).

The AuASB is supportive of the importance of representation from amongst financial report user groups if an oversight Board were to be formed, a development with which in principle we agree. However, we have some concern that auditing practitioners are not sufficiently represented within the UK structure. The AuASB has for a number of years included representation from the public sector and academia, and has recently broadened its membership further to include an additional academic and also a non-accountant representative. We are currently monitoring the position in the UK and will be further considering the workings of the new arrangements once they become fully operational.

8. INTERNAL OVERSIGHT BOARD

The AuASB notes with interest recent developments in the market place whereby some public accounting firms are themselves creating internal oversight boards for decision making with respect to auditor independence issues. The AuASB supports initiatives that adopt various forms of best practice corporate governance within suppliers of audit and assurance services as well as within entities serviced by these suppliers.

9. OVERSEAS DEVELOPMENTS AND RELEVANCE TO AUSTRALIA

Whilst Australia should always look to overseas developments to monitor best practice, recent overseas developments in relation to auditor independence should be considered carefully. The January 2002 issuance of the International Federation of Accountants Section 8 “Independence” document, and its broad acceptance by the Australian Accounting Bodies through their December 2001 re-exposure of the proposed guidance, means that ethical guidance reflecting an international consensus on best practice will be issued in Australia after due process in relation to the re-exposure draft is complete.

10. INITIATIVES BY THE AUASB

ANNUAL DECLARATION BY AUDITOR TO BOARD

The Ramsay Report recommends that the auditor declare, “that the auditor has maintained its independence in accordance with the *Corporations Act* and the rules of the professional accounting bodies.” The AuASB agrees with such a declaration and is soon to issue an Audit & Assurance Alert that will provide information on best practice for such a disclosure. As, the revised Professional Statement F1 of the Code of Professional Conduct will, when issued after due process, adopt a conceptual approach as well as example situations from which rules can be gleaned, it is important the wording of this declaration reflect compliance with the “spirit” of the Code of Professional Conduct and not just “the rules of the professional accounting bodies”.

DISCLOSURE OF NON-AUDIT SERVICES

Australia has long enjoyed transparency in terms of the disclosure of fees for non-audit services provided by the auditor. In many ways it can be argued that

international developments, especially in terms of non-audit service provision disclosures, are conforming to existing Australian requirements.

The AuASB notes the transparency of existing disclosures with respect to client expenditure on non-audit services provided by the auditor and agrees with further disclosure of the nature of such services. The AuASB has contacted the AASB, requesting that the improved disclosure of non-audit services be placed on the AASB work program. Additionally, the AuASB is soon to issue best practice guidance in relation to this type of disclosure, which will add to transparency in this regard.

11. CONCLUDING COMMENTS

The above comments are not to suggest room for complacency in terms of auditing standards, compliance with Auditing and Assurance Standards and monitoring of that compliance, ensuring individual competency in fulfilling the audit function, or vigilance with respect to threats to auditor independence. The AuASB is committed to continuous improvement in processes with respect to Auditing and Assurance Standards and related guidance.

However, the AuASB believes it important to not over react to current events until more is known of the circumstances behind recent corporate collapses lest “solutions” are created that may seem appropriate on the surface, but which in fact may exacerbate rather than minimise any deficiencies in corporate reporting or corporate governance. Implementing effective mechanisms for improvement in all aspects of the corporate reporting process, including a corporate reporting model that is more transparent, is very important.

The AuASB believes the existence of an active audit committee, composed of an appropriate number of non-executive directors, provides an excellent market-based mechanism to oversee the audit function. We welcome steps to strengthen audit committees and the role they play in sound corporate governance.

Another mechanism that might be considered to strengthen corporate governance is for the management of the company to report formally to the audit committee annually on the effectiveness of a company’s internal control and governance procedures. The audit committee could review this management report and take any appropriate action to satisfy members with respect to the report’s content and to remedy any problems. Discussing the management report with internal and external auditors and/or seeking further assurance might then be appropriate.