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Contact Michael Coleman

22 March 2002

Dear Sir

## **Independence of Australian Company Auditors**

We are pleased to provide you with our comments on the Ramsay report on Independence of Australian Company Auditors.

### **KPMG's commitment to independence**

KPMG recognises the importance that independence plays in the role of the auditor. 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 therefore welcome the review undertaken by Professor Ramsay, which provides the opportunity for real reform and represents a sound basis for advancing the debate on auditor independence.

We support the general thrust of the proposals contained in the report. However, certain recommendations in the report require further consideration, not just in isolation but also in the context of broader regulatory issues impacting the audit profession and the financial reporting framework within which the business community operates. These issues, as well as our response to specific recommendations contained in the report are detailed in the attachment to this letter.



KPMG, KPMG, an Australian partnership, is a member of KPMG International, a Swiss association.



## **Matters for consideration**

We take the opportunity to emphasise the following issues raised in the attachment:

### ***Regulatory framework***

We support the establishment of some form of oversight body as proposed in the Ramsay report, which may serve to improve the market's perceptions concerning audit independence. But, 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.

We believe that the focus of the recommendations contained in the report is too narrow. Recent international developments in the United Kingdom and Ireland, as well as proposed changes in the United States, have to a large extent overtaken the Ramsay report proposals. We therefore consider it necessary to investigate these and other options that may be available to improve the current regulatory framework. 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. Addressing the issue of audit independence alone will only deal with a portion of the issues being debated.

### ***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 are derived from a different conceptual basis, and 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 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.

### **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.

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. 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**

There has been significant liability reform recently 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 which is not in anyone’s interests.

Consideration of establishing a statutory cap on an auditor’s liability and replacement of joint and several with some form of proportionate liability is needed to restore balance in an environment heavily weighed against auditors.



## **Conclusion**

We have 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, and look forward to the Government's response to the Ramsay report recommendations.

Yours faithfully

Michael Coleman  
*National Managing Partner, Assurance and Advisory*



Independence of Australian  
Company Auditors  
- A response to the Ramsay  
Committee Report

KPMG Assurance and Advisory  
March 2002  
*This report contains 29 pages*  
RamsaySubmission0322.doc

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# **1 Introduction**

Professor Ramsay's report focused on audit independence and provides a good basis for advancing the debate insofar as it regards the independence of auditors. The report provides the opportunity for real reform and we welcome the review and the general thrust of the proposals in Ramsay. There are some practical implications of some of the proposals and we explain these in this submission.

The debates more generally have moved on from a focus on audit independence. Audit independence is one small element of the role and function of an audit. The quality of an audit and the enforcement of quality are more relevant issues for consideration.

The audit, in turn, is one element of the financial reporting framework and corporate governance process and improvements can be made in many areas of these processes. To complete the debate, in this submission we expand on the fundamental matters that we believe require change.

## **2 Audit quality is the key issue**

Audit independence alone doesn't guarantee a quality audit – an independent poor quality audit is still a poor quality audit. Where there have been investigations into failed audits, evidence has shown that auditors have not applied auditing standards appropriately rather than that they were not independent. There are a number of components to a quality audit, most of which are not visible to the external observer.

Quality is established through many means - notably through using experienced and qualified personnel who have been trained in professional ethics and professional scepticism and who carry out their work with integrity and objectivity. Top quality auditing standards are also important. In addition, enforcement of these standards, is also required through professional discipline and oversight.

## 3 Enforcing ethical and auditing standards

### 3.1 Summary

The auditing profession is required to follow ethical and auditing standards in carrying out its work. Doubts about the quality of some audit work have led to questioning of the ethical and auditing standards.

Australian auditing standards reflect world best practice and the ethical standards are in the process of being updated to meet IFAC requirements. (This represents adoption of one of Ramsay's key recommendations). The Australian auditing profession is committed to continuous improvement of its standards.

Where there have been problems relating to the failure of an audit to identify material misstatements in financial reports, these problems have invariably related to the application of the standards. Some commentators have argued that the profession's monitoring and enforcement processes have lacked rigour. To help improve the market's perceptions about these concerns, the profession needs to consider the adoption of more transparent and rigorous discipline, with strong penalties, when breaches do occur.

### 3.2 Ethical standards

The ethics of the profession and individuals within it are the cornerstone of qualification and membership. Ethics are personal qualities that drive the behaviour of auditors.

Auditors are required to follow the profession's ethical rules set out in the *Statement of Professional Conduct* (the Code). Section B of the Code requires members to:

- Consider the public interest in servicing their clients, a responsibility to protect the collective well-being of the community
- Show utmost integrity, approaching professional work in a straightforward, honest and sincere manner
- Maintain objectivity in judgement, remaining impartial and free of influence
- Retain independence, remaining free of any interest that might influence or be seen to influence integrity or objectivity
- Respect confidentiality of information acquired in the course of work
- Carry out work in accordance with the technical and professional standards relevant to the work
- Perform duties with due care, competence and diligence
- Behave ethically, in a manner consistent with the good reputation of the profession.

These principles are an important part of an auditor's training and a requirement for qualification. Adherence to the principles must be demonstrated throughout the auditor's career. They are also pre-requisites for registration as a company auditor (for which educational and professional qualifications must be in place, practical experience incurred and a personal reference provided).

Hence within the auditing profession, there is a strong ethical culture which emphasises objectivity and independence.

Despite this, the existence of the current debate shows that the auditing profession has not adequately explained and communicated what underpins the auditor's work. The standards supporting the culture lack visibility. More importantly, there has been an apparent lack of priority given to monitoring compliance with ongoing ethical standards. As a result sections of the community seem to doubt the profession's commitment to objectivity and independence. In the interest of accountability, we believe that this is an area where the profession's processes need to be updated. As GW Bush outlined recently in the US, investors should have complete confidence in the independence and integrity of companies' auditors. This led President Bush to announce a review of the supervisory processes. We expand on possible regulatory and governance options for Australia in a later section of this submission.

The lack of visibility of the ethical culture has also led to a suggestion that a public "audit commission" for the private sector audit could be considered. We consider this to be a backward move in many ways, not least that such a body is unlikely to have the skills to assess which auditor should be appointed to undertake an audit.

### **3.3 Auditing Standards**

A company audit report is the end result of substantial work which is governed by auditing standards, set by the Auditing & Assurance Standards Board. Currently in Australia there are 43 auditing standards and considerable additional guidance material to assist in aspects of an audit.

Australian auditing standards reflect "world's best practice" through a long standing policy of harmonisation with globally accepted international standards of auditing, ISAs (since 1994/5) and Australia is regarded as an influential contributor to the international debate of what is best practice auditing.

The standards are also subject to extensive due process with interested parties given ample opportunity to express their views and to ensure that the proposed standards are relevant, consistent and logically derived.

There have been circumstances where auditors have failed to identify material misstatements in financial report. This has not been due to shortfalls within the internationally regarded auditing standards, but due to the application of the standards. Any examination of how the framework of auditing might be strengthened in the light of recent business failures or perceived audit failings should have regard to two important points:

- (a) not all business failures are linked to audit failures; and
- (b) if there is an audit failure, it is not the standards but individual application of them that is likely to be at fault.

Reforms need to concentrate on the monitoring and enforcement processes of the profession and the audit firms.

Ramsay called for greater Audit Committee involvement in the audit process. We believe that part of this will include understanding the scope of the audit and the auditor's quality control mechanisms. The Audit Committee activities are undertaken on behalf of the board, who are in turn the surrogates of the shareholders. To the extent that this brings more transparency and accountability into the process we support this proposal.

There has been a suggestion that explicit legal backing could be given to the auditing standards as a way to ensuring compliance. There is a danger in 'fixing what is not broken' in an attempt to respond to perceived issues. Increasing legislation in this area would add another burden to businesses. Also legislation by its nature can have a tendency to encourage rules based compliance which would weaken the current audit environment.

**Recommendation: Review and strengthen procedures for monitoring the application of ethical and auditing standards and the disciplinary processes in respect of breaches, but do not include these rules in legislation.**

## **4 Regulatory framework and governance needs improvement**

### **4.1 Summary**

An oversight board has been proposed by Ramsay and while we agree that the establishment of such a body may improve some of the market perceptions about audit independence, we believe that the proposed focus is too narrow. 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. 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.

### **4.2 Background**

KPMG are serious about improving the current market perception of the auditing profession. The faith in the profession has been visibly shaken by the recent experiences both in the US and Australia. This faith must be restored if we are to have an effective system of financial reporting on which an efficient capital market is based.

Professor Ramsay had the responsibility of considering the independence of the auditing profession, particularly in light of the HIH experience. In addressing this, his report recommends the establishment of an independent oversight board, the Auditor Independence Supervisory Board, ("AISB"). We accept that the establishment of an AISB may help to deal with some perceptions about auditor independence. We are concerned that this, alone, is not enough to restore the faith in the financial reporting framework and the auditing profession that is required.

It is necessary to investigate other options that may be available to improve the current regulatory framework. Set out below is a summary of the current arrangements, some comments on the establishment of the AISB plus a number of other options which should be considered in the context of this debate. This is by no means an exhaustive list and we recommend that a thorough examination and consultative process be established to consider a broader, more holistic approach to regulation.

It is interesting to note that in the UK, such an investigation has led to the development and implementation of a new system of non-statutory regulation of the accountancy profession. The UK's new system brings under one umbrella (the Accountancy Foundation and Review Board) responsibilities for setting auditing standards (Auditing Practices Board), the development of ethical standards (Ethics Standards Board) and for discipline (Investigation and Discipline Board). Whilst, the success of this new system remains to be seen it is a step in the right direction to achieve a more comprehensive approach to regulation and may provide a useful model for us in Australia.

### **4.3 Current arrangements in Australia**

The current arrangements for regulating the Australian auditing profession are fragmented and not transparent to the investing public.

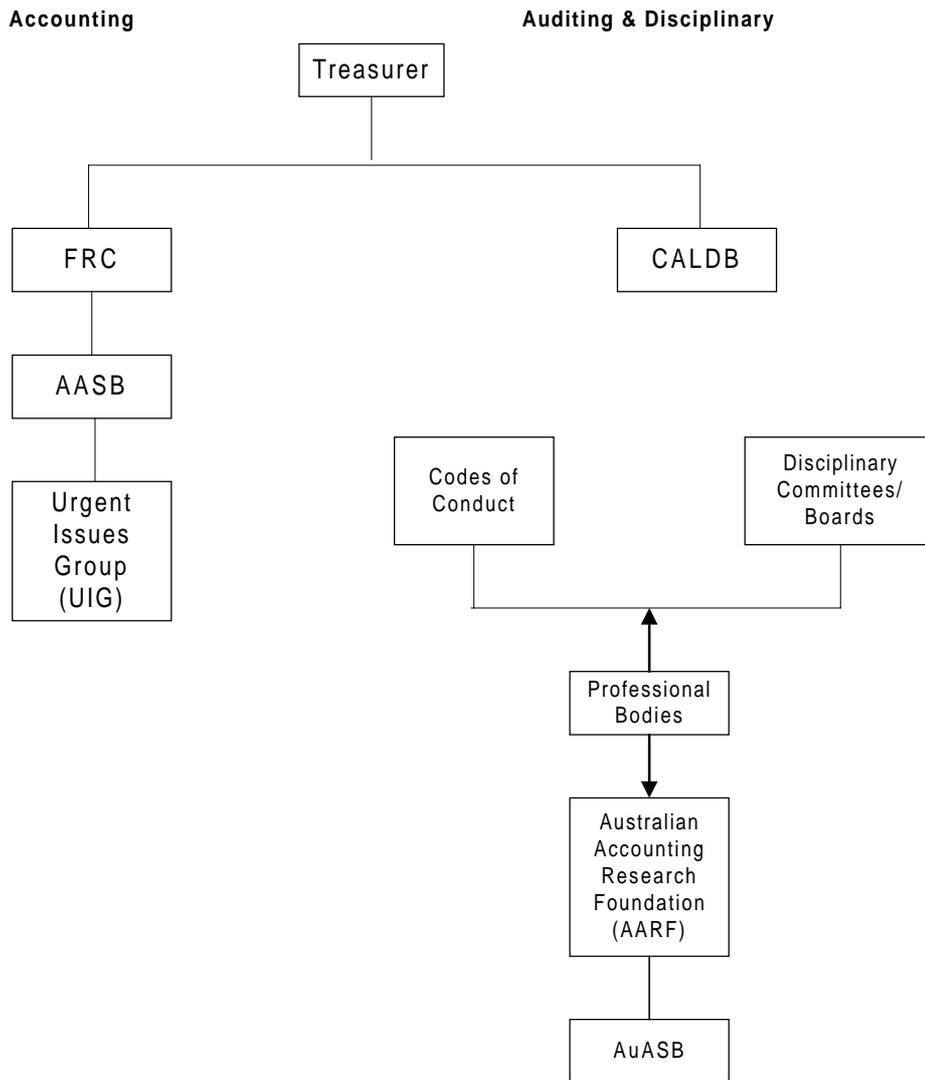
The current process for setting, monitoring and enforcing professional standards is fragmented and generally not well understood by users of financial reports. The Financial Reporting Council (“FRC”) is a statutory body responsible for providing broad oversight for setting accounting standards in Australia. Accounting standards are set by the Australian Accounting Standards Board (“AASB”). The AASB takes direction from the FRC and issues accounting standards only after approval by the Government (Treasury), the Australian Securities and Investments Commission (“ASIC”) and the joint professional accounting bodies

Auditing standards are set by the Australian Auditing and Assurance Standards Board (“AuASB”) which is effectively governed by the joint professional bodies. Auditing standards are binding only on members of the professional bodies.

ASIC is responsible for the registration of company auditors, as well as enforcement of compliance with accounting standards. Company auditors are required to demonstrate a level of professional experience in order to retain their registration certificates. The Companies Auditors and Liquidators Disciplinary Board (“CALDB”) reviews applications made by ASIC regarding compliance with accounting standards, and can take remedial action against auditors and liquidators.

In addition, the joint professional bodies have their own processes for the maintenance of professional standards. This includes the requirement that all members be able to demonstrate continuing auditing experience to maintain professional practising certificates. They also have their own disciplinary procedures and act upon non-compliance with accounting or auditing standards.

The current framework is presented in the diagram below:

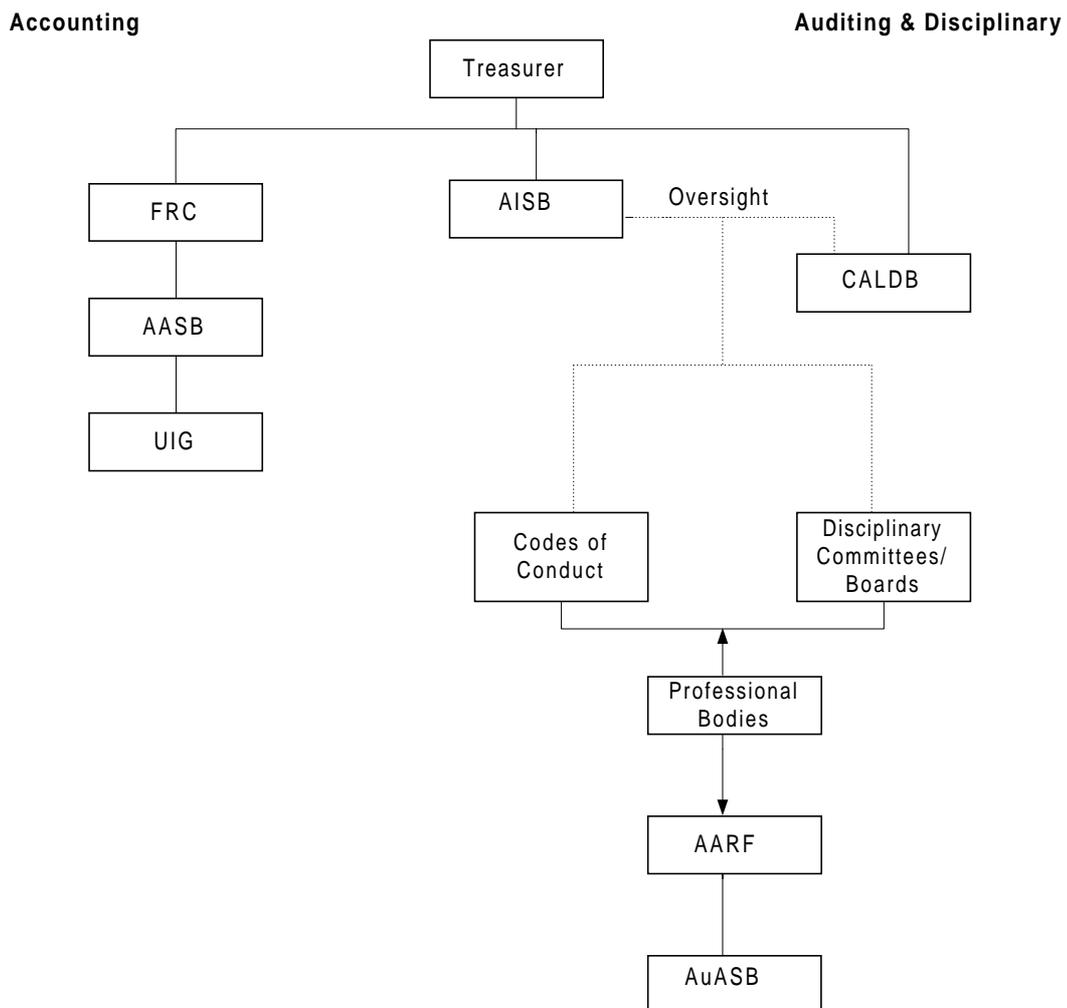


## 4.4 Alternatives to the Current Approach

### 4.4.1 Establishment of an Auditor Independence Supervisory Board (“AISB”) as proposed by Ramsay

Ramsay has proposed the AISB as an additional body to monitor independence. Whilst the AISB will add a further safeguard to the present system it may not necessarily address the present perceived lack of effectiveness. There is a risk that it may be seen to simply add another layer of administration.

The impact of Ramsay’s proposal can be presented as follows:



We accept the establishment of the AISB would go some way to restoring public confidence in auditor's independence. We agree that improvements can and should be made to the teaching of professional and business ethics and that an independent body monitoring compliance of audit firms and companies with the proposed new rules on independence would probably act as a deterrent to unethical behaviour. We are sceptical, however, that "monitoring" alone is enough. We are unclear as to what recourse the AISB would have over companies and/or audit firms that it identifies as not complying with the proposed new rules. It seems that referrals will be made to the existing bodies responsible for enforcement and discipline, ie CALDB and the joint professional bodies. However, the perception that existing enforcement and disciplinary arrangements have not proved to be entirely effective is exactly the issue we are all attempting to deal with.

We generally agree with the proposed composition of the AISB although we note that most of the proposed membership duplicates the current representation on the FRC and may therefore prove a burden on the industry bodies being asked to nominate representatives. In addition, whilst we believe that wide industry representation is important, consideration should be given to reducing the size of the board. A 12 member board is rather unwieldy and it may be more efficient if there were no more than 8 members (this is consistent with the UK model).

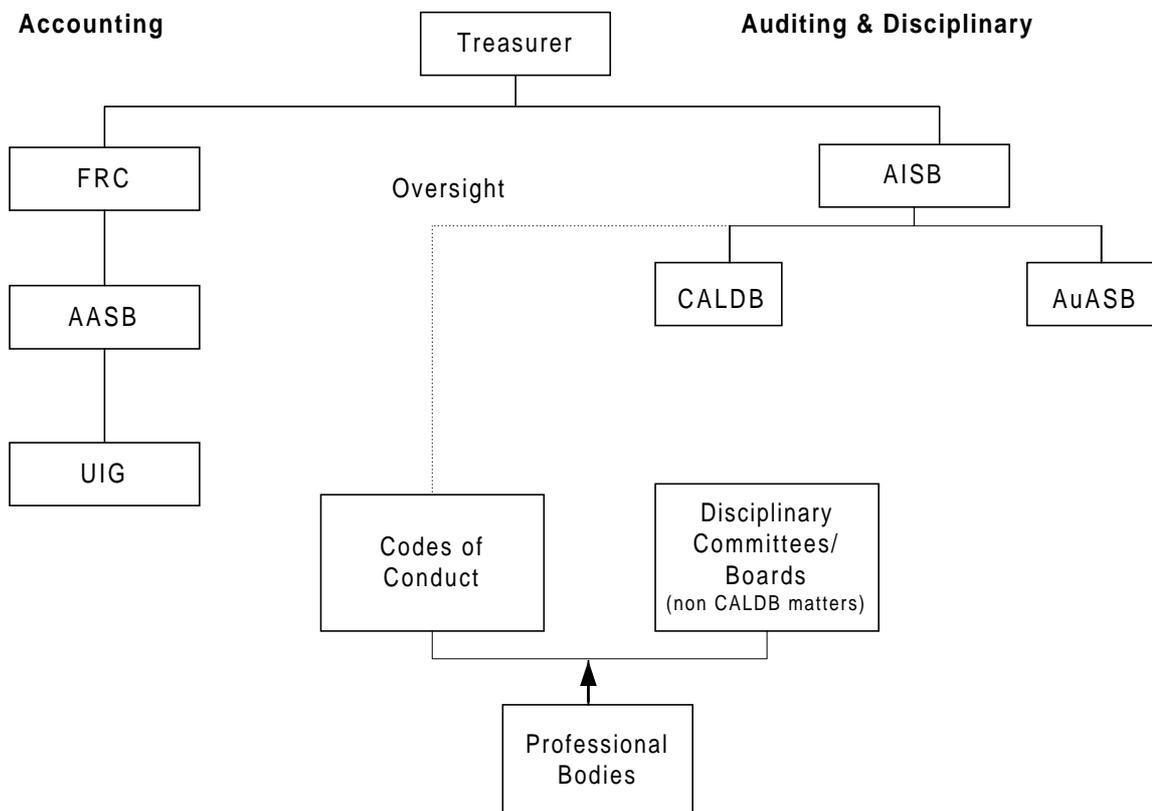
We agree with the proposed funding arrangements for the AISB. We acknowledge that some commentators will be concerned that this undermines the true independence of the AISB, however, we believe that the safeguards proposed will prevent the joint professional bodies from exerting any undue influence. In addition, it is necessary to make sure that the funding arrangements are adequate to ensure that the AISB can properly discharge its functions.

Suggested alternatives to the operation of the AISB as suggested by Ramsay are contained in the sections below.

**4.4.2 Establishment of an AISB with a broader mandate for overseeing the setting of auditing standards and enforcement/disciplinary activities**

Expanding the mandate of the proposed AISB, by also including the responsibility for oversight of the development of auditing standards would result in some logical realignment of responsibilities.

This option is illustrated in the diagram below:



Some of our concerns regarding the establishment of the AISB alone, could be alleviated by expanding its proposed role. The AISB could be given a broader mandate and be responsible for providing broad oversight for setting auditing standards in Australia as well as for overseeing current enforcement/disciplinary activities.

The AISB could act in relation to auditing standards in a role similar to the existing FRC, ie. it would:

- Oversee the operation of the AuASB including:
  - appointing its members;
  - approving and monitoring its priorities, business plan, budget and staffing arrangements;
  - determining its broad strategic directions;
  - providing direction, advice or feedback on matters of general policy and procedures; and
  - monitoring the effectiveness of its consultative arrangements.
- Monitoring the development of international auditing standards, with the overriding objective of ensuring that Australian auditing standards are of equal, if not higher, quality than those promulgated by international standard setters.
- Monitor the operation of Australian auditing standards to assess their continued relevance effectiveness and objectives.
- Oversee the operation of the current bodies responsible for enforcement and discipline; including:
  - appointing members;
  - determining priorities, including an assessment of ‘public interest’ cases; and
  - resolving any potential conflict in judgements between the two separate disciplinary bodies by nominating, up front, which body should be responsible for reviewing individual complaints/cases.

This model could be applied with or without the additional responsibilities for enforcement and discipline.

Given an expanded role for the AISB, the proposed funding arrangements should be reconsidered. Where funding was solely provided by the joint professional bodies, then the independence of the disciplinary process, in particular, could be perceived to be undermined. An element of public funding should be considered – perhaps a portion of auditor’s registration fees could be diverted to the AISB.

Application of this option would:

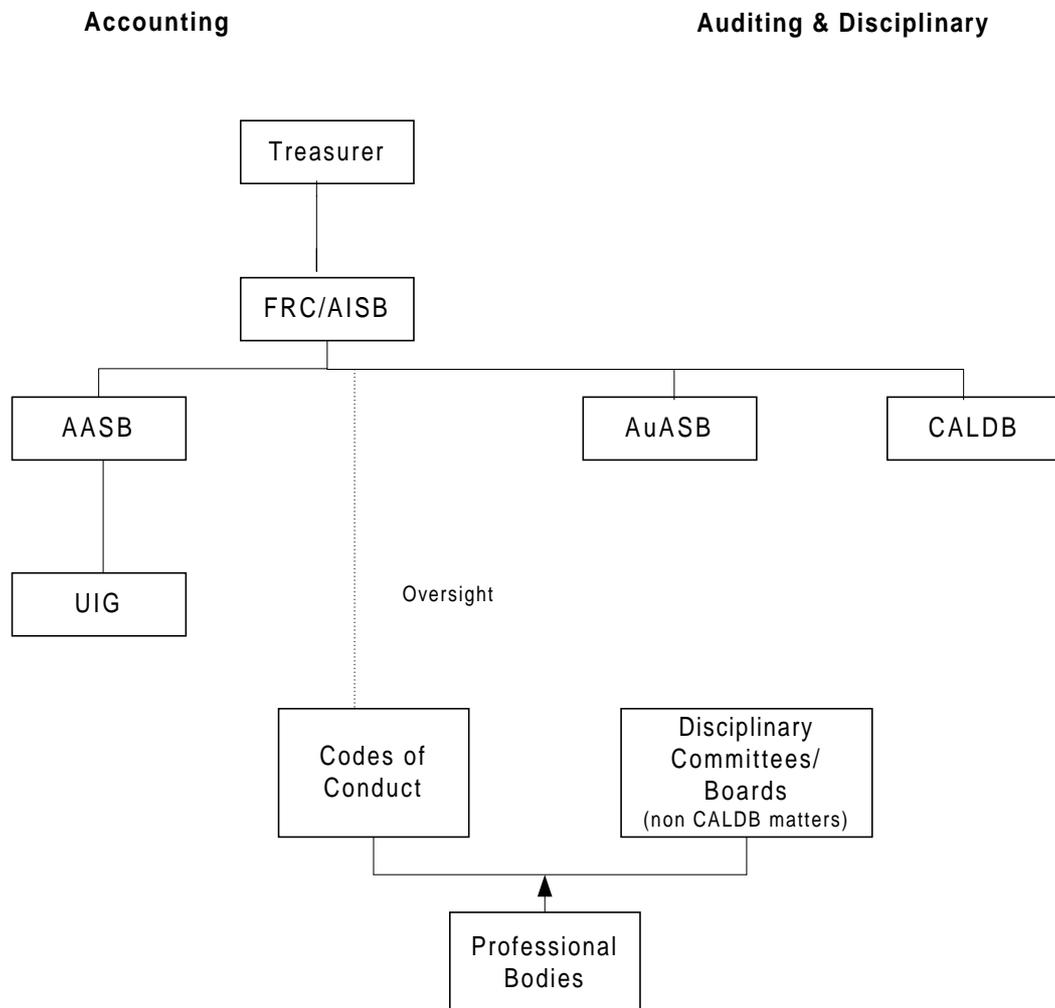
- result in standards being binding upon all auditors, not just members of the joint professional bodies (as is currently the case); and
- avoid the duplication that exists within the current disciplinary procedures, ie. an auditor can currently be ‘tried and tested’ twice with different outcomes.

However, the establishment of this oversight board is still adding another layer of regulation to an already complex and fragmented system.

**4.4.3 Extending the role of the current FRC to include the proposed role of the AISB and overseeing the setting of auditing standards and enforcement/disciplinary activities**

The establishment of only one oversight body, responsible for all elements of financial reporting, would help ensure consistency in the strategic direction of the standard setting bodies.

This option is illustrated in the diagram below:



This proposal extends the mandate of the existing FRC to include the role of the AISB, proposed under Ramsay, plus the additional responsibilities set out in 4.4.2 above.

Such an approach would eliminate the need for industry representative bodies to find more than one representative to sit on the various oversight boards. In addition, Government would receive one coherent report on the Australian reporting and auditing framework as a whole.

In order to make the oversight Committee effective, however, it is critical that the Committee is appropriately resourced. We agree that the current membership of the FRC has the appropriate mix of public, commercial and professional representation. However, the extended responsibilities under this proposed model must be properly discharged if Australia is to have an effective system of standard setting and regulation. We question whether or not, this can be achieved by individuals working part-time, with limited resources, on critical issues.

## **4.5 Additional comments for improving the current regulatory framework**

### **4.5.1 Establishment of a new Disciplinary Board**

One of the many frustrations of a professional in public practice is the current arrangements for discipline. As highlighted above, an auditor in professional practice could quite possibly be subjected to review by two independent bodies. He/she could be cleared of any wrong doing by one of those bodies but still be disciplined by the other. This is obviously an unsatisfactory state of affairs.

Consideration should be given to eliminating the two bodies involved and having only one body responsible for disciplinary activities. This should either be a statutory body; or non-statutory body established independently of the joint professional bodies, possibly something similar to the Investigation and Disciplinary Board (“IDB”) being established in the UK. The focus of the Board should be on cases of public concern. It should hear cases referred from either ASIC or the professional bodies. The UK Board, is a part-time Board of not fewer than three and not more than eight members.

### **4.5.2 Amendments focused on providing greater transparency**

One of the major criticisms of the auditing profession and the regulation of the profession is the lack of transparency with the current processes. Auditing Standards Board meetings have only very recently been held in public, whilst CALDB and joint professional bodies disciplinary activities are held in private. If the current basic system of regulation is to be retained then some minor amendments as set out below, would, we believe improve the transparency of the arrangements and enhance public confidence in the efficacy of the system.

All standard setting bodies should publish comprehensive annual reports of their activities. These should be available to anyone who is interested. The report should comment upon the strategies, objectives and achievements of the particular body for the year under review; as well as providing information on its membership, funding and general modus operandi.

The bodies responsible for discipline should continue to publish details of their disciplinary activities on a regular basis. They should also publish an annual report summarising numbers of cases heard, the outcome of those cases, and general rationale of decisions made in relation to public interest cases.

**Recommendation: To improve the market perception of the profession, a thorough analysis into the oversight of the total financial reporting framework and the auditing profession as a whole should be undertaken. Recent events have superseded Ramsay's brief and addressing the issue of audit independence alone will only deal with part of the issue.**

## **5 Enhanced financial and audit reporting**

### **5.1 Audit reports and audit scope need to be revisited**

Recent collapses have again highlighted that the role of audit and the auditor is not well understood. 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 easier it to understand what the audit is and does.

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. While this is a desirable outcome, it would be unfeasible for auditors to make such comments within the current litigious environment.

The audit report explains what the audit does and provides an opinion on the truth and fairness of the financial report.

It is a specific and highly technical report, developed along the lines it has due to legal challenges and liability concerns. As noted in a later section, the joint and several liability rules and professional insurance arrangements have been interpreted to imply that auditors are a good target for legal claims and actions. The result is that auditors have, of necessity, become ‘risk averse’ when reporting.

We recognise that there is opportunity to make the audit report a more easily read and understood report and consider this to be an important priority to address.

The assurance the auditor provides at present is limited to the financial report. Shareholders and others recognise that other information provided with the financial report is equally as important to their needs, for example directors’ reports and environmental reports. Both the US and the UK have assurance over other aspects in the annual package.

The US has an audit level service for the MD&A which assures the Board and Audit Committee that “the MD&A presentation is in line with SEC requirements; the historical financial information is accurately derived; and the underlying information provides a reasonable basis for the disclosures made”.

The UK requires a report to the shareholders on certain of their Combined Code disclosures (which relate to the internal control processes) made by the board.

Subject to liability considerations, we support revisiting the scope of the audit and the audit report. This could take the form of, for example:

- Rewriting the report to more ‘plain English’ language

- Expanding the work and report to cover governance, risk management and internal control aspects of relevance to shareholders' appreciation of their company
- Expanding the scope of the audit for other issues of on-going and legitimate relevance to shareholders, such as the financial health of the company

**Recommendation: Expand the scope and format of the audit report, within liability confines, to cover matters such as governance, risk management, internal control and financial health, and express it in plain English.**

## 5.2 Continuous reporting

Markets are demanding better and more frequent reporting. A number of other countries have already addressed this in their reporting frameworks and there is demand in the current environment for more. The quality of the information available to the Australian capital market should be at least equal to overseas best practice.

The pace of change in corporate dynamics and earnings capabilities has made timeliness of reliable information to shareholders more important. Financial reporting must not only be informative and reliable but also provided to users in a timely fashion. The increase in use of the internet for economic communications increases the pressure on timeliness of information.

Many countries require, or are in the process of mandating, frequent market reporting, for example:

The US requires quarterly reporting by its listed entities and these quarterly reports must be reviewed by the auditor.

UK listed companies prepare half year accounts and some high growth companies are required to do quarterly accounting.

Singapore has recently introduced quarterly reporting.

Other than the annual reports, Australian companies are only required to produce half-year accounts.

The call for more extensive and timely reporting of corporate financial and non-financial information is growing.

In the US, President Bush in his ten point plan for regulatory improvements included two proposals for better information:

- Investors should have quarterly access to information needed to judge financial performance
- Investors should have prompt access to critical information

In addition, the US accounting body, AICPA, in a recent submission to the US Congress stated that quarterly reports were outdated and “investors need more frequent corporate financial and non-financial disclosures (i.e. on-line, real time) to make informed decisions.

Continuous disclosure of price sensitive information is in place in Australia now. However there are no requirements for verifying the reliability of the information. Assurance on disclosure on a real time basis is possible but up to now, there has not been substantial market demand for this.

It is timely to review existing reporting requirements both for their adequacy and timeliness.

**Recommendation: Review reporting requirements in Australia and overseas to develop an improved market information framework regarding continuous reporting.**

### **5.3 Shortcomings in the financial reporting framework**

The intrinsic value of many companies is not reflected in the annual financial report. There are many established methods of collecting and disclosing information of relevance to investors which are not incorporated within the present financial reporting regime. Whether some or all of this additional information should be brought into the financial report needs to be debated. This is a wide ranging but important issue and work is needed to investigate the best way forward for Australian companies.

The financial reporting model has been questioned in Australia and in other countries due to market valuations of entities relying increasingly less on the annual financial report. There are many reasons for this, including the ability of investors and analysts to obtain other financial and non-financial information related to entities and greater sophistication of computerised analysis techniques.

The scope of financial reporting standards also is a relevant part of this. With new business models some commentators argue that financial reporting standards have not kept up to date, with no scope to include intangible but potentially valuable items, including relevant ratios and analysis within the scope of financial reports.

The auditing profession has recognised these issues and there are a number of projects and individual solutions in the market looking to provide information, and in some instances assurance, on an entity’s “value creators”.

The perceived or real problems concerning the financial reporting framework are far reaching and beyond the remit of this submission. Further work needs to be undertaken to ensure the reporting framework continues to deliver credible information going forward.

**Recommendation: Investigate ways to expand or amend the financial reporting framework to provide a more comprehensive view of the state and value of the company.**

## 6 Financial reporting requirement to be ‘True & 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 are derived from a different conceptual basis, and emphasise substance over form when applying the requirements. However part of the re-examination the regulatory framework for standard setting in Australia (recommended above), could include consideration of the legal status of ‘true and fair’.

The requirements of the Corporations Act 2001 (“the Corporations Act”) and the Accounting Standards set by the Australian Accounting Standards Board, provide our current framework for preparing reliable and meaningful financial reports.

The Corporations Act (Section 296) requires that a financial report must comply with Australian Accounting Standards and goes on to say (Section 297):

*“the financial statements and notes for a financial year must give a true and fair view ... This section does not affect the obligation under Section 296 to comply with accounting standards.”*

In cases where the directors of a company are of the opinion that compliance with accounting standards does not allow a true and fair view of the entity to be shown, accounting standards must still be complied with, and directors must include a note to the financial report.

These requirements were introduced by the Corporations Amendment Act 1991. Prior to 1991, the Law provided that directors did not have to comply with an accounting standard if to do so would mean that the financial report did not give a true and fair view. This provision was changed due to perceived abuses.

Financial reports are currently the subject of some criticism because of the volume of information being presented. There are some concerns that any additional information disclosed in the notes of the accounts to give a true and fair view could be lost.

In the UK, accounting standards allow for a departure from a standard if special and exceptional circumstances mean compliance with a particular requirement in an accounting standard is inconsistent with the requirement to give a true and fair view

In such cases ‘informed and unbiased judgement’ must be used to devise an appropriate alternative treatment, which should be consistent with the economic and commercial characteristics of the circumstances concerned. In addition, particulars of any material departure from an accounting standard, the reasons for it and its financial effects should be disclosed in the financial statements.

Similarly, IAS standards allow in rare circumstances a departure from accounting standards in order to achieve a fair presentation in the financial report.

IAS 1, "Presentation of Financial Statements", paragraph 13 states,

*"In the extremely rare circumstances when management concludes that compliance with a requirement in a Standard would be misleading, and therefore that departure from a requirement is necessary to achieve a fair presentation, an enterprise should disclose:*

- (a) that management has concluded that the financial statements fairly present the enterprise's financial position, financial performance and cash flows;*
- (b) that it has complied in all material respects with applicable IAS except that it has departed from a Standard in order to achieve a fair presentation;*
- (c) the Standard from which the enterprise has departed, the nature of the departure, including the treatment that the Standard would require the reason why that treatment would be misleading in the circumstances and the treatment adopted; and*
- (d) the financial impact of the departure on the enterprise's net profit or loss, assets, liabilities, equity and cash flows for each period presented."*

This provision has not been translated into Australian accounting standards due to the Corporations Act restriction.

**Recommendation:** We believe it is appropriate to include discussion regarding the status of requirements for 'true and fair' in any reassessment of the Australian financial reporting framework.

## **7 Legal liability reform would enable more comprehensive reporting**

There has been significant liability reform recently 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 'deep pockets' are targeted. This involves expensive and time consuming defence of unwarranted actions which is not in anyone's interests.

Although not specifically addressed in the Ramsay Report, it is timely to again revisit the issue of an auditor's liability relative to the conduct of an audit, the report and opinion.

The rising cost of professional indemnity insurance and its diminishing availability in the market place has meant that a party cannot be certain, in the event of a claim against the auditor of a company, that such a claim can be satisfied. The current cost of professional liability risk for the Big 5 firms globally represents conservatively 14% of audit revenues generated and the ever increasing magnitude of such claims has resulted in auditors being unable to obtain cover for amounts that are well beyond the capacity of the professional indemnity insurance market. These circumstances threaten the ongoing viability of the large audit firms and, consequently the best interests of national public welfare.

It is also generally accepted that when a loss occurs, it may not be wholly attributable to the auditor's work. Yet, even if the responsibility for a loss is only partially due to the audit, the impact of the concept of "joint and several liability" is that the auditor may be required to meet the entire judgment, in the event of the other parties' inability to pay. There is no justification for the disproportionate burden on auditors of the financial consequences of commercial fraud and failure.

Indeed, the fact that auditors are required by their professional bodies to maintain professional indemnity insurance makes firms an immediate target in any litigation.

As a consequence of these factors, the establishment of a statutory cap on an auditor's liability and reform of the law on joint and several liability, where financial loss is involved, needs to be re-considered.

These are complementary reforms and address the problems of uncertainty to the community by providing the auditor access to adequate and certain insurance cover and a solution to the currently inequitable allocation of damages.

A view has been expressed that auditors should not be able to limit their liability. This approach will ultimately result in increased uncertainty as to the availability of insurance cover, thus leading to a decline in those wishing to join the profession and a decrease in

those firms wishing to undertake the audit role. None of those outcomes will serve any benefit to the community.

A scheme exists in New South Wales that caps liability for auditors, having regard to the level of the fees charged (up to a maximum of \$20 million), this is only available in the State and, as State Legislation, may be overridden by Federal Law. Despite its limitation, the scheme does provide benefits by giving greater surety that its members will have adequate cover and resources (as required by the Scheme) to satisfy any claims. In addition, it requires certain professional standards to be met and risk management training to be undertaken, thus leading to the delivery of improved professional services<sup>1</sup>.

It is generally true that when a company fails, it is the auditor that comes under scrutiny. Yet, it is not the auditor who makes the daily decisions that may affect a company's strategy, affairs or policies, nor are they the party that appoints the executives or board. However, it is inevitable that the auditor will be sued. On the basis of joint and several liability, it is also likely that the auditor will be sued for the total loss, as the insurance cover and assets are attractive targets for litigants. The result being that insurance is required to cover not only the auditor for their liability but also that of other impecunious or uninsured parties.

To ensure that there is an acceptable balance between the risks associated with an auditor's role and the public interest in having an independent audit conducted, a capping of liability, proportionate liability legislation and abolition of joint and several liability of defendants are required.

The 1993 report of the Ministerial Council for Corporations Working Party recommended that the 'arbitrary and unfair consequences of the rules regarding joint and several liability of auditors' should be addressed in a review of the law.

**Conclusion: There is a strong case for greater disclosure of information which will be subject to audit or review. This can be more readily implemented under a framework of limitation of liability, some form of proportionate liability and/or abolition of joint and several liability of defendants.**

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<sup>1</sup> Western Australia is looking to introduce a similar scheme in 2002. No other state has a scheme in place.

## **8 Auditors need to be experienced and multi-skilled to maintain and improve audit quality**

To conduct quality audits and provide the assurance that markets demand, firms need to attract and retain personnel of the highest quality, with a range of business and industry skills. Senior audit personnel develop strong business and risk management skills through their involvement over many years in a wide range of assurance, advisory and business risk assessment engagements for their audit clients.

Audit effectiveness in the complex environment in which many businesses operate requires the use of high calibre personnel and experienced technical specialists.

In particular, auditors need a high level ability to understand business risks, and to be able to hold their own against skilled, knowledgeable and articulate business people in evaluating complex business transactions. This requires the highest level of technical expertise in areas such as tax, control systems, treasury and other business risk activities.

Auditors are also required to provide rapid independent accounting and taxation advice in complex transactions such as acquisitions. Understanding these issues and areas is important to building audit knowledge and auditors holding a range of skills and expertise are important for a quality audit.

To attract and retain personnel of this calibre requires a sufficient volume of work, to provide them with the experience and challenge to develop and maintain their expertise. This is currently achieved by providing non-audit services in their area of expertise to the firm's clients.

The profession provides post-graduate business training to hundreds of graduates each year, many of whom subsequently pursue their careers in industry and the public sector. This flow of experienced accountants, grounded in the disciplines and controls of the audit process, adds considerably to the quality of the accounting function in business.

A narrowly based audit practice would experience immense difficulty in recruiting and retaining the appropriate calibre of personnel in the face of:

- A highly competitive employment market
- Limited ability to obtain experience on complex transactions
- Restricted career opportunities, currently available through a broadly based firm

In summary, the ability to continue to attract and retain the highest calibre of experienced personnel is imperative in maintaining a strong and highly qualified profession respected by the market in Australia and internationally.

**Conclusion: Audit quality will suffer if Boards are restricted from utilising their auditors to undertake services other than financial statement audits.**

## **9 Responses to specific Ramsay recommendations**

### **9.1 Corporations Act requirement for a statement of auditor's independence**

We strongly support independence of auditors, in fact and in appearance, and believe that the IFAC rules codify and explain these requirements well. Legislation, however, is not the appropriate vehicle to achieve effective audit independence.

We strongly support the principle that auditors should be and be seen to be independent. The concept of independence is fundamental to auditing and one which has been embedded in our profession since it began.

Professor Ramsay's report recommends that the Corporations Act be revised to include a general statement requiring the company auditor to be independent. We consider that legislation is not the right vehicle for establishing requirements for independence. Legislation would require a simple definition of independence to be included in the Act, but this would not be possible to achieve. Unsuccessful attempts in other countries to define the meaning of "independent director" demonstrate that independence does not have a simple, standard definition. The concept of an auditor's independence is even more complex to articulate and is strongly dependent on personal qualities.

The International Federation of Accountants' (IFAC) have recently issued new independence rules. The IFAC rules have been subject to extensive review globally and were finalised with broad global consensus in November 2001. They therefore represent global best practice.

The situations which cause problems in practice, for example errors of professional judgement, undue influence or coercion, or misplaced faith in client personnel, have been codified in the IFAC rules as threats arising from self interest, self review, advocacy, familiarity and intimidation. The rules require, in every circumstance, the individual and the audit firm to identify and evaluate those circumstances and relationships that create threats to independence and take appropriate action to eliminate them. Certain threats may be too strong to be covered by any safeguard and where these can be clearly defined they have been identified in the IFAC rules.

We support the IFAC rules, which provide real reform the process. They are being adopted in Australia through revisions to the professional bodies' Statement of Professional Conduct, Section F1, Professional Independence (the Code). The proposed revisions are currently undergoing a review process which has provided the profession and others the opportunity to contribute.

The Code must be adhered to by all professional accountants.

The concept of audit independence is broader than a “checklist”, which would likely develop if attempt was made to build a definition into the law. Compliance with the form of the checklist may not equate to an independent state of mind. The Code will represent a strong and detailed explanation of the issues and complexities concerning independence and provides a framework allowing a more robust application in practice than legislation could achieve.

**Recommendation: The IFAC rules should be adopted in Australia through revisions to the professional bodies’ Statement of Professional Conduct, Section F1, Professional Independence.**

## **9.2 Rotation of auditors**

We strongly support the Ramsay recommendation of mandatory rotation of the audit signing partner, not the audit firm, after a maximum of 7 years.

Calls for mandatory rotation of audit firms is misguided. The cumulative knowledge and experience of the audit team is important for a quality audit. Rotation of the key decision makers in the team is a useful safeguard against over-familiarity. Research has shown that there are likely to be more audit failures in the first years of an audit, hence mandatory rotation of audit firms after an arbitrary period will only serve to weaken our markets.

## **9.3 Auditors should attend Annual General Meetings**

Ramsay proposes a legal change to require auditors to attend Annual General Meetings. We believe that the auditor should attend the AGM but that it is not necessary to legislate to achieve this.

We fully support any steps to strengthen the role of the auditor and to facilitate the accountability of the auditor to shareholders.

The auditor, particularly of listed public companies, should be obliged to attend the AGM, and respond to questions relevant to the conduct of the audit and the preparation and content of the auditors report.

We therefore support recommendations 6.127 of the Report, but question whether it is necessary for this requirement to be legislated.