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The General Manager
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The Treasury
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Response to the Ramsay Recommendations re 'The Independence of Australian Company Auditors'

Thank you for the opportunity to provide comments on the report issued by Professor Ian Ramsay in October 2001 'Independence of Australian Company Auditors' (the Ramsay Report). Pitcher Partners is a large accounting firm of approximately 350 staff and partners and provides accounting, audit and advisory services to medium and large *Australian* based businesses. Our comments reflect the issues arising in implementing the Ramsay recommendation in this segment of the market place, in contrast to those primarily concerned with capital markets.

We have a number of concerns regarding the recommendations the Ramsay Report puts forward, and appreciate the decision to seek wider consultation. In summary our major concerns are:

1. Any action taken to revise auditor independence issues is unlikely to resolve the underlying problems surrounding corporate collapses.
2. To provide early warning of corporate collapses the whole area of corporate governance needs to be considered. This includes consideration of business risk, management policies, accountability relationships and financial reporting. Many of these issues are beyond the scope of a statutory financial statement audit.
3. ***If*** audit failures are found to be a factor contributing to corporate collapse (and this is not yet proven), then it is more likely that it is the firm's audit *process* rather than auditor independence that will be the cause of any problem.
4. Perceptions of auditor independence vary significantly depending on the context for the company-auditor relationship. In particular there are significant differences in context for proprietary and public or listed companies. Professor Ramsay has

made an inappropriate arbitrary distinction between small proprietary companies and all other entities *without* consultation with stakeholders from local business.

5. Australian business is unique in that it is composed of a large proportion of family businesses. The recommendations made have the potential to impose rules governing relationships between companies and their auditor, which are relevant in the context of capital markets, but which could stifle the provision of timely financial expertise to local family businesses.

Each of these concerns is explained in more detail below.

1. Undue Attention to Auditor Independence

Auditors have been perceived as having 'deep pockets' and have become the target for claims when companies fail. As a result the auditor and auditor independence has attracted a disproportionate amount of attention that has been further stimulated by the media. For every high profile corporate collapse there are an unknown number of audits, where neither the audit nor audit independence is questioned.

2. The Perceived Intention to Address Corporate Collapses

We acknowledge the factors prompting this review, as discussed in the introduction to the Ramsay Report. Namely, recent overseas work in the area of auditor independence and secondly publicity concerning auditor independence following the failure of a number of listed Australian companies during the first half of 2001. It is worth noting that earnings management and corporate failures have also prompted the overseas developments in this area, particularly in the USA. If the real issue is an early warning of potential corporate failure by means of the auditor, then action taken to prescribe auditor independence will not address the underlying problem.

The audit of financial statements is only one aspect of corporate governance. Corporate governance covers all aspects of management and accountability, and includes the entity's business strategies, internal controls and choice of accounting policies to report the transactions which flow from the strategies adopted. The whole topic of corporate governance needs closer review to improve practice and prevent poor business decisions, including poor reporting practices. The appropriateness or otherwise of business decisions are currently outside the scope of an audit.

3. Audit Process vs Auditor Independence

Each audit firm follows its own methodology in applying auditing standards. It is disturbing that through all the adverse publicity surrounding the auditor, the audit approach followed by the audit firm has not been questioned by the media but instead the focus has been on auditor independence. It is certainly much easier to be critical regarding auditor independence rather than examining or evaluating a process. A focus on auditor independence rather than a focus on the audit process could be a 'band-aid to fix a broken bone' approach. It would be worthwhile considering whether any individual firm has a higher incidence rate for audit negligence claims, to ascertain whether it the process rather than independence causing the problems.

4. The Context for Company-Auditor Relationships

Not withstanding the above comments we recognise that auditor independence rules had not been revised for many years prior to the issue of the Ramsay Report. That process has now been completed at both an international and national level by the accounting profession. However, the development of regulation by the accounting profession is dominated by the 'Big 5' accounting firms. Neither the revised professional rules, nor the Ramsay recommendations recognise the contextual differences for relationships between auditors of listed corporations and auditors of local business. Appendix A of the Ramsay Report provides a list of the stakeholders consulted during the review. The list indicates that there has been *no consultation* with representatives of local businesses. Given that more than 80% of Australian business is small business, and independence rules potentially apply to all auditors, there is an urgent need to recognise the contextual differences to prevent local business losing access to financial expertise.

The primary driver for independence is users needs. For proprietary companies there is often little or no separation between managers and owners, and therefore an audit is more likely to focus on regulatory compliance rather than conflict of interest. Also, differences in corporate structures can significantly impact on accessibility to information. Third party users of financial information provided by proprietary companies are usually finance providers, and these users are able to command access to information as a condition of the finance agreement. ***These are fundamental differences in context, with significant impact on perceptions of independence and hence the independence rules for auditors.***

Proprietary companies also display greater transparency in their business relationships than listed entities. For example:

- Financial report users are often clearly identifiable and often have an interactive relationship with business operations (for example: owner-managers, members of public companies limited by guarantee or finance providers).
- These users often carry *large personal risk* in the event of business failure.
- There is open, frequent communications and easier access to reporting information.
- Business operations are often:
  - restricted to one or two main activities
  - limited to only a few locations
  - organised in simple corporate structure
  - managed and reported using non-complex IT systems.

The audit firm is perceived to be independent because it is removed from the day-to-day activities of the business and is not financially dependent on the client. Therefore, for example, the audit firm will be able to provide other services without impairing independence because of the nature of existing relationships and transparency regarding non-audit engagements and their outcomes. The degree of transparency in these circumstances is significantly greater than disclosures made in the financial reports of listed entities of fees paid for non-audit services, which only provide an indication of any non-audit relationships.

These factors have not been considered in the Ramsay Report, which focuses on listed companies. For these reasons, we strongly oppose any prescriptive measures to enforce a 'one-size-fits-all' approach to determining independence. In particular, we believe that rules to address perceptions of independence applicable to auditors of listed companies, *should not be imposed* on auditors of proprietary companies.

5. The Application of Recommendations in the Context of Local Business Needs

General Statement of Principle Requiring Independence

The discussion refers to a 'reasonable investor with full knowledge of all relevant facts and circumstances'. In the case of proprietary companies the 'reasonable investors' form a closed group. This context is significantly different to 'reasonable investors' in capital markets. Therefore a consideration of 'relevant circumstances' including all relationships between the auditor and the audit client, by the two groups of investors might provide significantly different conclusions.

List of Core Circumstances which Create a Lack of Independence

- **Employment Relationships**

A small proprietary company is not required to prepare financial statement in accordance with the Corporations Law and is not required to have an audit except in certain specific circumstances. Therefore the concessions granted to *small* proprietary companies in the recommendations have limited value.

Points 3 regarding employment by the client of a former auditor/employee of auditor, and point 4 regarding a retired audit partner joining the board of the audit client are potentially detrimental to the well being of proprietary companies. Proprietary companies do not often have extensive in-house expertise and do not have the resources or willingness to have different financial advisers, auditors or consultants. Their owners are often fiercely protective of proprietary information such as their business strategies and reporting information. As such it is likely that they will seek to recruit financial expertise from a practice which is known to them.

We believe that where there is transparency regarding these employment arrangements, users are not disadvantaged. In contrast, proprietary companies will be disadvantaged if they are not able to continue a relationship with their audit firm after recruiting ex-audit staff.

In these situations the entity should disclose any relationships in their financial report and the audit firm can employ safeguards to protect their independent status in accordance with Professional Statement F1.

- **Financial Relationships**

We concur with these recommendations.

- **Business Relationships**

We concur with these recommendations.

- **Non-Audit Services**

Proprietary companies do not usually have an audit committee. However, we concur with *a principle* that requires disclosure and agreement of the terms of engagement between the audit firm and client, as this could also be applied to proprietary companies. This is already addressed to some extent in Auditing Standard AUS 204 'Terms of Audit Engagements'. However, the recommendation needs to be restructured to recognise the nature and structure of local business, if these rules are to have universal application.

The provision of non-audit services impacts on perceptions of independence when the audit firm receives substantial non-audit fees. However, we believe that the provision of other services to proprietary companies will not impair independence if transparency is ensured. The auditor is able to maintain independence and objectivity due to the following factors:

- the scale of operations of proprietary companies is often significantly smaller than the scale of operations of a listed company;
- the relative influence of executives, who are also owner-managers;
- relatively limited availability of funding, hence greater attention to initiation of new projects by owners, managers and users;
- increased risk for personal loss by users, hence increased scrutiny of detail by owners, managers and users.

Other Measure that Enhance Audit Independence

- **Establishment of an Auditor Independence Supervisory Board**

We do not concur with a recommendation to establish an Auditor Independence Supervisory Board, which seems to add another unnecessary and expensive bureaucratic layer into the process. We believe that the independence, role and authority of the existing Australian Auditing & Assurance Standards Board should be strengthened, perhaps through oversight from the Financial Reporting Council rather than through the Professional Accounting Bodies.

- **Audit Committees**

This recommendation specifically applies to listed companies. However it is worth noting that it is the *effectiveness* of an audit committee, rather than its *existence* that will improve corporate governance. The recommendations do not ensure that the audit committee will be effective.

- **Appointment and Removal of Auditors**

We concur with these recommendations in respect of listed companies.

- **Disciplinary Matters**

No specific comments.

- **Attendance of Auditor at AGM**

The scope of the auditor's responsibilities is clearly laid down in legislation. However, as demonstrated in the media coverage given to recent high profile corporate collapses, users expectations might be quite different and in many cases they may be unreasonable. Therefore, although auditors may attend the AGMs of

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listed companies they will only respond to questions relevant to the conduct of the audit and preparation and content of the auditor's report. Australian Auditing Guidance Statement AGS 1046 'Responding to Questions at an Annual General Meeting' directs auditors to decline any questions that are beyond the scope of audit responsibilities.

In particular, the auditor's report does not provide assurance in relation to individual elements of the financial report, or other aspects of operations such as the adequacy of the entity's system of internal control. Without further education of users and investors as to the role and responsibilities of auditors, it is difficult to see how an auditor's attendance at an AGM will add value to the process.

However, if the auditor's attendance at AGMs is simply to facilitate questions regarding independence issues and other services provided, then this objective may be achieved.

Other Issues Considered During the Review

This section appears to reiterate current requirements

Our overriding concern is that rules to address perceptions of independence relevant to listed companies and capital markets are *not* inadvertently imposed onto local family businesses, which are mainly proprietary companies. Local family business has special needs, and these businesses have an important place in the Australian economy. Pitcher Partners already supports family business research at Monash University. (refer to our web-site at www.pitcher.com.au for further information). We would be willing to work with Treasury if necessary, to promote an understanding of the information needs of these Australian businesses.

Please contact me if you would like to discuss any issues arising from this submission.

Yours sincerely,

T J BENFOLD
Partner

S. DIANNE AZOOR HUGHES
Technical Director

cc: The Hon. Ian Macfarlane MP
Federal Minister for Small Business