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Mr R Charles MP
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Our ref JCPAA-submission.doc

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6 June 2002

Dear Sir

Review of Independent Auditing by Registered Company Auditors

We are pleased to provide the Joint Committee of Public Accounts and Audit with our comments about the Committee's Review of Independent Auditing by Registered Company Auditors.

Introduction

KPMG is very conscious of the importance that independence plays in the audit function. Independence directly impacts the credibility of the audit service that we provide, and accordingly, it is promulgated not only in the written rules that we follow but also in the actions and thoughts of our partners and staff. Our clients make us acutely aware of the premium they and their stakeholders place on our independence, so it is incumbent upon us to ensure this receives the attention it deserves.

We believe that Australia has a strong, dedicated audit profession that operates in line with world's best practice. This extends to the forum of independence, where KPMG and the profession have embraced a comprehensive code of professional conduct recently promulgated by the Institute of Chartered Accountants in Australia and CPA Australia (*Professional Statement F1 Professional Independence*). KPMG supports the key recommendations contained in the Ramsay report and have already amended internal policies, including the introduction of mandatory audit partner rotation on all listed audit clients.

We acknowledge that recent corporate collapses have undermined confidence in the financial markets. In particular, focus has been placed on the perceived failure of financial reports to provide appropriate insight into corporate performance. This focus has included a perception that external audit reports should provide some form of early warning of pending failure. The perceived proximity of auditors to managements and boards of directors in some of these collapses has lead to the focus on auditor independence as a "solution" to restore confidence.

Australia's financial reporting framework has many facets. In our opinion the focus on ensuring auditor independence, whilst not inappropriate of itself, misses the key elements of reform needed to our framework to ensure confidence in our markets is maintained. These elements are summarised below, and are commented on in more detail in the following attachments:

- *Independence of Australian Company Auditors – A response to the Ramsay Committee Report*, which represents KPMG's views on the key elements of reform and recommendations contained in the Ramsay report.

- *KPMG Australia's Commitment to Independence and Quality - an Important Discussion, and Questions and Answers*. These documents further elucidate KPMG's views on relevant matters surrounding the current debate, and are aimed at informing our partners and staff, clients and other stakeholders of what we see as the critical issues.

Regulatory framework

Australia's regulatory model for monitoring and ensuring accountability in the financial reporting and auditing standards area, undertaking disciplinary hearings and encompassing auditor oversight, is fragmented with authority partially vested in both the government regulator and the profession.

Recently, the UK has implemented a new regulatory model, Ireland has proposed a new supervisory structure and the US is revisiting the SEC's role in oversight. We consider it necessary to investigate these and other options that may be available to improve the current regulatory framework. This goes beyond the recommendations contained in the Ramsay report which was only concerned with independence. Several key issues will need to be considered in this context so that any proposed structure is transparent and workable without adding unnecessary complexity, is appropriately resourced with the skill base required, and is appropriately funded.

We therefore recommend that a thorough review of the oversight of the financial reporting framework and the auditing profession as a whole be undertaken.

Financial reporting requirement to be "True and Fair"

The recent corporate collapses and Enron, in particular, have raised serious doubt about the limitations in financial reporting that exist in the United States, in part due to the so called "Black Letter" approach to setting and applying accounting standards. Australian accounting standards, while derived from the same conceptual approach as the United States, emphasise substance over form when applying the requirements. However, part of the re-examination of the regulatory framework for standard setting in Australia could include consideration of the legal status of "true and fair". Currently, the Corporations Act 2001 specifies that financial statements must give a true and fair view, but this is effectively given secondary importance due to the requirement to comply with accounting standards.

We believe it is appropriate to include discussion regarding the status of the "true and fair" requirement in the Australian financial reporting framework debate, a view we understand is shared by the Australian Securities and Investment Commission, given:

- the extensive fall-out from the Enron collapse in particular, which has highlighted the dangers of following a prescriptive "form" based approach rather than one of substance;
- the financial reporting framework adopted in the United Kingdom and within International Accounting Standards allows for departure from accounting standards in limited circumstances where the departure is necessary in presenting a true and fair view; and
- this is an area that has drawn commentary, and in some cases criticism, of the current situation in Australia from certain sections of the business community.

Financial Reporting Model

The financial reporting model must be improved to more transparently describe business operations, disclose leading indicators and trends (many of which may be non financial) and better inform investors about risks and performance. Investors and stakeholders are demanding increasing access to information that they would consider is more relevant.

Retrospective analysis of performance must give way to real time reporting. The technology to support this change exists today. With real time reporting there must be real time auditing based on understanding an entity's processes for error prevention, and not just after the fact detection. While some tools exist that assist clients in improving performance reporting and extend the reporting framework well beyond the traditional interim and full year financial reporting mechanisms, these tools need to be developed further so that they become common practice.

Audit reports and audit scope need to be revisited

The audit report is the public document describing the outcomes of the audit. Although attempts have been made over a number of years to improve the nature of the audit report, it is still highly technical and not readily understandable. Simplification of the audit report into a "plain English" style is necessary to make it easier to understand what the audit is and does. The current form of the audit report also tends to perpetuate the "expectation gap" that exists between certain users of financial reports and the audit profession regarding the scope and purpose of an audit. Should significant changes in the financial reporting model emerge, there will need to be a new form of audit report.

A more fundamental improvement would be to expand the audit report to comment on other relevant issues such as governance, risk management and internal control, together with key indicators of the financial health of the company referred to above. Whilst this is a desirable outcome, it would not be feasible for auditors to contemplate such an expansion of scope within the context of the current level of liability attaching to the outcome of audits.

Legal liability reform would enable more comprehensive reporting

A key element to ensuring an effective and appropriately resourced audit and oversight function is liability reform.

Recently there has been significant liability reform in relation to auditors in the northern hemisphere, with the UK introducing Limited Liability Partnerships and Canada implementing proportionate liability. Auditors' reluctance to report more fully is largely due to the real risk of spurious legal actions. The Australian unlimited liability environment, a legal prohibition on limiting liability, and the concept of "joint and several liability", which is out of step with where other countries have moved, encourages a "blame" and litigious culture where auditors with presumed "deep pockets" are targeted. This involves expensive and time-consuming defence of unwarranted actions that are not in anyone's interests.

The establishment of a statutory cap on an auditor's liability or replacement of joint and several with some form of proportionate liability is needed to restore balance in an environment heavily weighed against auditors. This is also critical so that the auditing profession may continue to attract and develop appropriately skilled professionals. Failure to act will inevitably lead to loss of audit quality, or could jeopardise the very existence of the auditing profession as we know it.

Conclusion

KPMG has been, and will continue to be, committed to maintaining our independence both in fact and in perception. The stakes are too high for firms such as KPMG to make light of independence issues or to ignore the current domestic and international developments that are impacting auditor independence. We will therefore continue to participate actively in advancing the debate on auditor independence and associated financial reporting and corporate governance issues.

We look forward to the opportunity of further discussing our views with you.

Yours faithfully

Michael J Coleman
National Managing Partner Assurance and Advisory