Submission by Australian National Audit Office to the JCPAA Review of Independent Auditing by Registered Company Auditors

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Executive Summary

Introduction

The Australian National Audit Office (ANAO) welcomes the opportunity to contribute to the JCPAA's review of independent auditing by registered company auditors. Given recent corporate failures in Australia and internationally and the increasing complexity and levels of risk in commerce today, it is timely to review the auditing framework to ascertain whether it may be strengthened, through stronger professional non-statutory regulation, stronger statutory regulation, or a combination of these approaches.

This submission focuses primarily on independent auditing by registered company auditors, the subject of the committee's inquiry. The framework supporting the Auditor-General's independence is also briefly discussed, as the Auditor-General, pursuant to the *Corporations Act 2001*, is a registered company auditor.

The current framework governing the auditing profession relies on a co-regulatory model, with key statutory provisions governing the responsibilities of registered company auditors set out in the *Corporations Act 2001* and the professional requirements determined by CPA Australia and The Institute of Chartered Accountants in Australia.

These professional bodies pronounce the standards of experience, training, integrity and ethical behaviour required of their members. However, central to independence within this framework is the consistent application and proper execution of existing standards and practices. This aspect is one of adherence, where the application and performance of participants to the existing requirements is central to the framework's reliability. Recent pronouncements, such as Professional Statement F1 'Professional Independence', serve to highlight the importance of this fundamental issue.

In considering the independence of registered company auditors, it is important to view their role in context, particularly in relation to the role of directors, and the financial reporting requirements of companies. It is the directors of a company that are responsible for corporate governance and ensuring statutory requirements have been met.

Directors rely on governance arrangements within the company to ensure that its financial statements contain no misstatement of material fact and no omissions are made that result in the statements becoming materially misleading. These governance arrangements should be supported by a structure of accounting and disclosure requirements intended to ensure financial reporting meets the mandated standards of accuracy, completeness and comparability. There is some scope to improve the governance of companies and compliance with the financial reporting framework through regulation, for example, by introducing legislative amendments to the Corporations Act to enhance the role of audit committees in corporate governance.

While the Auditor-General's position is unique in that the *Auditor-General Act 1997* clearly provides for his statutory independence and mandate, the ANAO would benefit from developments within the profession to strengthen the independence of private sector auditors because, as a matter of policy, we adhere to professional requirements supplemented, as necessary, by practices to cover the Auditor-General's special relationship with the Parliament.

Future Direction

The ANAO considers that there is a range of steps that could be taken to strengthen the independence of auditors and provide greater public confidence in their performance and the role that they have in adding credibility to financial reports prepared by companies, including:

- underlining the independence of auditors in statute;
- enhancing the role of audit committees in corporate governance;
- improving the disclosure of 'other services' provided by auditors;
- encouraging the profession to tighten current guidelines on 'other services' work that auditors are able to undertake; and
- encouraging the wider involvement within the profession of users and preparers of financial statements and reports, particularly in the setting of auditing standards and guidelines.

These options for enhancing the independence of auditors may be pursued under the current co-regulatory model or through other forms of statutory, or non-statutory regulation. These are matters for decision by the government and the profession co-operatively, given the level of interdependence between both parties in current arrangements.

Accountability and Regulation

Background

Key Elements in the Financial Reporting Framework

It is not only auditors that have responsibility within the financial reporting framework. In considering the current issues relating to auditor independence, there are three key elements:

- corporate governance by company directors;
- financial reporting requirements; and
- the role of auditors.

Corporate governance can be defined as the framework established by a governing body to ensure that stakeholders have assurance that the organisation is fulfilling its responsibilities with due diligence and accountability. As such, it is reflected in an entity's corporate and other structures, its culture, its policies and the ways in which it deals with its various stakeholders.

The Australian Accounting Standards Board, and the Auditing and Assurance Standards Board of the Australian Accounting Research Foundation are responsible for the development of financial reporting and auditing standards and guidance, respectively. As noted earlier, the professional bodies, CPA Australia and The Institute of Chartered Accountants establish the ethical rules and professional requirements. These requirements recognise that the objectives of the accountancy profession are to work to the highest standards of professionalism; to attain the highest levels of performance; and generally to meet the public interest requirement.

Auditors have an important role in ensuring that the companies they audit present an accurate, complete and current picture of their financial condition. Auditors have professional obligations under the Professional Code of Conduct and legislative obligations under the *Corporations Act 2001*. The Companies Auditors and Liquidators Disciplinary Board is responsible for disciplinary matters concerning the professional obligations of auditors. The legislative obligations are monitored and enforced by the Australian Securities Investment Commission (ASIC).

Performance of Participants Including Auditors

"There is a difference between the expectations of users of financial reports and the perceived quality of services from the accounting and auditing profession. This gap in expectations has two elements:

- the difference between the expectations of users and the reasonable standard of financial reporting and auditing which the profession can be expected to deliver (referred to as "unreasonable expectations"); and

- the difference between the reasonable standard of financial reporting and auditing which the profession can be expected to deliver and the services which are being delivered by the profession (referred to as "inadequate performance"). "[1]

The notion of the "expectation gap" is applicable to all participants providing a professional service within the accounting framework, not just the auditor. While acknowledging that the existing standards and legislation may be improved to narrow any perceived gap, it is some commentators' contention[2] that the primary reason for imminent corporate failures not being brought to the attention of stakeholders is non-adherence to the existing standards and legislative requirements.

If any of the participants (including auditors) to the financial reporting framework do not perform their duties with appropriate professionalism (as required by the accounting bodies standards and practices), rigor and diligence, there is a reduction in the reliance that can be placed on the financial statements.

Audit Independence

It is a common understanding within the profession that independence requires independence of mind, in appearance and in substance. The existing standards provide that the external auditor can only undertake non-audit services where there is no perceived, or real, conflict.

Professional Requirements

Statement of Auditing Standards AUS 1 requires an auditor not only to be independent, but also to appear to be independent. The perception of audit independence is fundamental to the credibility of the profession. For the purpose of this Statement:

(a) *actual independence* is the achievement of actual freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure; and

(b) *perceived independence* is the belief of financial report users that actual independence has been achieved.[3]

The profession has addressed the issue of audit independence through Statement of Auditing Practice *AUP 32 'Audit Independence'* and through the Professional Statement F.1 'Professional Independence' of the Code of Professional Conduct, mentioned earlier.

The purpose of AUP 32 is to provide guidance to auditors when considering independence, whereas professional statement F.1 'Professional Independence' addresses the principles of independence. Professional independence is a concept fundamental to the accounting profession requiring members to approach their

[1] A Research Study on Financial Reporting and Auditing – Bridging the Expectation Gap 1994 ASCPA and ICAA.
[2] See Rob Wylie's comment: Sydney Morning Herald. Saturday 20/04/2002 Business News, Page 43 and KPMG article published in CHARTAC Accountancy News, April 15,2002, Page 3.
[3] Extracted from CPA Australia Members' Handbook December 2001 issue, AUP 32.

professional work with integrity and objectivity and that, in each assignment undertaken, a member in public practice must both be, and be seen to be, free of any interest that is incompatible with objectivity.

While compliance with the Code of Professional Conduct is mandatory, and members may be called upon to justify any apparent transgression, it is the extent to which the profession monitors and investigates adherence to the terms and the sprit of the Code that may need review to assess whether there is scope to strengthen compliance in this key area of professional practice.

The ANAO supports the Ramsey[4] report recommendation that the auditor should make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the *Corporations Act 2001* and the rules of the professional accounting bodies.

Legislative Requirements

The Ramsey report recommended changes to section 324 of the *Corporations Act 2001* dealing with employment relationships between auditors and clients, the report also recommended that the Corporations Act be amended to include a general statement of principle requiring an auditor to be independent. The ANAO sees benefits in the tightening of legislative requirements covering audit independence. In particular, we underline the importance of legislation to support the independence of auditors.

Following a series of corporate failures in the late 1980s, the Ministerial Council for Corporations (Minco) established a Working Party to prepare a report concerning professional liability in respect of claims arising from the *Corporations Act 2001* or related common law.

One of the recommendations in the professional liability report was that there should be a review of the regulation of company auditors with a view to ensuring that there is an appropriate legal framework for the supervision, independence and disciplining of company auditors in relation to their functions under the law. This review was completed in July 1997. It contained a series of recommendations addressing a range of issues, including the registration of auditors, post-registration supervision of auditors, and their appointment, independence and discipline. The Ramsey report noted that, to date, none of the substantive recommendations has been implemented.

Rotation of Audit Firms

The rotation of audit firms over time has been subject to considerable debate. The ASIC has publicly supported the compulsory rotation of audit firms every five years.

ASIC claims that with rotation, the nexus built up by relationships and commercial pressures for auditors to maintain long-term economic relationships would be broken. ASIC argues that, "Partner rotation, while useful during the life of the audit engagement, will not achieve the same result as firm rotation. It is not credible that one partner will seriously challenge the established audit practice and advice previously provided by his firm through

[4] Ian Ramsey, Independence of Australian Company Auditors, Review of Current Australian Requirements and Proposals for Reform, Commonwealth of Australia, October 2001.

another partner. Rotation of firms, as encouraged by CPA Australia, is the more credible process."[5]

While audit rotation may aid in ensuring audit independence, the benefits at a practical level need to be considered in terms of cost. Audit quality is inherently dependent on the auditor's knowledge of the client's business. A solid understanding of the client's business processes, its people, operations, risks, controls and corporate governance arrangements is essential for a sound audit. With audit rotation, the potential for the benefits arising from this accumulation of knowledge and understanding is diminished. Empirical evidence from studies indicates that an audit is most vulnerable to failure in the first or second year of taking on the client when the client knowledge is low. For example, an investigation by the Quality Control Inquiry Committee of the United States SEC Practice Section which concluded that, of the 406 cases of alleged audit failure reviewed, such failure occurred three times more frequently in the first two years of a firm's tenure with a client than in subsequent years.[6]

An alternative to rotating firms could be to rotate audit partners which has been supported by major accounting firms. This would have the benefit of maintaining the client knowledge through other staff within the firm, while at the same time breaking the relationship bond. This approach is consistent with the Australian Auditing Practice Statement *AUP 32 'Audit Independence'*, which recommends the periodic rotation of audit staff and audit partners after a suitable period of time.

In comparison, Italy and Singapore have enacted mandatory legislation in their Corporations Law requiring rotation of audit firms. However, the United States adopted the concept of internal rotation where the audit partner-in-charge rotates within the appointed firm at a specified interval. The United States Security and Exchange Commission (SEC) requires that firms replace the partner-in-charge after seven consecutive years on a SEC engagement.

International Experience

The International Federation of Accountants (IFAC), the European Commission and the United States SEC's rules, all contain two broad principles underlying both the rules and the proposals related to independence:

(a) an accounting firm must be, and must be seen to be, independent of its audit clients; and

(b) an auditor must not audit his or her own work.

Similarly, in addressing issues of audit independence, the proposals of IFAC and the European Commission and the SEC's rules focus on the following three key relationships between accounting firms and their audit clients:

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[5] Address by David Knott, Chairman ASIC 'Protecting the Investor: The regulator and Audit' 15 May 2002.

[6] American Institute of Certified Public Accountants SEC Practice Section, 1992.

(a) employment relationships;

(b) financial relationships; and

(c) provision of non-audit services.

IFAC Code of Ethics

The IFAC has addressed the issue of auditor independence in the “IFAC Code of Ethics for Professional Accountants”. The code requires auditors to be independent of their audit clients. The Code of Ethics provides a framework built on principles, for identifying, evaluating and responding to threats to independence. These principles are used to:

- identify threats;
- evaluate the significance of those threats; and
- eliminate or reduce any threats to an acceptable level.

European Commission Consultative Paper on Audit Independence

The European Commission published a paper in December 2000 addressing the issues surrounding audit independence. The objectives of the Commission’s recommendation on statutory auditors’ independence are to provide a fundamental set of principles that:

(1) contributes to provide EU capital markets with the assurance that statutory audits of financial information provided by European companies are carried out at uniformly high levels of audit quality;

(2) ensures that facts and circumstances threatening statutory auditors’ independence will be interpreted and addressed consistently throughout the EU;

(3) helps to provide a level playing field for the provision of statutory audit services within the single market; and

(4) contributes to the ongoing development of international ethical standards in order to achieve that published financial information is audited at an equivalent level throughout the world.

The European Commission and the members of the EU Committee on Auditing considered a recommendation to be the quickest way to achieve these objectives without preparing new legislation. However, if the recommendation does not bring about the desired harmonisation on independence rules within the EU, the Commission has indicated it will reconsider the need for legislation.

United States Legislative Approach

In response to the problems raised by events relating to Enron, the US has introduced the *Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002* (CARTA). This legislation creates a statutory “public regulatory organisation” to oversee the public accounting profession. The Act also calls on the United States

SEC to improve and modernise, through rulemaking, disclosure processes. In addition, CARTA requires the SEC and others to study the following issues about which questions have been raised in the aftermath of Enron's collapse:

- audit independence;
- improper influence on conduct of audits;
- real-time disclosure of financial information;
- insider trading;
- improved transparency of corporate disclosures; and
- oversight of financial disclosures.

The CARTA proposes maintaining auditor **independence** by stipulating that a public accountant not be considered independent of its audit client if it provides that client with financial information system design or implementation, or internal audit services. The Act limits those services that create an inherent conflict with auditing, barring inappropriate compensation mechanisms, and penalising firms whose performance is substandard.

Through CARTA, the SEC has been granted the civil enforcement to sanction any **improper conduct** by any officer, director, or affiliated person of an issuer who has misled or improperly coerced an auditor in the course of an audit.

CARTA requires issuers to make **'real time' disclosures** of information concerning the issuer's financial condition and operations. The SEC, as a first step in achieving this objective, is introducing rules to accelerated filing by companies of their quarterly and annual reports.

Stronger restrictions on **insider trading,** addressing employees trading in their company's stock, have also been included in CARTA.

In addition, CARTA seeks to **improve the disclosures** in public companies' registration statements and periodic reports, so they provide adequate and appropriate disclosure of certain off balance sheet transactions and relationships.

In addressing improved **oversight of financial disclosures,** CARTA requires the SEC to set minimum periodic review requirements to ensure that the periodic reports of the largest issuers will be subject to a regular and thorough review.

Improvement Opportunities

Against the above background, there is broad support for the review of the framework applying to the audit of companies and its effective application.

Principle Based Standards and Policies

Flowing from recent events, an argument can be made for moving further towards principle based standards and policies, rather than relying on restrictive technical prescriptions. The ANAO favours this approach and considers that caution is warranted in the over-use of prescriptive legislation and standards that may place unnecessary restrictions on the profession to the determent of the quality, and efficient conduct, of the audit.

Principle based standards and policies can adequately encapsulate the intention of the standard setters and regulators. As a result, where standards and regulations are principle-based rather than rule-based, it is difficult to introduce schemes that are designed to manipulate financial results.

For example, Professor David Boymal, the national director of accounting and audit at Ernst & Young, advocates that the purpose of accounting standards needs to clearly set down the intent of the standard setters so the executive management, accountants, and auditors in particular, are discouraged from signing off on complex schemes designed to subvert accounting standards. By way of illustration, on the specifics of particular financing devices used in industry and the public sector, notably in the area of leasing, Professor Boymal explains “the purpose of the leasing rules, according to the standard also known as AASB 1008, is to ‘prescribe the accounting treatment for leasing transactions’… just think if the standard had said: ‘The purpose of this leasing standard is to prescribe the accounting for leasing transactions so that the use of leases as a means of “off balance sheet financing” is to be restricted to a limited number of circumstances’… Such a change in wording for all accounting standards… would ensure that the accounting rules contain relevant guidance about appropriate accounting practice even when innovative transactions that were not envisaged when the standard was being developed come about.”[7]

This approach would provide an overriding principle within the standard that discourages off-balance sheet transactions. Consequently, new approaches leading to off-balance sheet transactions not specifically excluded from that standard are avoided.

The ANAO supports the Australian Accounting Standard Board’s move toward the inclusion of overriding principles within new and re-released Australian accounting standards. The recently re-released Australian Accounting Standard AAS1 ‘*Statement of Financial Performance*’ is an example of the principle-based approach. The standard includes a new provision that revenues and expenses must not be set-off unless required or permitted by another standard. This general principle precludes preparers from reducing the transparency of their activities by netting off revenues and expenses. This approach prevents the development of innovative transactions that could result in inappropriate accounting practice.

Audit Committees

There is scope to formalise the relationship between the auditor and an organisations’ audit committee. In particular, the audit committee should provide a formal sign-off on issues relating to audit independence to the Board. As previously noted, the ANAO supports the introduction of legislation enhancing the role, and existence, of audit committees. However any approach, needs to be balanced with practical considerations to take account of various company structures and size.

[7] Tom Ravlic: CFO April 2002

The integrity of the audit committee could also be strengthened with legislative support. The ANAO has observed enhanced corporate governance in the public sector arising from the stronger role being adopted by audit committees', including audit committees having independent members that bring external views and experience to committee meetings.

In addition, the ANAO supports due consideration being given to Ramsey's recommendations that the audit committee:

- comprises 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 effect the financial reporting processes or requirements of the entity;
- actively reviews the operations and recommendations generated by the internal and external audit functions; and
- appoints and advises the Board on the adequacy of remuneration of external auditors.

Expansion of Audit Reporting

The current audit report on financial statements is limited to expressing an opinion on two major components. The first component makes the assertion that the financial statements are presented fairly[8] in accordance with professional reporting requirements. The second component makes the assertion that the financial statements are presented fairly in accordance with relevant statutory requirements.

Australian Auditing Standard AUS 702 '*The Audit Report on a General Purpose Financial Report*' states:

> "The audit report should include a section headed "Audit Opinion" or "Qualified Audit Opinion", as appropriate. This section should clearly express the auditor's opinion as to whether the financial report is presented fairly in accordance with:
>
> (a) accounting Standards and other mandatory professional reporting requirements; and
>
> (b) when appropriate, relevant statutory and other requirements."[9]

[8] Note that consistent with the Corporations Act the ANAO uses the phrase 'true and fair' rather than 'presents fairly'.
[9] Extracted from CPA Australia Members' Handbook December 2001 issue, AUS 702.

Previous studies (eg Cadbury[10] and Bosch[11]) have made recommendations for improving company disclosures of corporate governances practices. Further, suggestions have also been made to expand audit reporting to include commentary on the adequacy of control structures within the organisations being audited. The only notable change in Australia from such studies has been the Australian Stock Exchange Listing Rule 4.10.3 requiring listed companies to include in their annual reports to shareholders the main corporate governance practices in place during the company's reporting period. Independent attestation on that important issue of corporate governance practice does not currently feature in annual reports.

Where the auditor has concerns regarding corporate governance issues such as, internal control, risk and fraud management, the current practice is for these to be brought to the attention of management via a management letter, and ultimately to the Board, via board reports. In the public sector, these issues are bought to the attention of additional stakeholders. For example, the ANAO addresses such issues of accountability and performance in Auditor General's Reports to the Parliament (see 'Communication with Stakeholders' on page 22 of this submission).

Provision of Non Audit Services

With the increase in the provision of non-audit services by accounting firms, it is timely to update the Australian requirements in this regard. There are various ways in which the provision of non-audit services by the external auditor can be monitored, such that scrutiny is improved leading to the exclusion of incompatible or conflicting services.

The United States proposes to introduce legislation stipulating that a public accountant not be considered independent of its audit client if it provides that client with financial information system design or implementation, or internal audit services. The proposal limits those services that create an inherent conflict with auditing.

It is possible to introduce prescriptive and restrictive legal requirements to exclude external auditors from providing other (perceived) incompatible services. However, it is difficult to introduce legislation that will successfully govern personal relationships between auditors and their clients.

The ANAO believes that, at a minimum, the external auditor should not provide internal audit services. That said, however, the ANAO would favour the organisation's audit committee being responsible for deciding which non audit services are appropriate for the external auditor to provide.

The ANAO supports Ramsey's recommendation that the provision of non-audit services by audit firms to their clients be dealt with in several ways:

(a) by revised and updated professional ethical rules;

[10] Committee on the Financial Aspects of Corporate Governance, (1992), 'Report of the Committee on the Financial Aspects of Corporate Governance', (Cadbury Committee), Gee and Co. Ltd., London.
[11] Business Council of Australia, (1993), 'Corporate Practices and Conduct' (Second Edition), (Bosch Working Group), information Australia, Melbourne.

(b) by mandatory disclosure of non-audit services and the fees paid for these services; and

(c) by strengthening the role of audit committees.

Wider Involvement of Participants

There is no single entity responsible for the monitoring, investigation and disciplinary action associated with corporate failures. A range of professional and regulatory bodies contributes to the control and regulation of the industry. Streamlining those bodies and bringing them all under one “organisation” that is independent of the profession would assist monitoring of the consistent application of controls and regulation. It would also raise the visibility and awareness of participants operating within the framework. The ANAO would encourage the wider involvement of users and preparers of financial reports within the profession in the setting of auditing standards and guidelines.

The establishment of an umbrella organisation of this type is supported by CPA Australia in its April 2002 paper “Financial Reporting Framework – The Way Forward” which recommended the establishment of an umbrella body that would administer three sub-bodies responsible for standard setting, monitoring/investigation and the discipline function of the profession.

Such an organisation could consider reviewing the financial and non-financial disclosures of all large companies similar to the United States SEC proposal to review all annual reports of the Fortune 500 companies. As part of the monitoring and disciplinary function, the proposed organisation could also monitor the adequacy of non-audit service description and fee disclosure. The results of this monitoring process could then be communicated to the Government and other key stakeholders.

Commonwealth Accountability Framework

This part of the submission briefly addresses the framework supporting the Auditor-General's independence, noting that the JCPAA's terms of reference include "the extent to which it may be necessary to enhance the accountability of public sector auditing". The measures currently in place to address accountability and regulation in the public sector and differences in approach between the public and the private sector are outlined below.

Legislative Framework

Reforms of the 90s

The financial model operating in the Commonwealth public sector serves as a good example of how the recent reforms have enhanced accountability and financial management. The Commonwealth public sector accountability framework is governed by three primary pieces of legislation:

- *Financial Management and Accountability Act 1997* (FMA);
- *Commonwealth Authorities and Companies Act 1997* (CAC); and
- *Auditor General Act* (A-G) *1997.*

This package of legislation, enacted in 1997, replaced the *Audit Act 1901*. The new legislation was in response to the 1989 Joint Committee of Public Accounts (JCPA) report titled, *"The Auditor General: Ally of the People and the Parliament."*

It was considered that the former *Audit Act 1901* did not readily support the contemporary financial management expectations. There was a shift from the traditional roles of "administering" to the expectation that financial resources are "managed" in an efficient, effective and ethical manner.

The FMA Act and the CAC Act require the Chief Executive Officer (CEO) to "manage the affairs of the agency in a way that promotes proper use of resources for which the Chief executive is responsible." Proper use refers to the efficient, effective and ethical use of resources. The two Acts also state that the CEO (or directors in the case of CAC bodies) must establish and maintain an audit committee for the organisation, with the functions and responsibilities required by the Finance Minister's Orders in the case of FMA bodies. Consequently, public sector managers have become key participants, and been given specific responsibilities, in the financial management framework established by legislative reform. These are two examples of regulation strengthening the responsibilities of participants in the framework, as well as raising their awareness of expectations placed on them by stakeholders.

Auditor-General's Role and Responsibility

Historically, the Parliament has recognised the need for an independent Auditor–General given the position's fundamental importance to the accountability of government. In the Federal Parliament, the fourth Bill introduced following Federation was the former *Audit Act 1901*.

The *Auditor-General Act 1997* provides a legislative framework for the Office of the Auditor-General and the ANAO. The Act establishes the Auditor-General as an "independent officer of the parliament", a title that symbolises the Auditor-General's independence and unique relationship with the parliament. The Act also outlines the mandate and powers of the Auditor-General, as the external auditor of Commonwealth public sector entities.

The Auditor-General's mandate extends to all Commonwealth agencies, authorities, companies and subsidiaries with the exception of performance audits of Government Business Enterprises (GBEs) and of persons employed or engaged under the *Members of Parliament Act 1994*. Performance audits of wholly owned GBEs may only be undertaken at the request of the responsible Minister, the Finance Minister or the Joint Committee of Parliamentary Accounts and Audit (JCPAA).

As the JCPAA is aware, the operational independence of the Auditor-General is strengthened by the relationship with that committee. That strength is embodied in the JCPAA's responsibility for overseeing the audit functions and reports of the Auditor-General. The JCPAA also reviews the estimates of the ANAO and makes overall budget recommendations to the Parliament and the Executive on the appropriate level of funding for the Office. Thus, it is the Parliament that is the principal audit client; standing in the stead of the community (shareholders) and it is the Parliament that makes the ultimate decision in relation to the resources that should be applied to the external audit. This approach underlines the independence of the Auditor-General in the public sector by removing the issue of fee dependence between auditor and auditee. While audit fees are charged for all audits of statutory authorities and companies, these fee receipts are paid to consolidated revenue; the ANAO costs are directly funded by appropriation.

The independence of the Auditor-General is also highlighted by the method of his/her appointment. Prior to recommending an appointment to the Governor-General, the relevant Minister (the Prime Minister) must refer the proposed recommendation to the JCPAA and obtain the Committee's approval.

Audit Methodology

The legislative framework for in the public sector provides the necessary foundation for the conduct of financial statement audits and performance audits by the Auditor-General.

During 2000-01, the ANAO implemented a revised financial statement audit methodology as part of its ongoing continuous improvement program. The new methodology emphasises the need for a detailed understanding of the organisation and associated business risks and seeks to place greater reliance on business processes and management controls. The ANAO financial statement audit methodology is outlined in the diagram below.

Audit Methodology Outline

Co-Develop Expectations	Set Context	Process Risk Analysis	Residual Audit Procedures	Assess Results
Clear articulation of what is required and expected from external audit relationship	Clear understanding of strategic business objectives, enterprise-wide risks and control environment	Review of all key business processes. Linking business risk to financial statement risk Assessment of controls and other treatments by which agency manages risk	Additional audit procedures to cover financial statement assertions not addressed by process analysis. General audit procedures	Opinion on financial statements Conclusion on risk and control framework. Feedback on ANAO and agency performance
Audit Service Charter	Audit Strategy Document	Management Letter	Results of Financial Audit Report	Audit Opinion

Materiality

All financial statement audits are performed having regard for materiality. Materiality is defined as the magnitude of an omission or misstatement that, individually or in the aggregate, in light of the surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the financial statements would have been changed or influenced by such omission or misstatement. Material errors are thus defined as those errors that individually or in the aggregate could have a material effect on the financial statements being audited.

The auditor bases the resources and procedures employed in the performance of financial statement audits on the assessment of materiality. The scope of a financial statement audit, both in Australia and internationally, clearly states that the audit procedures employed be directed at the detection of material errors or misstatements. The procedures will not result in the detection of all errors and misstatements simply because the audit procedures and resources required to detect all errors and misstatements would be prohibitive.

In the circumstance where the auditor has concerns with matters noted during the course of an audit, which are not material to the financial statements, the auditor would consider bringing the issue to the attention of the management of the body being audited in the form of a management comment. A differential factor between the private and the public sector is that all significance issues are also reported to the relevant Minister and the Parliament. In the ANAO, there is joint planning between both financial statement and performance audit teams and these teams are also encouraged to engage in ongoing discussion on these issues. These discussions may result in the development of a review through one of our performance audit products.

New Auditing Standard on Fraud

The Auditing and Assurance Standards Board (AuASB) recently issued Auditing Standard AUS 210 'The Auditor's Responsibility to Consider Fraud and Error in an Audit of a Financial Report'. The new standard clarifies the auditor's role in detecting and preventing fraud, by setting out the basic principles and essential procedures required of auditors.

AUS 210 was developed as part of the international effort to increase the possibility of fraud detection by auditors.

In line with the requirements of the new standard auditors will need to increase their efforts in the consideration of fraud and error in financial reports. There are now clear requirements for auditors to consider, document and communicate with management on the issue of fraud.

In response to the new Auditing Standard the ANAO has instituted a specific audit procedure, which addresses the internal controls of an agency to prevent and detect fraud. This procedure is required to be completed by senior management, which reflects the importance that the ANAO places on the issue.

Quality Control

An important part of the audit process is the quality control procedures in place to ensure that the highest possible standards are maintained. Quality control is the system of policies and procedures established to provide reasonable assurance that audit work is conducted in accordance with ANAO and professional auditing standards. The ANAO's quality control program reviews:

- the operating environment within which we conduct our audit work; and
- requirements in relation to performance of individual audits.

The Quality Control procedures in place expand upon the professional framework established in the ANAO's Corporate Plan and Code of Conduct. The procedures are based upon ANAO and professional auditing standards, in particular *AUS206 Quality control of audit work, APS4 Statement of Quality Control Standard* and *APS5 Quality Control Policies and Procedures* as well as the ethical requirements of the Institute of Chartered Accountants and the Australian Society of Certified Practicing Accountants.

The ANAO's Professional Framework

In performing our audit role, the ANAO Corporate Plan states that we will be guided by values of:

- independence;
- professionalism;
- commitment;

- ethics and Integrity;
- responsiveness;
- innovation; and
- objectivity.

Supporting these Corporate Plan values is the ANAO's Code of Conduct. The ANAO's Code of Conduct has been designed to assist the ANAO and individual staff members in implementing the Corporate Plan. It takes account of contemporary public service ethical issues and is consistent with, and complementary to the Official Code of Conduct for public servants.

The Code is not intended to be prescriptive but rather to guide staff in their behavioral and decision making activities. The Code deals with issues such as:

- confidentiality of information;
- providing information to clients;
- care of official data and documents;
- conflicts of interest;
- use of ANAO resources;
- application of other (e.g. ICAA; ASCPA) codes;
- gifts, benefits and hospitality; and
- dress standards.

General Quality Control for Financial Statement Audits

The following quality control policies are aimed at creating an environment, which should ensure that all audits are conducted in accordance with ANAO and Professional Auditing Standards.

Professional Independence

Staff must adhere to the values of independence, professionalism, commitment, ethics and integrity, responsiveness, innovation and objectivity. In this respect, staff must be aware of, and at all times comply with, the requirements and philosophy contained within the ANAO's Code of Conduct.

Employment

Selection criteria for all audit positions have been designed to ensure that persons will only be employed where they have attained and maintained the technical standards and professional competence to enable them to perform their professional responsibilities with due care.

In order to maintain technical and professional competence, all professional staff are required to meet the professional development requirements of the Institute of Chartered Accountants or the ASCPA. Responsibility for this rests with the individual, in conjunction with their supervisor. The ANAO provides access to relevant training programs to assist in this respect.

Assignment of Personnel to Engagements

Supervisors ensure that staff are only assigned to these roles where they have necessary skills and experience to properly perform the responsibilities of the roles.

Supervision

Staff are provided with levels of supervision and direction appropriate to their skills and experience. It is the responsibility of the Audit Manager to ensure that all auditors working on an engagement receive appropriate direction and supervision.

Guidance and Assistance

It is the responsibility of each supervisor to ensure that adequate guidance and assistance is provided to staff in the context of the task in hand, development and the capabilities and experience of the staff member.

Where additional support is needed, the Research and Development Branch is available to provide guidance and assistance on technical or audit policy matters.

Client Evaluation

Professional auditing standards require an evaluation of prospective clients and a review, on an ongoing basis, of existing clients to determine whether the audit firm has the independence and ability to service the client properly. Given the ANAO's audit mandate, it is not appropriate to conduct such an evaluation to determine whether or not the ANAO will act as auditor for a client. However, the evaluation is relevant in the context of assigning the client to a specific Signing Officer and in decisions in relation to project management arrangements.

As part of its annual strategic planning processes, ANAO conducts an evaluation of all audit clients, determining whether:

- for reasons of independence, it is necessary to reassign audit clients to different Signing Officers; or

- in order to obtain specialist skills required to service the client properly, it is necessary to enter into project management arrangements.

Where the evaluation of clients indicates that the ANAO does not have the specialised skill needed to undertake the audit, in the case of government business enterprises such as Telstra and Australia Post, the ANAO contracts-out those audits. Where particular skills are required for discrete parts of an audit, supplementation is achieved through the contract-in of specialists.

Other Services

Any provision of other services by the ANAO is required to be approved by at least two Senior Executive Officers. A recent review has resulted in the strengthening of controls surrounding the provision of other services. It is the ANAO’s policy to presume that the following kind of services would impair independence:

- internal audit services;
- taxation advice;
- actuarial services;
- accounting policy advice;
- services relating to the setting up and/or maintenance of significant accounting records and systems;
- the preparation of accounts and records or financial statements of the agency; and
- any other services related to fundamental aspects of the entity's business and/or strategic planning, including Information Technology.

Specific Quality Control for Financial Statement Audits

The following policies specifically relate to quality control within the Financial Statement audit and accordingly, staff must have a thorough understanding of them and apply them in all situations.

Supervision and direction

Auditors should be provided with levels of supervision and direction appropriate to their skills and experience. It is the responsibility of the Audit Manager to ensure that all auditors working on an engagement receive appropriate direction and supervision.

Review

Review of work completed, by reference to the working papers and other documentation, is a fundamental part of the audit process. Audit work must be reviewed to ensure that it has been performed in accordance with the approved plans, that the work has been adequately documented and that conclusions and findings are appropriate and have been properly resolved. It is the responsibility of the Signing Officer and Audit Manager to ensure that audit work is reviewed and evidenced as having been reviewed.

Second Signing Officer Involvement

All audits with a high audit risk or high strategic risk and medium audit risk, will be subject to Second Signing Officer involvement. The Second Signing Officer must be nominated prior to commencement of planning, and recorded in audit strategy documentation. The focus of this involvement is to be an integral part of the audit process, rather than a review. The Second Signing Officer must satisfy himself or herself whether the proposed audit opinion is appropriate. The level of involvement will depend on the risk rating and nature of the client and the audit issues involved.

Quality Assurance Review Program

An important part of the efforts to ensure the financial statement product of the ANAO is the highest quality is the quality assurance program in place. The objective of the program is to ensure that the audits were carried out in accordance with the Auditor-General's Auditing Standards, and the ANAO's policies and procedures.

The quality assurance program is the responsibility of the Research and Development Branch of the ANAO. It has two elements, namely, an internal process carried out by the Research and Development Branch, and external reviews carried out by one of the big four accounting firms.

Communication with Stakeholders

A key part of the accountability mechanisms is the communication of audit findings with key stakeholders. There are three forms of communication for audit findings depending upon the significance of the issues.

- management Letters;
- letters to Ministers; and
- reports to Parliament.

Management letters, addressed to the management of agencies, contain detailed audit findings. The findings are categorised depending upon the significance of the issues. The three categories of findings are:

- "A Findings" - Significant – requiring immediate attention;
- "B Findings" - Important – requiring attention within 12 months; and
- "C Findings" - Improvement opportunity.

At key stages of the audit process, letters are also provided to Ministers. Also, reports may be provided to relevant Portfolio Ministers in relation to audit clients within a Ministers' portfolio. These letters report all significant audit findings (A & B) for audit clients within the portfolio.

Finally, at the completion of the key stages of the audit process (Interim and Final) the Auditor-General tables a report in the Parliament. The first report tabled in a financial year, titled *"Control Structures as part of the Audits of the Financial Statements of Major Commonwealth Entities"* summarises issues relating to internal control structures, financial systems, controls and processes arising from the interim phase of the financial statement audits.

The second report tabled in the financial year, titled *"Audits of the financial statements of Commonwealth Entities"*, brings together the results of all financial statement audits for that year including the Commonwealth Government of Australia Consolidated Financial Statements.