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Report 391

Review of Independent Auditing by Registered Company Auditors

Joint Standing Committee on Public Accounts and Audit

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Chairman's Foreword

In the last two years there have been a significant number of high profile corporate failures in Australia. While business is an inherently risky activity, the sudden failure of seemingly healthy companies came as a shock. These failures can impact on the community in many ways, most significantly through the personal and financial losses incurred by shareholders, creditors and employees.

Of course the responsibility for corporate failures ultimately lies with a company's management and directors. Nevertheless, the Committee considers investors should be able to retain a reasonable expectation that the statutory audit function will identify and highlight when a company may be in difficulty. In a broader sense, these failures pointed to inadequacies of the corporate regulatory regime and the inadequate nature of corporate governance exercised by some in the business community.

Auditors carry a significant public trust and responsibility that must be at the forefront of all their decisions and actions. There has been a change in the profession over time from an emphasis on professional ethics to a more business-oriented focus. This focus on commercial imperatives has for some, it seems, taken precedence in recent years at the expense of good ethical practice. The same can be said for the business community where we have witnessed a decline in ethical practice and an abrogation of responsibilities and obligations to the broader community. In this light, an associated aim of the Committee's recommendations is to promote enhanced ethical professional culture in the audit and accounting profession and the business community.

It has been said that when Arthur Anderson signed off on an audit he put his reputation, credibility and standing in the community on the line. Arthur Anderson has passed on and sadly, for at least some in the profession, so have his ideals.

Directors of publicly listed companies have clear responsibilities and obligations that must be met. Directors also need to have the appropriate skills, experience and support mechanisms to effectively analyse and verify information in order to be able to ask the right questions and make well-considered decisions. The Committee has previously inquired into these issues in the context of government business enterprises and maintains that the principles of that inquiry and the subsequent recommendations are generally applicable to the private sector. However, in the course of this inquiry the Committee did not receive enough evidence in this area to enable it to make a major statement at this time.

It is important to recognise that the Australian situation is not the same as that in the United States and we have not witnessed the same level of excesses that are being revealed in the US. The Committee is not convinced that an overly prescriptive reaction is warranted or appropriate. Rather, there needs to be an appropriate mix of principle and prescription. It is impossible to demand infallibility or implement a 'zero-risk' policy. Given the inherent risk of business and the need for risk to drive entrepreneurial activity, a risk management rather than a risk aversion approach is appropriate and increased accountability should be demanded of the corporate sector and audit profession.

The Committee's findings are based on a number of observations of both the audit and accounting profession and the business community, which shaped the ensuing framework of recommendations. Our findings are also influenced by our longstanding involvement in corporate governance and the audit framework governing accountability in the public sector.

Current audit practice is limited to an attestation that financial statements have been prepared according to accounting standards. In forming the opinion, the auditor does not necessarily explore broader issues that may impact on the on-going viability of a company, such as the adequacy of corporate governance practices, risk management and internal control processes.

In turn, because a company's governance practices, risk management and internal control processes are not regularly and rigorously tested, their continued veracity and importance to the ongoing viability of the company may be overlooked.

Oversight of both audit firms and listed companies is deficient. There is very little transparency regarding the independence (and to a lesser extent competence) of the firms carrying out audits. In regard to listed entities there is a lack of, and incentives for, compliance with accounting standards. The recent spate of corporate earnings restatements demonstrates that, regardless of any changes in audit structure or functions, only concerted action to police management activities will address these problems.

There are also concerns regarding the lack of informative and timely information being available to the market and a low level of public confidence (shared by some academics) in the veracity of the information produced by adhering to the accounting standards framework.

Broader reporting to incorporate governance practices, risk management and internal control processes require an appropriate framework against which these broader issues may be audited. This will force companies to pay due attention to their corporate governance principles and practices. In addition, it will provide more information to shareholders and other stakeholders.

Changes to the current unlimited liability environment are required to protect auditors if they are to comment on a broader range of issues.

Public confidence in the independence of audit opinions needs to be restored. This requires a mechanism to, in effect, 'audit the auditor' on matters of independence and competence.

Increased surveillance of compliance with accounting standards is required to ensure aggressive accounting practices are not used to mislead shareholders, even though such practices may be in accordance with current black letter requirements.

Better disclosure is required to improve the ability of the users of financial reports and the market in general to understand the companies they invest in, and in particular, the risks associated with those investments.

Our proposed solution is designed to address these issues and compel companies and auditors to enhance their management of corporate governance and audit independence. Rather then advocating prescriptive regulation and mandating arbitrary limits or benchmarks, the central element of our reform proposal is to provide a framework enabling a broadening of the scope of the audit function to include, for example, corporate governance, risk management, internal control issues or other performance-type issues. To support this new framework and the process of management improvement (and to promote more transparency) we also propose an enhanced oversight role for the existing regulator, the Australian Securities and Investments Commission (ASIC).

The key findings and recommendations of the report include that:

- The *Corporations Act 2001* be amended:
  - ⇒ to require the Chief Executive Officer and Chief Financial Officer of a company to sign a statutory declaration that the company's financial reports comply with the *Corporations Act 2001* and are materially truthful and complete;
  - ⇒ to require all publicly listed companies to have an audit committee of independent members;
  - ⇒ to require audit firms to report annually to ASIC on independence issues;
  - ⇒ to clarify the relationship between the need for financial statements to comply with accounting standards and provide a true and fair view; and

⇒ to include a general statement on audit independence.

- the Financial Reporting Council develop a set of corporate governance standards, which would be given legislative backing in the *Corporations Act 2001*;
- the Australian Stock Exchange Listing Rules be amended to require additional reporting by companies;
- ASIC explore the cost and benefits of introducing performance audits in the private sector and in conjunction with the ASX, evaluate the costs and benefits of requiring pronouncements and other disclosures under the continuous disclosure listing rule to be subject to a credible degree of assurance; and
- a framework for protected (or whistleblower) disclosure be established in the *Corporations Act 2001*, including clear accountability mechanisms over the administration and management of disclosures.

In addition, the Committee was particularly attracted to the idea of Independence Boards within audit/ accounting firms as proposed by Professor Keith Houghton. One of the 'Big Four' has proceeded with implementation of Professor Houghton's proposal, one is seriously considering implementation and one believes it achieves the same outcomes in a slightly different manner.

It is significant that this is the first time the JCPAA has undertaken an inquiry into private sector issues. Nevertheless, the JCPAA has a long history of actively seeking to strengthen the role and independence of the Commonwealth auditor as an essential agent of government accountability to the Parliament and ensuring good corporate governance in the public sector. This inquiry has been an opportunity for the Committee to bring its expertise in audit and corporate governance matters to bear on the issue of audit independence generally.

It is the Committee's intention to maintain a watching brief on these important national issues.

In conclusion, and on behalf of the JCPAA, I would like to thank all those who have contributed to this inquiry.

Bob Charles MP

Chairman

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Chair	Mr Bob Charles MP	
Deputy Chair	Ms Tanya Plibersek MP	
Members	Senator Richard Colbeck	Mr Steven Ciobo MP
	Senator Rosemary Crowley (until 30/6/02)	Mr John Cobb MP
	Senator John Hogg	Mr Petro Georgiou MP
	Senator Claire Moore (from 27/6/02)	Ms Sharon Grierson MP
	Senator Andrew Murray	Mr Alan Griffin MP
	Senator Nigel Scullion	Ms Catherine King MP
	Senator John Watson	Mr Peter King MP
		The Hon Alex Somlyay MP

Membership of the Sectional Committee

Chair	Mr Bob Charles MP	
Deputy Chair	Ms Tania Plibersek MP	
Members	Senator Rosemary Crowley (until 30/06/02)	Mr Steven Ciobo MP
	Senator Andrew Murray	Ms Sharon Grierson MP
	Senator John Watson	Mr Alan Griffin MP
		Mr Peter King MP
		Hon Alex Somlyay MP

Committee Secretariat

Secretary	Dr Margot Kerley
Inquiry Secretary	Mr Adam Cunningham
Research Officer	Mr Bill Bonney
Administrative Officers	Ms Maria Pappas
	Mr Jeremy O'Connell

Duties of the Committee

The Joint Committee of Public Accounts and Audit is a statutory committee of the Australian Parliament, established by the *Public Accounts and Audit Committee Act 1951*.

Section 8(1) of the Act describes the Committee's duties as being to:

(a) examine the accounts of the receipts and expenditure of the Commonwealth, including the financial statements given to the Auditor-General under subsections 49(1) and 55(2) of the *Financial Management and Accountability Act 1997*;

(b) examine the financial affairs of authorities of the Commonwealth to which this Act applies and of intergovernmental bodies to which this Act applies;

(c) examine all reports of the Auditor-General (including reports of the results of performance audits) that are tabled in each House of the Parliament;

(d) report to both Houses of the Parliament, with any comment it thinks fit, on any items or matters in those accounts, statements and reports, or any circumstances connected with them, that the Committee thinks should be drawn to the attention of the Parliament;

(e) report to both Houses of the Parliament any alteration that the Committee thinks desirable in:

(i) the form of the public accounts or in the method of keeping them; or
(ii) the mode of receipt, control, issue or payment of public moneys;

(f) inquire into any question connected with the public accounts which is referred to the Committee by either House of the Parliament, and to report to that House on that question;

(g) consider:

(i) the operations of the Audit Office;
(ii) the resources of the Audit Office, including funding, staff and information technology;
(iii) reports of the Independent Auditor on operations of the Audit Office;

(h) report to both Houses of the Parliament on any matter arising out of the Committee's consideration of the matters listed in paragraph (g), or on any other matter relating to the Auditor-General's functions and powers, that the Committee considers should be drawn to the attention of the Parliament;

(i) report to both Houses of the Parliament on the performance of the Audit Office at any time;

(j) consider draft estimates for the Audit Office submitted under section 53 of the *Auditor-General Act 1997*;

(k) consider the level of fees determined by the Auditor-General under subsection 14(1) of the *Auditor-General Act 1997*;

(l) make recommendations to both Houses of Parliament, and to the Minister who administers the *Auditor-General Act 1997*, on draft estimates referred to in paragraph (j);

(m) determine the audit priorities of the Parliament and to advise the Auditor-General of those priorities;

(n) determine the audit priorities of the Parliament for audits of the Audit Office and to advise the Independent Auditor of those priorities; and

(o) undertake any other duties given to the Committee by this Act, by any other law or by Joint Standing Orders approved by both Houses of the Parliament.

Terms of reference

With the spate of recent noteworthy corporate collapses both within Australia and overseas, the Joint Committee of Public Accounts and Audit wishes to explore the extent to which it may be necessary to enhance the accountability of public and private sector auditing.

In particular, the Committee is keen to determine where the balance lies between the need for external controls through government regulation, and the freedom for industry to self-regulate.

List of abbreviations

AARF	Australian Accounting Research Foundation
AASB	Australian Accounting Standards Board
AuASB	Auditing & Assurance Standards Board
ACCA	Association of Certified Chartered Accountants
ACCI	Australian Chamber of Commerce and Industry
AG	Auditor-General
AICD	Australian Institute of Company Directors
AISB	Auditor Independence Supervisory Board
ANAO	Australian National Audit Office
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
CAC	Commonwealth Authorities and Companies
CALDB	Companies Auditors and Liquidators Disciplinary Board
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CLERP	Company Law Economic Reform Program
FRC	Financial Reporting Council

FMA	Financial Management and Accountability
IASB	International Accounting Standards Board
ICAA	Institute of Chartered Accountants in Australia
IFAC	International Federation of Accountants
JCPAA	Joint Committee of Public Accounts and Audit
NIA	National Institute of Accountants
NYSE	New York Stock Exchange
OECD	Organisation for Economic Cooperation and Development
PAAC	Public Accounts and Audit Committee
SEC	Securities and Exchange Commission

Glossary of terms

Emphasis of Matter	A section in the audit report used to draw attention to a relevant matter without affecting the nature of the audit opinion
Joint and several liability	The notion that deems parties acting independently are equally responsible and liable for any loss or injury caused to another party
Market Operator	The term used in the *Corporations Act 2001* to refer to the entity that manages the listed share market
Management discussion and analysis	Commentary containing an analysis and explanation of a company's financial and operating performance, position and future prospects. It is often described as giving users the ability to view the company 'through management's eyes'
Non-audit services	Consulting services or activities provided to an audit client by the audit firm, which are outside the scope of the external audit engagement
Proportional liability	The notion that equates the extent of a party's responsibility, for any loss or injury caused to another party, to the proportion or degree of fault involved
Share options	A form of remuneration, which gives the recipient the ability to buy nominated shares in the future, usually at the market price at the time option is granted or at a price to be set when the option is exercised

Recommendations

2 CORPORATE GOVERNANCE

Recommendation 1

That the *Corporations Act 2001* be amended to require the Chief Executive Officer and Chief Financial Officer of a company to sign a statutory declaration that the company's financial reports comply with the *Corporations Act 2001* and are materially truthful and complete. This declaration must be attached to the company's financial reports whenever they are lodged with ASIC and provided to the company's members and the market operator pursuant to this Act.

Recommendation 2

That the *Corporations Act 2001* be amended to require all publicly listed companies to have an independent audit committee and the Act prescribe the minimum requirements in regard to the role, responsibilities and composition of an audit committee.

Recommendation 3

That the Financial Reporting Council:

- develop a set of corporate governance standards, including prescriptions for internal audit, taking primary guidance from the findings of the ASX's Corporate Governance Council; and

- take all steps to ensure these standards be given legislative backing in the *Corporations Act 2001*, as either pursuant to or mirroring Section 334.

Recommendation 4

That Section 1288 of the *Corporations Act 2001* be amended to incorporate the following principles:

■ require audit firms undertaking assurance audits of publicly listed companies to submit a report to the Australian Securities and Investments Commission (ASIC) on an annual basis detailing how audit firms have managed independence issues in the preceding period and any future independence management issues that are deemed pertinent;

■ provide ASIC with the authority to investigate and address independence issues arising from these reports or from other sources as ASIC considers appropriate; and

■ require publication of the ASIC benchmark criteria used for determining the adequacy of the internal systems and processes of large audit firms.

3 FINANCIAL REPORTING

Recommendation 5

In the process of adopting the international accounting standards by January 1 2005, as announced by the FRC, the AASB should ensure that those contentious issues and deficiencies identified by the Committee are resolved as a matter of priority at the earliest possible date.

Recommendation 6

That Section 297 of the *Corporations Act 2001* be amended as follows:

■ add the requirements that, in undertaking the assessment of a true and fair view, directors must consider the objectives contained in section 224 (a) of the *ASIC Act* and must include a statement in the financial report that they have done so.

■ delete the current footnote that states:

If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under paragraph 295(3)(c).

■ add the following new sub-sections:

In the case of conflict between sections 296 (compliance with accounting standards) and 297 (true and fair view), the notes to the financial statements must indicate why, in the opinion of the directors, compliance with the *accounting standards would not give a true and fair view of the financial performance and position of the company.*

The notes to the financial statements must include a reconciliation to provide additional information necessary to give a true and fair view.

Recommendation 7

It is recommended that Sections 307 and 308 of the *Corporations Act 2001* be amended to require the auditor to form an opinion and report on any additional disclosure made pursuant to Section 297.

Recommendation 8

It is recommended that the Australian Stock Exchange amend the Listing Rules to require additional reporting by companies in the following areas:

- commentary on internal control systems, including risk management processes;
- management discussion and analysis;
- commentary on the main factors affecting reported financial performance and financial position;
- commentary on the key judgements made in the application of accounting policies;
- results for a set of key performance indicators pointing to the health of the organisation; and
- details of directors' and executives' performance appraisal or management systems .

4 THE AUDITING FRAMEWORK

Recommendation 9

That Section 324 of the *Corporations Act 2001* be amended by including:

- the following statement

The Auditor must be independent of the company in performing or exercising his or her functions or powers under this Act.

- a footnote to indicate that this statement may be interpreted by reference to the Code of Professional Conduct of the Professional Accounting Bodies.

Recommendation 10

That the following sections of the *Corporations Act 2001* be amended:

- Section 307 be amended to require that auditors form an opinion on whether the company has complied with corporate governance standards (see Recommendation 3);
- Section 308 be amended to require the auditor to report as to whether the company has complied with corporate governance standards (see Recommendation 3); and
- Section 308 be amended to require the audit report to include comment on significant matters arising during the audit process.

Recommendation 11

That ASIC explore the cost and benefits and alternative methods of introducing performance audits in the private sector and, in conjunction with the ASX, evaluate the costs and benefits of requiring pronouncements and other disclosures under the continuous disclosure listing rule to be subject to a credible degree of assurance and report its findings to the Treasurer.

Recommendation 12

To support an expansion in the role of registered company auditors, the following reforms should be put in place to provide a greater level of protection for their personal assets:

- principle of *joint and several liability* replaced with the principle of *proportional liability*, so as to provide a more equitable basis for allocating damages;
- amend the *Corporations Act 2001* so that audit firms can operate within limited liability structures; and
- introduce a cap for professional liability claims to limit the quantum of damages which can be awarded against auditors.

Recommendation 13

That a framework for protected (or whistleblower) disclosure be established in the *Corporations Act 2001*. Included in this framework should be clear accountability mechanisms over the administration and management of disclosures.