15 March 2002

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

FAO:

Dear

Independence of Australian Company Auditors

The five major accounting firms in Australia are pleased to present the attached paper for consideration as part of your review of the Ramsay report, the appropriateness of the accounting profession's rules on audit independence and the balance of regulation and self-regulation.

The integrity and ethics of the audit process are important aspects of an effective capital market and we are fully committed to supporting any initiatives that enhance the process.

Audit independence is only one of a number of areas where improvements to the perceptions about capital market activities can and should be made. We believe it is also timely to address important underlying issues through a proper review of the financial reporting regulatory framework, governance, and audit. These investigations should include both the timeliness and credibility of company reporting and the assurance provided by an external auditor.

Yours sincerely

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Independence of Australian Company Auditors

Introduction

The Ramsay report provides the opportunity for real reform and is a good basis for advancing the debate insofar as it relates to the independence of auditors. We welcome the review and support the general thrust of the proposals contained in the report.

There are certain proposals in the Ramsay report which require further consideration and the practical implementation of those will need additional work. In addition there are important issues other than those covered in the review which are fundamental to any serious reform in the financial reporting environment. In this submission, we expand on the main issues.

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. In an effort to advance the debate, major areas where improvements could be made are noted below.

Enforcing ethical and auditing standards

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. 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.

Recommendations: Review and strengthen procedures for monitoring the application of ethical and auditing standards and the disciplinary processes in respect of breaches.

Enhanced financial and audit reporting

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.

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.

Continuous reporting improvements

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.

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

Shortcomings in the financial reporting framework

The intrinsic value of many companies is not reflected in the annual financial report. Indeed, evidence suggests that the financial report value of a company accounts for, at best, around 20%-50% of its market value. There are two main reasons for this: (1) the measurements used in financial reports are not always the most relevant for market purposes; and (2) the market value reflects a number of other components, including future prospects and non-financial information.

There are many established methods of collecting and disclosing information relevant to markets but not included within the financial reporting regime. Whether this 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.

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.

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.

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.

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.

Industry knowledge needs to extend well beyond technical accounting areas to provide auditors with an ability to properly evaluate complex business transactions and the associated risk issues. It is not possible to conduct a quality audit without industry specialists in areas such as tax, control systems, treasury and other business risk activities.

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

Regulatory framework and governance needs improvement

An Oversight Board (AISB) has been proposed by Ramsay and while we agree that the establishment of such a body might improve some of the market perceptions about audit independence, we believe that such a 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.

Recommendation: To improve the market perception about 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.

Response to specific Ramsay recommendations

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 the requirements well. Legislation is not the right vehicle to achieve effective audit independence.

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

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.

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.