

16 August 2002

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

Dear Mr Charles,

Auditor Independence of Registered Company Auditors

Over the past several months we have had the opportunity of interacting on the issue of auditor independence. You are aware of my proposal for an Independence Board and the application of these principles by PricewaterhouseCoopers. You might also be aware that the accounting firm KPMG has decided to conduct an external review of various aspects of its auditor quality, including independence. The distinguished scholar, Ken Trotman of the University of New South Wales, and myself will lead the inquiry. Both these developments represent an attempt by two of the accounting firms to provide evidence to the market as to the quality of their audit processes in particular the quality of their independence decision making. They are both attempts at "competing" in the market place in respect of auditor independence. Both firms should be complimented for this although there is still much room for improvement in a number of different dimensions.

While I hope that I have answered the questions asked of me by the JCPAA, I thought it appropriate to provide my personal overview about the way Australia could go usefully forward, given binding constraints and international developments. To my mind, the prime objective of the Inquiry, despite it being labeled in respect of auditor independence, is to try and enhance the quality of financial information that is delivered to the capital and other markets. As I have indicated financial reports are merely the representations of management and if an audit is both competent and independent of management then this lowers information risk, adds to the credibility of the disclosures made and enhances market efficiency. The recent crises, controversies and collapses have noticeably undermined market confidence in respect of the integrity of financial information including but not limited to the role of the auditor in this process.

By and large there are two general approaches to ensure and enhance the quality of information to the market. One is the regulatory route where governments and regulators can insist on certain minimum standards. The other is essentially a market based approach, which while not being able to enforce minimum standards, ensures higher quality through competitive processes. My belief is that the way forward will involve a combination of the two approaches but the real question is - what is the balance between the two?

For the reasons outlined in my original submission to the JCPAA Inquiry, I do not believe a highly regulatory solution will greatly assist. An industry wide oversight board will have the advantage of being able to observe and deal with the largest and most

serious problems and inappropriate behaviour within the auditing industry; but it will probably only do this after economic damage has been done and only when the matter has been revealed through some other process where it is easily measured and judged to be inappropriate. Threats to independence and the circumstances surrounding them are frequently much more subtle. They can also be considerably less economically damaging if they are handled contemporaneously rather than after the fact. Given that the US Congress has taken the highly regulatory route with the Sarbanes-Oxley Act 2002 there will be strong pressure exerted on Australian legislatures and regulators to take a similar line. While it might come to pass that we need enhanced regulation, setting up a completely separate oversight board strikes me as potentially counter productive.

I still passionately believe that each firm (or an umbrella body for smaller firms) should set up Independence Boards to provide a "window" through which the market can observe these accounting firms and watch them compete against each other in respect of independence. In so doing each auditee and auditor can strike the appropriate balance for their particular circumstances. It removes the damaging "one size fits all" philosophy of high regulation regimes. If you read literally the Sarbanes-Oxley Act it precludes auditors from providing all "expert services unrelated to the audit". Essentially, this means they can provide no other service other than if it is non-expert. If this law is administered as written it will be extraordinarily damaging to the American business community and the economy more generally. It is frequently the case that the auditor is the most efficient and effective supplier of certain consultancy jobs. The Sarbanes-Oxley Act removes that as a possibility. It strikes me as a significant over-reaction to what has been economically and socially damaging series of events in the US. This has not happened in Australia to the same extent and I hope we do not over-react in the same way .

Essentially I continue to champion for a low regulation solution which enables boards of directors (and their audit committees) and auditors to agree amongst themselves what is best in the particular circumstances of each company.

To return to my original submission, I believe that each audit firm needs a "window" on its independence processes and there needs to be separation between the commercial decision making within the audit firm and independence decision making which should be made by some other body; the members of which have no commercial interest in the outcome of their decision. Secondly, there needs to be much greater disclosure to the shareholders about the characteristics of the auditor and the quality controls within the audit firm. Thirdly, I find the idea that CFOs and CEOs personally certify the accounts to be an attractive one and it would be something that I would strongly support.

In summary given the international position, we as a jurisdiction may well be pressured into having an auditor oversight board. I for one would be not in favour of setting up a new structure to run this independence oversight board. If it needs to exist it probably should be an offshoot of the existing regulator, ASIC. Additionally, I would hope the JCPAA would recommend as best practice the establishment of Independence Boards within audit firms that wish to have publicly traded companies as clients. In addition I would resist the temptation of having a long list of precluded services. However, I would require that there be full and complete disclosure in respect of what services are provided and that these services would be only available to the auditee with the express approval of the auditee's audit committee. Finally for the reasons announced in several

place the idea of mandatory firm rotation should not be included in any recommendations. It is likely to produce an economically inefficient solution and would be damaging to the market generally.

I hope these observations have been of use to you.

Yours sincerely,

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