



AUSTRALIAN  
INSTITUTE OF  
COMPANY  
DIRECTORS

ABN 11 008 484 197

*Professionalism in Directorship*

**Submission**

**To**

**Treasury**

**On**

**The Independence of Australian Company Auditors**

**21 March 2002**

## **The Australian Institute of Company Directors**

The Australian Institute of Company Directors (AICD) is the peak organisation representing the interests of company directors in Australia. Current membership is over 16,000, drawn from large and small organisations, across all industries, and from private, public and the not-for-profit sectors. Membership is on an individual, as opposed to a corporate basis.

The AICD is a federation of seven State divisions, each of which is represented on a National Council. Overall governance of the AICD is in the hands of its National Council which is comprised of the seven division Presidents, plus a National President, two National Vice-Presidents and a National Treasurer. AICD has several national policy committees, focusing on issues such as law, accounting and finance, environment, taxation and economics, and national education, along with task forces to handle matters such as corporate governance.

The key functions of AICD are:

- to promote excellence in director's performance through education and professional development
- to initiate research and formulate policies that facilitate improved director performance
- to represent the views and interests of directors to government, regulatory bodies and the community
- to provide timely, relevant and targeted information and support services to members and, where appropriate, government and the community
- to maintain a member's code of professional and ethical conduct
- to uphold the free enterprise system
- to develop strategic alliances with relevant organisations domestically and internationally to further the objectives of the AICD

## Introduction

AICD has reviewed Professor Ian Ramsay's report 'Independence of Australian Company Auditors Review of Current Australian Requirements and Proposals for Reform' (the Report) and welcomes the opportunity of providing comments.

As company directors are intimately associated with the audit function AICD members have considered the Report in detail and are keen to be involved in dialogue with the government in relation to the Report and implementation of its recommendations.

AICD is pleased to note that the Report and its recommendations made extensive use of the publication 'Audit Committees: Best Practice Guide' ('Best Practice Guide'), (written by AICD, the Auditing and Assurance Standards Board and the Australian Accounting Research Foundation). AICD believes that this publication provides valuable assistance to members of audit committees and boards and will assist in raising awareness of best practice.

AICD provides the following comments in relation to the Report. In Part 1 the comments are of a general nature and in Part 2 the comments relate to specific recommendations made in the Report.

### Part 1 General Comments

AICD notes that company failures can have many causes, including market or regulatory risk, strategic misjudgement, incompetence, and dishonesty. The independence of auditors is only one of a number of possible factors, which could contribute to a company's failure. Enquiries into recent failures are still afoot, and we cannot now know their conclusions. However, we do know that no amount of regulation can remove the risks inherent in the free market system. Indeed, beyond a certain point, additional regulation can be counterproductive. It is a question of striking a balance between encouraging innovation and the taking of legitimate business risks, and protecting investors (large and small). Similarly, no amount of regulation can prevent fraud and malpractice where the parties involved are sufficiently determined. Some of the comments in this submission reflect a concern for this balance, and for more cost-effective approaches to the common goal, rather than differences of principle. There is also the need to review any proposals for significant regulatory change, and particularly for structural change (for example, the proposed Audit Independence Supervisory Board), in the light of any broad lessons which emerge from the investigations now afoot.

The Report proposes a number of changes to the Corporations Act in relation to the independence of auditors, which would have the effect of increasing the level of 'black-letter' law in this area. AICD is concerned that this may encourage people to comply with the letter as opposed to the spirit of the law. In addition, detailed prescriptive legislation is less able to keep pace with and respond to changes in the business environment. In many instances self-regulation is more flexible and more likely to be effective when there are active professional bodies, as exist in Australia.

AICD notes that increased regulation increases the costs of the regulated. These costs rise rapidly as one goes up the diminishing return curve and are also subject to economies of scale. It follows that, for any given standard (conceptually, a point on the diminishing returns curve), the proportional cost is higher for a small company than for a larger one. As a result, a number of the changes to regulation proposed by the Report are likely to impose a higher burden on smaller companies than on larger companies.

AICD believes that co-regulation is the appropriate regulatory model in the area of independence of auditors and endorses the Report's support for this approach. The AICD notes that the Institute of Chartered Accountants in Australia and CPA Australia are currently revising their Professional Statement F1 on Professional Independence to incorporate the conceptual approach embodied in the International Federation of Accountants rules. In general terms, AICD believes that encouraging improved ethical behaviour through such professional statements is more likely to produce desirable ethical behaviour than increasing the level of black letter legislation.

AICD's support for the co-regulatory approach raises the issue that incorporating a number of the Report's recommendations into the ethical rules of the profession means that auditors who are not members of a professional body would not be bound by these rules. AICD believes this is best addressed by requiring all auditors to be members of a professional body. If necessary, this requirement could be incorporated into the Corporations Act or associated regulations.

The Report seems to give the impression that the audit committee is responsible for all matters and decisions relating to the audit. AICD suspects this is not the intent but, for good order's sake, stresses that an audit committee, where it exists, is a delegate of the board. The board **must and should** retain ultimate responsibility for decisions in relation to the audit. A properly constituted and well functioning audit committee is an invaluable resource for a board. However, it is the board that must take and bear full responsibility for the financial statements and as a result the outcome of the audit and be responsible to the shareholders (who appoint the auditor) for the decisions that it takes.

## **Part 2      Comment on specific recommendations**

### **Recommendation at 5.04**

**It is recommended that the Corporations Act be amended to include a general statement of principle requiring an auditor to be independent.**

AICD would agree to the inclusion of a general statement of principle in the Corporations Act with a specific reference in that Act to a definition of independence in the ethical rules of the profession.

AICD has difficulty with the recommendation at 5.04 to incorporate a 'reasonable investor' test into the Corporations Act. AICD is concerned that the inclusion of a subjective test into legislation would lead to uncertainty without improving behaviour.

### **Recommendation at 5.05**

**It is also recommended that the auditor must make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the Corporations Act and the rules of the professional accounting bodies.**

Currently most firms make such a declaration and AICD believes this is good practice as it gives the board an opportunity to make an assessment about an auditor's independence. The making of such a declaration should not be mandated in the Corporations Act but should be incorporated into the rules of the profession. An obligation on auditors to notify a board of any conflict that has arisen, together with an obligation on the board to respond to the auditors' notification, should also be incorporated into the professional rules.

### **Recommendations at 5.35 Employment relationships**

AICD believes that the majority of recommendations on employment relationships detailed in this section of the Report are appropriate. However, AICD does not believe these proposals should be implemented by extending the provisions of the Corporation Act, but that they should be covered by the ethical rules of the profession.

There are two situations in this section where AICD has particular reservations. Firstly in the case of a client employing a current auditor or an employee of the auditor and secondly in the case of retired audit partner joining a board within two years of retiring from the firm.

In the first case, AICD supports the long-standing practice of employees of audit firms providing services on secondment, provided that it is subject to their not being involved in decision-making roles and to their work being reviewed by client management.

In the second case, AICD does not agree that a former audit partner (being the partner who actually signed the audit opinion) should not be able to join a board within two years of retiring from the audit firm. Provided that there is full disclosure to shareholders, they should be able to choose who is to be a director.

AICD believes if an audit partner or recently retired audit partner is to join a board he or she should stand for election at the Annual General Meeting; that is, he or she should not fill a casual vacancy prior to that AGM. Such an approach would emphasise the importance of shareholders formally considering all relevant issues, including the possibility of any conflict, before the audit partner or recent audit partner assumes a position on the board.

AICD notes that an auditing firm cannot control and therefore be held accountable for the actions of a former partner. Furthermore, any such partner may have ceased to be a member of a professional body, and therefore no longer be subject to its ethical rules and associated oversight. Any preclusion or constraints on retired audit partners becoming directors of companies they have audited cannot therefore be implemented

via the ethical rules of the profession. In this instance, AICD believes any such preclusion or constraint would be best implemented via regulation under the Corporations Act.

### **Recommendations at 5.59 Financial Relationships**

AICD believes that the majority of financial relationships detailed in this section of the Report are appropriate but believes they should be included in the ethical rules of the profession and not in section 324 of the Corporations Act.

AICD supports the introduction of a materiality test in the recommendation dealing with investments in audit clients.

In the section dealing with loans to and from audit clients AICD would be concerned to ensure that this only applies to partners directly involved in the audit of the company concerned and their relatives.

### **Recommendations at 5.94 Provision of Non-Audit Services**

AICD is pleased to note the recommendations in this area are to be included in the ethical rules of the profession.

### **Recommendations at 6.34 Auditor Independence Supervisory Board**

AICD believes that these recommendations require further thought. It may be that a board looking only at the issue of independence is too narrow. If the aim is to improve investors' confidence in the auditing profession, the proposed board might be better served to look at the whole process relating to the appointment of auditors. This is particularly the case given that the issues that have arisen relating to the audit process both in Australia and overseas, are more about the competence with which an audit is carried out than about the independence of the auditor conducting the audit.

AICD doubts the utility of adding a further layer of regulation without evidence that it can provide any measurable benefit.

Given the list of responsibilities outlined it is doubtful that one senior appointment and a very small staff could cover that mandate. Creating such a body will raise expectations, which will create more problems than it solves if the body does not have the capacity to meet those expectations. Boards comprised of representatives of interested institutions, often do not work very well, and have a tendency to drift towards the lowest common denominator.

AICD would be concerned to ensure that any such a board should be funded out of ASIC levies (which are paid by the business sector) and not by a further levy on business. Under this approach, there can be no suggestion of such a board being or being seen to be captured by any particular interest group.

### **Recommendations at 6.75ff Audit Committees and Appendix D**

The general comment (see Part 1 above) that over emphasising the role of the audit committee may diminish the board's overall responsibility for decisions relating to audit and the auditor's independence is repeated.

AICD believes that the current approach in the Australian Stock Exchange Listing Rules (Listing Rules) to audit committees should be retained and that they should not be mandated for listed companies. This does not mean that AICD does not believe that a properly constituted audit committee is not good practice but rather that an audit committee may not be appropriate for all companies.

AICD does not support inclusion of the recommendations relating to audit committees in Appendix D to the Report in the Listing Rules, in part because the benefits of audit committees extend well beyond listed companies. It is preferable that they are included in industry codes such as the Best Practice Guide. In this connection AICD notes that a number of the recommendations in Appendix D to the Report are already included in the Best Practice Guide.

The composition (including the number of independent directors) of an audit committee should not be mandated.

Consideration of the position of smaller companies is particularly relevant to this section of the Report, because a number of the recommendations impose disproportionate burdens on such companies. Major overseas stock exchanges for example, New York, London and Tokyo do not have the long tail of small listed companies that are listed on the Australian Stock Exchange. In those markets, small companies are catered for by regional or other small exchanges, and companies only graduate to the larger exchanges after they have reached a certain scale and demonstrated a capacity and /or willingness to observe more onerous requirements. Australia does not have a significant sector of such "feeder" exchanges.

AICD believes that it is best practice to include independent directors on the audit committee and encourages smaller companies to follow this practice to the extent they are able to (see the Best Practice Guide p. 12). Indeed, AICD encourages companies to consider the appointment of independent directors for additional, and wider, reasons. However, AICD does not believe that the number of independent directors to be included on an audit committee should be mandated (Appendix D to the Report). The Report does propose a less onerous requirement of one independent director on audit committees of smaller companies; however, it is difficult to see how an audit committee with only one independent director can effectively counter management's monopoly of internal information and control systems.

Where there is an audit committee AICD supports a written charter for audit committees (see Best Practice Guide p.12).

A company's ability to obtain the information as to whether the remuneration paid by the auditor to individuals performing the audit is tied to the provision of non-audit services (at 6.78 of the Report) is questioned. The more appropriate approach would be to state, in the relevant ethical statement, that the auditor should provide such information to the company so that it can make such a judgement.

### **Recommendation at 6.105 Appointment and Removal of Auditors**

The following Audit Review Working Party recommendations (as amended by the report) be implemented:

**1 The auditor of a listed company should be appointed and their remuneration determined on the recommendation of the company's audit committee.**

**(Recommendation 7.2)**

**2 The auditor of a company which is not listed should be appointed and their remuneration determined on the recommendation of the company's audit committee where such a committee exists. (Recommendation 7.3)**

Where an audit committee exists, AICD supports these recommendations (see p. 24 of the Best Practice Guide). Once again the point should be made that the audit committee's function is to make recommendations to the board which the board must then consider and act upon. The board **must and should** retain ultimate responsibility for decisions in relation to the audit

Where the board decides not to act upon the audit committee's recommendation AICD believes that the decision and the reasons should be minuted. AICD does not believe that this should be disclosed in the Annual Report as is proposed at point 4.2 in Appendix D to the Report.

**3 There should be mandatory rotation of the audit partners responsible for the audit of listed companies. (Recommendation 7.7) The rotation is to occur after a maximum of 7 years but may occur sooner if considered appropriate by those involved in the audit. There is to be a period of at least 2 years before the partner can again be involved in the audit of the client.**

AICD supports implementation of this recommendation as it will aid the perception of independence. The rotation requirement should be in the ethical rules of the profession.

**4 The Corporations Act or the ASX Listing Rules (or the ASX Guidance Note relating to continuous disclosure) should be amended to provide that a proposed change to the auditor of a disclosing entity is a continuous disclosure matter. (Recommendation 7.14).**

There should be no difficulty disclosing a change of auditor to the market once the board has actually made the decision to recommend a change of auditors to shareholders. The provision should be in the Listing Rules and not in the Corporations Act.

**5 The Corporations Act should provide that any proposal for appointment of auditors of a disclosing entity must contain information on the proposed fees. (Recommendation 7.15).**

AICD supports including this requirement in the Listing Rules as it is appropriate that the shareholders have this information before them when voting on the appointment of the auditor.



**Recommendation at 6.127 Attendance of Auditor at AGM**

**It is recommended that the Corporations Act be amended to require the company's auditor or a representative of the auditor to attend the AGM at which the auditor's report is tabled unless reasonable circumstances preclude the auditor's attendance. This requirement for auditors to attend AGMs should apply only to AGM's of listed public companies.**

AICD believes this is appropriate, however the obligation should not be expanded further than the existing Corporations Act requirement for the auditor to respond to questions 'relevant to the conduct of the audit and the preparation and content of the auditor's report' (Section 250T).