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15 March 2002

The General Manager,
Corporate Governance and Accounting Policy Division,
The Treasury, Langton Place,
PARKES, ACT, 2600.

Attention: Mr Wallace Fernandes

Dear Sir/Madam,

Independence of Australian Company Auditors (Ramsay Report)

The Auditing & Assurance Standards Board (AuASB) of the Australian Accounting Research Foundation (AARF) has reviewed the report by Professor Ian Ramsay "Independence of Australian Company Auditors" ('Ramsay Report') and welcomes the opportunity to provide comment on the Report. The AuASB congratulates Professor Ramsay on a comprehensive Report that was completed in an extremely short time frame.

The AuASB looks forward to continued contribution to the debate on auditing and assurance matters and to assisting further with issues that arise from the Ramsay Report relating to the AuASB's activities.

In the following pages, the AuASB provides comments in relation to the Ramsay Report. In Attachment 1, the comments are of a general nature and in Attachment 2 comments relate to specific recommendations made in the Report.

However we would like to emphasise the following points:

- In our view, there is no systemic evidence from recent or previous corporate failures or research that a problem exists with audit independence or audit quality. We would welcome further research and indeed believe that the investigations into current corporate collapses should be completed before any action is contemplated.
- In particular, there is no evidence that if firms perform other services that this in itself impairs auditor independence. Consequently, despite the ongoing debate on this issue, we agree with Professor Ramsay that no ambit restrictions on other services are required. Guidance in the Accounting Bodies' exposure draft Statement F1 is appropriate and adequate. Indeed, there is a strong argument that conduct of other services by audit firms can increase the quality of both the audit and the other services.
- The AuASB is pleased to take as an endorsement of the adequacy and comprehensiveness of existing Auditing and Assurance Standards and related

Guidance Statements, the fact that the Ramsay Report makes no adverse comment regarding the Standards or the activities of the AuASB. Having said this, the AuASB is committed to continuous improvement in the Standards and guidance that it issues. However, we acknowledge that such Standards need to be supported by effective enforcement mechanisms.

- Poor corporate performance, including failure, is a probable element of the commercial risk/return relationship inherent in the supply of debt or equity capital. In particular, audited financial reports whilst an important accountability mechanism, are only a subset of the information available to existing and potential investors and debt holders in their decision making.
- The AuASB believes the existence of active and effective audit committees, as proposed in the Ramsay Report, provides an excellent market-based mechanism to strengthen corporate governance and to oversee the audit function in companies. Other mechanisms to strengthen corporate governance exist and should also be considered.

We would also like to point out that in our view, the Ramsay Report's terms of reference failed to address the following important issues:

- the need to consider all aspects of the corporate governance framework;
- the need to consider a wider reporting model incorporating non financial information, prospective as well as historic information, and the provision of assurance on such information;
- the need to address the risk of fraud;
- the need to address communication to and education of financial reporting and auditing issues to users of financial reports;
- the need to improve current consultative processes.

Many of the above issues are within the AuASB's mandate and are in various stages of progress within the AuASB's work program. In addition, a major project on audit risk will be undertaken, which will see a further improvement in various Auditing Standards and guidance. The AuASB is monitoring this and other international developments closely, through its involvement with the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC).

Please do not hesitate to contact either myself or Mr Richard Mifsud at the Australian Accounting Research Foundation if you have any queries in relation to this response, or if there are any matters arising which you would like to discuss further. We would be pleased to provide more information on these matters should you be interested.

Yours faithfully,

W.R. Edge
Chairman
Auditing & Assurance Standards Board

ATTACHMENT A. GENERAL COMMENTS

1. THE ROLE OF AUDIT

The AuASB feels it is important to gain perspective on the events associated with the commissioning of the Ramsay Report. The Report acknowledges two primary sources for the initiative. First, overseas developments in relation to auditor independence and second, publicity with respect to auditor independence associated with the failure of several listed Australian companies during 2001. Comments on each of these issues follow.

a) Overseas developments and relevance to Australia

Whilst Australia should always look to overseas developments to maintain best practice, the overseas developments in relation to auditor independence should be considered with caution. The January 2002 issuance of the International Federation of Accountants Section 8 “Independence” document and its broad acceptance by the Australian Accounting Bodies through their December 2001 re-exposure of the proposed guidance means that **within a short time the Accounting Bodies’ Joint Code of Professional Conduct will reflect the latest international developments in provision of guidance on independence.** Additionally:

- Australia is widely acknowledged to have long enjoyed one of the most transparent regimes in terms of the disclosure of fees for non-audit services provided by the auditor. In many ways it can be argued that international developments, especially in terms of non-audit service provision disclosures, are conforming to existing Australian requirements.
- The AuASB’s long-standing commitment to international harmonisation of auditing and assurance standards (since 1995) together with its lead role in many International Auditing Practices Committee (IAPC) projects, including research projects, mean that Auditing and Assurance Standards in Australia are at least equal to and in a number of cases more rigorous than the equivalent International Standard on Auditing (ISA). The AuASB has recently updated its Standards in relation to fraud and error¹, in line with international developments. It is also monitoring closely ongoing international developments in the area of both the audit risk model and fraud and is likely to further revise Standards in light of these developments.
- In many areas, the AuASB has issued Standards and guidance on specific audit and assurance related matters that have later become the basis for an international auditing standard or guidance.

¹ AUS 210 “The Auditor’s Responsibility to Consider Fraud and Error in the Audit of a Financial Report” and AUS 218 “Considerations of Laws and Regulations in an Audit of a Financial Report”.

**ATTACHMENT A.
GENERAL COMMENTS**

The AuASB is pleased to take as an endorsement of the adequacy and comprehensiveness of existing Auditing and Assurance Standards and related guidance, the fact that the Ramsay Report notes no deficiency in the Standards or in the activities of the AuASB. Having said this, such Standards need to be supported by effective enforcement mechanisms.

ATTACHMENT A. (cont.)
GENERAL COMMENTS

b) Corporate failure and relevance to audit quality

It is important to note that company collapses have many causes and there is no evidence from either prior failures or from research, that a lack of auditor independence or audit quality is systemically involved. Informed investors are cognisant of the risk of their investment and investment strategy and seek and use information from many sources. Many parties play a direct or indirect role in the external reporting of corporate performance and there is a danger more is expected of auditors than they can be reasonably expected to deliver. These observations are explained more fully in the sections that follow.

i) *INVESTMENT RISK*

Poor corporate performance, including failure, is an inevitable part of the commercial risk/return relationship inherent in the provision of debt or equity by suppliers of capital. Investors and lenders choose the level of risk to which they subject themselves and it is their responsibility to manage that risk as appropriate. Sound investment principles through diversification and other strategies are well documented and available to investors and potential investors. Auditors cannot and should not be held accountable for investment and lending decisions subsequently proving to have been inopportune, merely by virtue of their association with a particular entity.

ii) *THE CORPORATE REPORTING FRAMEWORK*

Audited financial reports, whilst an important accountability mechanism, are only a subset of the information available to existing and potential investors and debt holders in their decision-making. Too often, misunderstanding and unrealistic expectations of the auditor's role within the corporate reporting framework occurs. There is a danger that the role of others, for instance management and the Board of Directors, audit committees, bankers, analysts, regulators and accounting standard setters, is overlooked in too quickly identifying corporate failure as audit failure. Even in the few cases where audit failure is determined to have occurred, it does not necessarily mean that corporate failure follows.

c) Audit quality

Of the many thousands of audits of financial reports conducted, an extremely low proportion has given reason to question the quality of the service provided. This is in no small part due to the strength of both the auditing profession and Auditing Standards. Inquiries currently in process into recent high profile corporate collapses in Australia and any ensuing litigation will determine whether or not audit quality was a factor in these cases. Until the outcome of these inquiries is known, the AuASB feels it is premature to alter the existing balance in the co-regulation model towards a more legislative, prescriptive approach.

The merit of allowing market-based mechanisms within the market for audit services to work actively to induce desired behaviour should not be underestimated. Imposing rules tends to create rule-based behaviour that encourages economic

ATTACHMENT A. (cont.) GENERAL COMMENTS

inefficiency, adding to the costs to be borne by all shareholders and eventually by consumers of goods and services.

d) The way forward

The above comments are not to suggest room for complacency in terms of auditing standards, compliance with Auditing and Assurance Standards and monitoring of that compliance, ensuring individual competency in fulfilling the audit function, or vigilance with respect to threats to auditor independence. **The AuASB is committed to continuous improvement in processes with respect to Auditing and Assurance Standards and related guidance.**

However, **the AuASB believes it important to not react with undue haste** to current events lest “solutions” are created that may seem appropriate on the surface, but which in fact may exacerbate rather than minimise any deficiencies in corporate reporting or corporate governance.. Implementing effective mechanisms for improvement in all aspects of the corporate reporting process, including a corporate reporting model that is more transparent, is very important.

Together with Professor Ramsay, **the AuASB believes the existence of an active audit committee, composed of an appropriate number of non-executive directors, provides an excellent market-based mechanism to oversee the audit function.** We welcome steps to strengthen audit committees and the role they play in sound corporate governance.

The AuASB is pleased to note that Professor Ramsay’s Report and recommendations draw heavily on one of its publications *The Audit Committees Best Practice Guide*². This Guide has been well received in the market place and provides an excellent source of reference for audit committee members and others in achieving sound governance of companies in which they have an interest.

Another mechanism that might be considered to strengthen corporate governance is for the management of the company to report formally to the audit committee annually on the effectiveness of a company’s internal control and governance procedures. The audit committee could review this management report and take any appropriate action to satisfy members with respect to the report’s content and to remedy any problems. Discussing the management report with internal and external auditors and/or seeking further assurance might then be appropriate.

² Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, issued jointly with the Australian Institute of Company Directors and the Institute of Internal Auditors - Australia, *Audit Committees: Best Practice Guide* (2nd edition, 2001).

ATTACHMENT A. (cont.) GENERAL COMMENTS

2. CONCEPTUAL FRAMEWORK VS PRESCRIPTIVE APPROACH

In general, the AuASB prefers a conceptual rather than prescriptive approach to the encouragement of ethical behaviour amongst members of the Auditing Profession.

Professor Ramsay's recommendations include legislating within the *Corporations Act 2001* to expressly prohibit auditors from being involved in a series of circumstances in which professional accountant independence is threatened. These circumstances are drawn from those identified in the International Federation of Accountants (IFAC) Section 8 "Independence" document as problematic for accounting practitioners.

However, the IFAC document was not designed to be used in a way where portions are extracted and provided with legislative backing. The complete document is written as a framework that describes factors that could threaten independence and safeguards that can be implemented to preserve independence. IFAC chose to move away from its previous approach, which attempted to identify particular problematic circumstances, in part because such an approach cannot capture all such circumstances and in part because it encourages compliance with the letter of the rules rather than the spirit of the rules. The major Accounting Bodies in Australia (CPA Australia and The Institute of Chartered Accountants in Australia – [ICAA]) have chosen to follow this same conceptual framework approach to ethical issues involving professional accountants, with their exposure draft Statement F1 mirroring the IFAC document.

Emphasising standards to be met rather than conduct which should be avoided is a much more positive approach to encouraging ethical behaviour. There is a danger that proscription will not achieve desirable outcomes and in fact may encourage a search for 'loopholes'. **What is required is a commitment to the spirit of the framework in its entirety rather than to the letter of portions of the framework that are given legislative backing.**

We believe this commitment is best achieved under the auspices of a Code of Professional Conduct to which members of the Accounting Bodies are bound, rather than direct government legislation.

3. SELF-REGULATION VS EXTERNAL REGULATION

One of the major disadvantages of highly detailed prescriptive legislation is that it may hinder the development of market-based solutions, since amendments to legislation are not a simple matter and may not keep pace with changes in the business environment.

On the other hand, self-regulation is more responsive and is more likely to be effective when there is an active professional or industry body in place (in this case CPA Australia and the ICAA), when the industry is mature (as is the accounting and auditing profession), and when 'industry' participants recognise their future viability depends on their relationship with the wider community (as does the accounting and auditing

ATTACHMENT A. (cont.)
GENERAL COMMENTS

profession) (Chapter 5, Final Report of the Taskforce on Industry Regulation, Treasury, August 2000).

The AuASB is not convinced that external regulation of the profession in the form of legislative change is likely to produce superior outcomes and believes the existing self or co-regulation model remains the best way to proceed.

4. FORMATION OF THE AUDITOR INDEPENDENCE SUPERVISORY BOARD (AISB)

The AuASB welcomes debate on the notion of an oversight Board but believes such a Board needs to have a broader focus than is proposed for the AISB in terms of ‘auditor independence’ alone. As we have expressed earlier, we do not believe that independence is the prime or only concern that needs addressing in this current environment.

The AuASB believes an oversight Board similar to that recently implemented in the UK in relation to institutional arrangements for the accounting and auditing profession is a model worthy of serious consideration. This UK model retains self-regulation and uses an oversight board to oversee the functions of auditing standard setting, development of guidance on ethics, discipline and registration of auditors, and other miscellaneous matters.

Whilst the AuASB is supportive of the importance of representation from amongst financial report user groups if an oversight Board were to be formed, we have some concern that auditing practitioners are not sufficiently represented within the UK structure, but in principle, we view the model as appropriate. The AuASB has for a number of years included representation from the public sector and academia, and has recently broadened its membership further to include an additional academic and also a non-accountant representative. We are currently monitoring the position in the UK and will be further considering the workings of the new arrangements once they become fully operational.

ATTACHMENT B COMMENTS ON SPECIFIC RECOMMENDATIONS

1. CORPORATIONS ACT STATEMENT ON INDEPENDENCE (Recommendation 5.04)

The AuASB is concerned with Recommendation 5.04 in that it is extremely difficult to define 'independence'. As paragraph 8.9 of IFAC Section 8 "Independence" states:

" The use of the word " independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others."

A subtle and complex notion such as 'auditor independence' does not lend itself to regulation and legislating in this way is likely to create non-trivial enforcement issues. The AuASB believes professional self-regulation is much more likely than legislation to be effective in this respect.

2. ANNUAL DECLARATION BY AUDITOR TO BOARD (Recommendation 5.05)

The Ramsay Report recommends that the auditor declare, "that the auditor has maintained its independence in accordance with the Corporations Act and the rules of the professional accounting bodies." **The AuASB agrees with such a declaration.** As, the revised F1 will, when issued, adopt a conceptual approach as well as example situations from which rules can be gleaned, it is important the wording of this declaration reflect compliance with the "spirit" of the Code of Professional Conduct and not just "the rules of the professional accounting bodies".

3. DISCLOSURE OF NON-AUDIT SERVICES (Recommendation 5.94b)

The AuASB notes the transparency of existing disclosures with respect to client expenditure on non-audit services provided by the auditor and agrees with further disclosure of the nature of such services. However, the setting of standards in relation to disclosures in financial statements is not within the AuASB's mandate and is the province of the Australian Accounting Standards Board (AASB). Hence implementation of this recommendation will involve AuASB liaison with the AASB. **The AuASB has already contacted the AASB, requesting that the improved disclosure of non-audit services be placed on the AASB work program.**

4. AUDIT COMMITTEES AND FINANCIAL LITERACY (Recommendation 6.77)

The AuASB agrees with the Report's emphasis on appropriately constituted audit committees as an auditee corporate governance mechanism that will enhance audit quality and provide internal oversight of auditor independence and other issues. The AuASB concurs also with the desirability of most audit committee members being conversant with financial and accounting matters.

However, the AuASB notes the difficulty of defining 'financial literacy' and notes that attracting suitably qualified directors and audit committee members may be made more difficult if there is a perception that heightened litigation risk accompanies the designation of 'financially literate'. Additionally, **the requirement for each committee member to be financial literate is onerous and might, at least in some circumstances and at some level, detract from other skill sets being available to**

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COMMENTS ON SPECIFIC RECOMMENDATIONS

committees and perhaps boards of directors (for instance, environmental, social, mining and engineering expertise).