

THE AUDITING FRAMEWORK

Introduction

- 4.1 Previously in this report the Committee has considered the need for reform in the area of corporate governance and in regard to the depth and nature of financial reporting. This chapter will consider whether further complementary reforms are required to the framework in which auditors operate to support these initiatives.
- 4.2 Audits can influence the market value of a company as investors place a higher level of trust in information that has been subject to an independent audit. Broadly, investors should be able to rely on the audit function to provide an independent and comprehensive review of the information being reviewed and of the judgements and estimates behind it.

What is an audit

- 4.3 An audit could commonly be described as the process of collecting and assessing evidence to support (or disprove) statements being made by the management of an organisation.¹ Audits are conducted on a variety of subject matters and include assessments of:
- financial statements or reports (the subject of this inquiry);
 - effectiveness and efficiency (commonly termed performance audits);
 - administrative and legal compliance;
 - prospective financial information; and

1 PricewaterhouseCoopers, *Exhibit* No. 11

- in fact, any agreed-upon procedure.
- 4.4 An audit is described in *Australian Auditing Standard (AUS) 106 – Explanatory Framework for Standards on Audit and Audit Related Services* as a service where the auditor’s objective is to provide a reasonable level of assurance² through:
- the issue of an opinion that enhances the credibility of a written assertion(s) about an accountability matter; or
 - the provision of relevant and reliable information and an opinion about an accountability matter where the party responsible for the matter does not make a written assertion(s).
- 4.5 This inquiry is concerned with those audits, undertaken by registered auditors, of a company’s financial reports produced in accordance with the *Corporations Act 2001*.
- 4.6 There is some disagreement however, as to what exactly the audit is attesting to. The submissions to this inquiry have variously mentioned that the auditor is attesting to the truth and fairness, reliability, validity, accuracy and correctness of those financial statements.
- 4.7 *Australian Auditing Standard AUS 702 – The Audit Report on a General Purpose Financial Report* prescribes the form and content of audit reports issued on general purpose financial reports. In particular, the standard requires that the audit report indicate whether, in the auditor’s opinion, the financial report is presented fairly in accordance with applicable Accounting Standards and other mandatory professional reporting requirements in Australia.
- 4.8 This standard recognises that this form of wording is not appropriate for the preparation of an audit report under the *Corporations Act*, which specifies the form that the auditor’s report should take. Reporting under the *Corporations Act 2001* is discussed further at paragraph 4.104.

Auditing and professional (ethical) standards

- 4.9 The auditing profession is required to follow a series of auditing and professional (ethical) standards in the conduct of its work. The auditing standards contain the basic principles and essential procedures, together with related guidance, to be applied during an audit and in audit-related services. The professional (ethical) pronouncements provide guidance on

2 A reasonable level of assurance is defined as a high, but not absolute level.

ethical issues and detail the minimum acceptable standards of professional conduct by members of the accounting profession.

- 4.10 The auditing standards are developed by the Auditing and Assurance Standards Board of the Australian Accounting Research Foundation and approved and issued by the National Councils of the two professional accountancy bodies. The Professional (ethical) standards, which form the Code of Professional Conduct, are set by the National Councils of the two professional accountancy bodies.
- 4.11 It has been suggested to the Committee that Australia's auditing and professional standards are of the highest quality and are world's best practice. For example, Mr Graeme Macmillan told the Committee that the Australian accounting bodies have invested considerable professional time and effort in developing the auditing standards to the extent that they now:
- ...are at least equivalent and mostly exceed international standards.³
- 4.12 The Auditing and Assurance Standards Board (AuASB) advised it has been committed to a program of harmonising the auditing standards with international auditing standards since 1995 and has played a significant role in many international research projects into auditing and assurance standards.⁴

The qualities of an audit

- 4.13 To be of greatest value an audit must have two key components, namely, it must be conducted competently and independently. Professor Keith Houghton told the Committee in his submission:
- ...financial reports that have attached to them a competent and independent audit have lower information risk in the market; lower risk results in higher stock price. Audits do, therefore, add value to a company and have the potential to affect stock price.⁵
- 4.14 Competency and independence are required to ensure that an audit is thorough, that is, it is based on a solid understanding of the client's business, including the risks the company faces and its operating environment. An audit should also be undertaken in accordance with

3 Mr Graeme Macmillan, *Exhibit No.2*

4 Auditing & Assurance Standards Board, *Submission No. 12*, p.S93

5 Professor Keith Houghton, *Submission No.1*, p.S07

relevant guidelines and standards and audit findings should be reported transparently, fairly and accurately.

- 4.15 The competence and independence of auditors is managed through the entry level educational requirements and the ongoing professional development and quality assurance processes of the accounting professional bodies and the accounting firms, including their policing of adherence to the auditing and professional (ethical) standards.
- 4.16 Professor Keith Houghton told the Committee:
- There is no doubt that the audit firms compete vigorously in respect of competence. This competition has led undoubtedly to the development of greater expertise and experience...⁶
- 4.17 Auditors' independence is a significantly more complicated and subtle issue for accountants to deal with. The independence debate is broadly considered to have two dimensions, commonly described as actual and perceived independence and issues associated with these dimensions will be addressed further in this section of the report
- 4.18 It should be noted that Professors Graeme Dean, Frank Clarke and Peter Wolnizer suggested to the Committee that the independence question goes beyond the physical and ethical dimensions. They contend that the constraints imposed on auditors by the need to ensure compliance with the accounting standards also impacts on their ability to form an independent opinion, because they are largely at the behest of the financial calculations and discretion of the preparers of the financial statements.⁷
- 4.19 The Committee notes that this situation is similar to the reliance of audit committees on management for information discussed at paragraph 2.117. Auditors should carefully consider the need to verify information received from management, particularly seeking independent sources of information against which internally generated information can be tested. In this regard, the Committee's recommendation that CEOs and CFOs personally attest to the veracity of the financial reports provided to the board will greatly assist in this respect.

Audit independence

- 4.20 The following is a summary of the major contemporary issues considered by the Committee regarding the independence of auditors.
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6 Professor Keith Houghton, *Submission* No. 1, p.S10

7 Professor Graeme Dean, Emeritus Professor Frank Clarke and Professor Peter Wolnizer, *Submission* No.11, p.S83

Ramsay Report

- 4.21 As discussed in Chapter 2, in October 2001, Professor Ian Ramsay released the report of his review into auditors' independence (commonly termed the Ramsay report).⁸ The report made five core recommendations and a series of minor recommendations to promote practices to enhance audit independence and also to address issues, which might indicate a lack of audit independence.
- 4.22 The vast majority of the submissions to the Committee, which have referred to the Ramsay report, have been supportive of the recommendations made. The main exceptions being:
- the Australian Stock Exchange (ASX) and the Australian Institute of Company Directors (AICD) suggested a principle-based approach, through the auditing and ethical standards was likely to prove more effective than attempting to prescribe measures of an auditors' independence in the *Corporations Act 2001*,⁹ and
 - some submissions have argued the responsibilities of the proposed Auditors' Independence Supervisory Board (AISB) should be subsumed into the existing regulatory framework, while others have suggested the proposal does not go far enough and have suggested alternative models, to address a wider range of issues associated with financial reporting in Australia.

Independence of the Public Sector auditor

- 4.23 Professor Ramsay recommended that the *Corporations Act 2001* be amended to include a general statement of principle requiring an auditor to be independent. That statement, he suggested, would make it clear that an auditor would not be considered to be independent if, they weren't, or could reasonably be seen as not, capable of exercising objective and impartial judgements.¹⁰
- 4.24 The Committee notes that legislative references to the independence of public-sector auditors is a fundamental feature of the systems of accountability operating throughout the government sectors in Australia. For example, the Auditor-General for Australia, Mr Pat Barrett AM, told the Committee that the *Auditor-General Act 1997*:

8 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001.

9 Australian Stock Exchange, *Submission No.21*, p.S176 and Australian Institute of Company Directors, *Submission No.26*, p.S220

10 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.29

...establishes the Auditor-General as an independent officer of the Parliament, a title that symbolises the Auditor-General's independence and unique relationship with the Parliament.¹¹

- 4.25 Responding to the Committee's request concerning the inclusion of legislative provisions mandating that private sector auditors should be independent, the ANAO told the Committee:

...a legislative provision requiring the independence of auditors, while largely symbolic, would have merit in that it sends a strong message to auditors and other stakeholders reinforcing the important principle of auditor independence.¹²

- 4.26 ANAO suggested the following form of words for such a provision:

The auditor must be independent of the company in performing or exercising his or her functions or powers under this Act.

- 4.27 The ANAO also suggested that any provision should be supported by a reference to the professional requirements on independence, which provide a basis on which independence can be assessed.

Conclusion

- 4.28 The Committee considers that Section 324 of the *Corporations Act 2001* would be the appropriate section of the Act to incorporate a general statement on the independence of the auditor.

Recommendation 9

- 4.29 **That Section 324 of the *Corporations Act 2001* be amended by including:**

- **the following statement**

The Auditor must be independent of the company in performing or exercising his or her functions or powers under this Act.

- **a footnote to indicate that this statement may be interpreted by reference to the Code of Professional Conduct of the Professional Accounting Bodies.**

11 Australian National Audit Office, *Submission No.27*, p.S239

12 Australian National Audit Office (supplementary), *Submission No.54*, p.S515

The provision of non-audit services

4.30 The extent of the risk to an auditor's independence posed by the simultaneous provision of audit and non-audit services to the same client, has generated a wide range of views amongst respondents to this inquiry and amongst other commentators generally.

4.31 A number of submissions have asserted that there is no evidence to support claims that the provision of both audit and non-audit services by the same firm compromises auditor independence by creating conflicts of interest. In his report, Professor Ramsay highlighted the arguments for and against the provision of non-audit service by auditors to their audit clients and concluded:

The mixed results found in the literature makes it difficult to draw firm conclusions...regarding the provision of non-audit services to audit clients...Audit independence studies examined during the course of this review have reached different conclusions concerning whether the provision of non-audit services impairs audit independence.¹³

4.32 Several submissions have contended that the provision of both audit and non-audit services allows a firm to develop valuable knowledge of a company's operations that assists in the audit process. For example, the AuASB told the Committee:

The greater the knowledge the auditor has of an entity, the more improved the quality of the audit will be. We would encourage doing other work to improve the quality of the audit.¹⁴

4.33 As indicated in Chapter 2 of this report, in May 2002, the professional accountancy bodies in Australia formally adopted *Professional Statement F1 – Professional Independence* as part of the professional code of conduct. This statement establishes a framework for the identification and evaluation of threats to audit independence, including through the provision of non-audit services and requires the application of safeguards to eliminate or reduce those threats.

4.34 In particular, the Statement provides guidance on the risks and possible actions to address those risks for a range of non-audit services and also recognises a number of activities that create risks that are so significant that the external auditor should not provide them, including:

13 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.113

14 Mr William Edge, *Transcript*, pa.78

- preparing, or making changes to source documentation or originating data;
- executing or authorising a transaction or other event;
- determining which recommendations made by the firm should be implemented by the company;
- reporting, in a management role;
- provision of accounting and bookkeeping services, in all but limited circumstances;
- the provision of valuation services, except in limited circumstances; and
- designing and implementation of the financial information technology system unless, amongst other things, the audit firm is not involved in any management decisions nor in the operation of the system.

4.35 Professor R. G Walker in his submission also identified a series of activities which external auditors should be prohibited from supplying, including:

- any involvement in the preparation of the financial statements, including preparation of the adjusting journal entries;
- valuation and due-diligence work;
- executive recruitment; and
- certain internal audit services, including work which is concerned with the provision of representations on performance or the integrity of the information systems.¹⁵

4.36 In contrast, many respondents have suggested that the simultaneous provision of non-audit services entails a significant and unacceptable level of risk of conflict of interest and should be prohibited. In particular, it was suggested to the Committee that the practice increases the perception by users of a company's financial statements that the auditors might be more sympathetic to the company and that audit independence has been compromised. This can result in a significant loss of confidence in the integrity of the external audit process.¹⁶

4.37 Mr J. W. Cameron, the Victorian Auditor-General, told the Committee:

the provision of non-audit services creates an environment for potential conflicts of interest, or the perception of such a conflict. The nature and credibility of the audit function demands that the

15 Professor R G Walker, *Submission* No.41, pp.S387-391

16 Auditor-General, WA, *Submission* No.30, p.S267

statutory provider be and be seen to be free of any other interest. The provision of non-audit services by an auditor is incompatible with the inherent nature of the regulatory role of the auditor.¹⁷

- 4.38 The United States has recently adopted legislation to prohibit the simultaneous provision of a range of non-audit services, including:
- bookkeeping or other services related to the accounting records;
 - financial information system design and implementation;
 - appraisal or valuation services;
 - actuarial services;
 - internal audit outsourcing services;
 - broker or investment adviser; and
 - legal services.¹⁸
- 4.39 The same US legislation also requires the company's Audit Committee to approve the engagement of the audit firm to provide any other non-audit services (that is, those not otherwise prohibited by the Act).
- 4.40 The Committee accepts that the simultaneous provision of audit and non-audit services creates risks to the auditors independence, both perceived and actual. The Committee believes, however, that attempting to identify and prevent all conflicts of interest in legislation is not practicable. It is considered that a more effective outcome may be achieved through better identification and management of these conflicts and the associated risks. Throughout this report the Committee has considered a range of measures which, through a mix of principle and prescription, are likely to assist companies and auditors deal with these issues. These include:
- enhancing the role and composition of audit committees (in this regard Appendix D of the Ramsay report contains useful information);
 - *Professional Statement F1 – Professional Independence* issued by the accounting profession;
 - Professor Houghton's suggestion for the establishment of Audit Independence Boards in audit firms; and
 - the Committee's recommendation that audit firms report annually to ASIC on how they have managed independence issues (Recommendation no. 4).

17 Auditor-General, Victoria, *Submission No.25*, p.S208

18 Section 201 of *Public Company Accounting Reform and Investor Protection Act, 2002*

4.41 A number of witnesses expressed support for this view. The following are indicative of the comments provided to the Committee:

■ Australian Institute of Company Directors:

...it will often be more effective to recognise conflicts and provide pragmatic safeguards, rather than simply banning audit firms from providing non-audit services.¹⁹

■ CPA Australia:

...business should be actively involved in ensuring the audit relationship is managed appropriately to protect its integrity and at the same time ensure full and frank disclosure takes place.²⁰

■ Professor Keith Houghton:

You need some process that identifies where this joint supply is a threat and where, in other instances, it is not a threat but is actually beneficial.²¹

4.42 Consistent with the view expressed in chapter 2 regarding the influence of US reforms, the Committee believes that the provision of non-audit services by Australian audit firms to the operations of US companies in Australia, or to the Australian subsidiaries of US companies, may potentially be affected by the recent prohibition of a range of non-audit services in the US.

4.43 Recently a number of corporations have publicly announced their reaction to the risks inherent in the provision of non-audit services by their auditors.²² The following recent examples are considered to be indicative of the fact that the risks are being recognised and of the practices being employed in response.

4.44 Westpac publicly stated it was their policy not to use their external auditor to provide non-audit work if their independence would be impaired, or seen to be impaired. Further, Westpac's Audit and Compliance committee is responsible for monitoring and assessing the independence of their external auditors and approving all non-audit engagements by the external auditors.²³

4.45 BHP Billiton told the Committee that it excludes its auditors from performing certain types of non-audit work, including work that has the

19 Australian Institute of Company Directors, *Submission* No. 26, p.S220

20 CPA Australia, *Submission* No.33, p.S292

21 Professor Keith A Houghton, *Transcript*, pa.9

22 The Committee also notes there is a trend amongst auditing firms to separate the structures of their auditing and consulting operations to deal with these risks.

23 'Social Impact Report', July 2002, available from www.westpac.com.au

potential to impair, or appear to impair, their independence and that its' Risk Management and Audit Committee regularly monitors all non-audit work provided by its auditors. BHP Billiton also advised, that as part of the recent tender for its audit services, it required the tendering firms to confirm that their audit fees were discreet and not reliant on fees from the provision of any other services.²⁴

The auditors' tenure

- 4.46 A number of submissions have contended to the Committee that a real threat to auditors' independence arises from issues associated with the auditors' tenure. Broadly the issues are around the extent of security over the appointment process and secondly, the period that a level of security should continue to exist.
- 4.47 The *Corporations Act 2001* affords an auditor the following degree of security:
- Section 327 provides that the auditor holds office until:
 - ⇒ death;
 - ⇒ removal or resignation from office in accordance with a resolution of the company at a general meeting as prescribed in section 329; and
 - ⇒ ceasing to be capable of acting as auditor in accordance with the qualification rules in section 324.
- 4.48 In addition, a company auditor is prohibited from resigning without applying to ASIC, stating the reasons for the desire to resign and until receiving the consent of ASIC. In relation to the requirements surrounding the resignation of auditors, Ernst & Young told the Committee:
- I actually see that as a very strong counter to the intimidation threat. It is very difficult for the auditor to resign...²⁵
- 4.49 The issues associated with the auditor appointment process have been considered in chapter 2, in particular the need for audit committees to play a stronger role in this process. In the following paragraphs the Committee will address the issues associated with length of tenure and the risk of over-familiarity with a client.
- 4.50 The recent Enron case in the United States demonstrated that audit firms with a long history of involvement with a company can establish complex relationships and linkages which may impinge on the degree (actual or perceived) of auditor independence and objectivity.
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24 Correspondence from Karen Wood, Company Secretary, BHP Billiton, 24 July 2002

25 Ms Ruth Picker, *Transcript*, pa.93

- 4.51 There is currently considerable debate as to the most effective way to address the risk from such associations and in the relative merits of mandating that audit firms rotate partners, or requiring a publicly listed company to periodically change the firm providing its external audit services.
- 4.52 A number of submissions and witnesses argued before the Committee that rotation of audit firms would be costly, economically inefficient and impact on the quality of audits. Professor Keith Houghton, for example, told the Committee:
- ...mandated rotation (of audit firms) would almost certainly, on average, give rise to lower quality.²⁶
- 4.53 Professor Houghton has also suggested there may be ‘potentially unintended and negative consequences’ to the introduction of the process of audit firm rotation and the prohibition of the joint supply of audit and non-audit services. To justify his point he used the following example:
- Audit firm A is the incumbent auditor (of XYZ) and the audit fee is one million dollars per year. Firm B provides tax services for both local and foreign subsidiaries of XYZ for a fee of two million dollars per year. Firm C provides internal audit services to XYZ for two million dollars per year. Firm D provides information technology and internal control consultancies to XYZ for a fee of 1.5 million dollars. At the end of the mandatory rotation period, which of the firms B, C or D will relinquish their lucrative consulting role to undertake the audit.²⁷
- 4.54 In response to a question about this example, Professor Houghton told the Committee he considered it unlikely that any of those firms would be willing to relinquish their contracts for the provision of non-audit services to assume the role of the external auditor suggesting:
- ...why would they rationally give up that relationship and that work to undertake an audit which might be less lucrative and might...be terminated at a prescribed period anyway?²⁸
- 4.55 When asked about the proposal for the mandatory rotation of audit firms, the Australian Institute of Company Directors told the Committee:
- ...there is a significant cost to the company and, therefore, to the shareholders in making that change...I believe the case is yet to be

26 Professor Keith Houghton, *Transcript*, pa.14

27 ‘On the trail of Better Auditing’, Professor Keith Houghton, About the House, July / August 2002

28 Professor Keith Houghton, *Transcript*, pa.2

presented that really indicates there would be significant benefit in light of the costs.²⁹

- 4.56 To support the contention that mandatory rotation of audit firms would be detrimental to the quality of audits, Deloitte Touche Tohmatsu provided the Committee with a copy of research recently completed in the United States which, based on its analysis, concluded there was:

...significantly more audit reporting failures in the earlier years of the auditor / client relationship than when auditors had served these clients for longer tenures. The results do not support the arguments of those who propose mandatory auditor rotation...³⁰

- 4.57 Professional Statement F1 highlights the risks of long associations of senior personnel with the same clients and recommends safeguards be put in place to reduce these risks, and in particular, for audits of listed companies, recommends the rotation of the lead engagement partner after periods no longer than seven years.

- 4.58 KPMG told the Committee that the major audit firms already have policies of partner rotation in place and said that by rotating the partner rather than the whole firm:

...you achieve the dual objective of keeping some understanding of the corporate history between the auditor and the business being audited, as well as providing a fresh set of eyes...³¹

- 4.59 Taking this issue further, the Committee received evidence which indicated the rotation of the lead partner was likely, on its own, to be insufficient to address the risks involved. For example, Mr J W Cameron and Mr R J Sendt, the Auditors-General for Victoria and NSW respectively, suggested to the Committee that rotation policies should also be applied to the detailed operational level of the audit process and include, for example, the audit manager.³²

- 4.60 The Australian Chamber of Commerce and Industry (ACCI) suggested rotation of the entire audit team, including managers and functional staff was also preferable.³³ Subsequently the ACCI explained the reason for this view when it told the Committee:

29 Mr Stuart Grant, *Transcript*, pa.175

30 Deloitte Touche Tohmatsu, *Submission* No. 52, p.S486. ('Auditor tenure and audit reporting failures', Marshall A Gieger and K Raghunandan, published in *Auditing: A Journal of Practice and Theory* in March 2002)

31 Mr Michael Coleman, *Transcript*, pa.204

32 Auditor-General, Victoria, *Submission* No.25, p.S211 and The Audit Office of New South Wales, *Submission* No.28, p.S249

33 Australian Chamber of Commerce and Industry, *Submission* No.20, p.S157

It would probably be the audit team rather than the partner that has the knowledge; it would not be the firm.³⁴

- 4.61 In contrast, other submissions argue that rotation within the audit firm was not a sufficient response to address the independence question. For example, Mr John Shanahan told the Committee that the mandatory rotation of audit firms was necessary, saying:

Rotation of audit firms after a five-year period will ensure that a completely fresh approach is taken to the audit, that a different methodology is applied and that there is no unquestioned reliance on prior years' work.³⁵

- 4.62 The Australian Securities & Investments Commission (ASIC) told the Committee:

The principle of rotating audit firms should be embraced to underpin the independence of auditors and to counter-balance the influence of any long-term relationship. It is not credible that one partner will seriously challenge the established audit practice and advice previously provided by his firm through another partner.³⁶

Recent overseas experience

- 4.63 The most effective way to proceed is still 'open for debate' in the United States and the United Kingdom.
- 4.64 Recent legislation in the United States³⁷ has mandated the rotation of lead partners of accounting firms by prohibiting them from providing audit services for more than 5 years. The legislation also requires the Comptroller-General of the United States to undertake a review of the potential effects of mandating the rotation of public accounting firms and to report the results of this review to Committees in both the Senate and the House of Representatives within 12 months.
- 4.65 The recently released draft report of the Coordinating Group's review of Audit and Accounting Issues in the United Kingdom concluded that, at present, a clear case for the mandatory rotation of audit firms had not been made and considered it was necessary to further examine the issue. It does, however, unequivocally endorse the concept of rotating audit partners, suggesting that maximum period of continuous engagement to the same audit client should be 5 years.

34 Mr Brent Davis, *Transcript*, pa.70

35 Mr John Shanahan, *Submission No.35*, p.S318

36 Australian Securities & Investments Commission, *Submission No.39*, p.S373

37 Section 203 of *Public Company Accounting Reform and Investor Protection Act, 2002*

Risk management

- 4.66 Some commentators accept the principle of audit firm rotation but also recognise the practical constraints and difficulties it would create, particularly in Australia, and acknowledge the disruption and cost issues and the practical constraints within the Australian marketplace. For example, KPMG told the Committee that introducing a policy of mandatory rotation of audit firms would undermine the importance of the auditor having a detailed knowledge of the business of the company being audited and may make it difficult for audit firms to retain quality staff.³⁸ The Committee understands this is particularly crucial in audits requiring unique or specialised skills, for example audits of ‘treasury risk management’ operations.
- 4.67 Others have contended that the risks can be managed through more vigilant and active management of the relationship with the external auditor. For example CPA Australia told the Committee that businesses need to:
- ...achieve an appropriate balance between developing adequate business knowledge within the external audit team and the perception and potential capture of the audit team.³⁹
- 4.68 CPA Australia suggest that at least, every five years or so, companies should be required to conduct a comprehensive review (which is to be publicly disclosed) to assess the need for the rotation of the audit firm.⁴⁰
- 4.69 Although it supports the principle of firm rotation, ASIC suggested that the default position of firm rotation after a certain period of time, could be deferred by a shareholders’ vote at the AGM, if they were provided with sufficient evidence that rotation was not appropriate in the circumstances.⁴¹

Conclusion

- 4.70 The Committee believes that, while legislative changes prohibiting the simultaneous provision of all non-audit services and the rotation of audit firms are more popular reactions in the eyes of the general public, these responses may not achieve the outcomes desired. In particular, there is a risk that prohibiting the provision of all non-audit services and mandating the rotation of audit firms may impede audit quality and drive up the

38 Mr Lindsay Maxsted, *Transcript*, pa 204 and Mr Michael Coleman, *Transcript*, pa.205

39 CPA Australia, *Submission No.33*, p.S291

40 CPA Australia, *Submission No.33*, p.S299

41 Australian Securities & Investments Commission, *Submission No.39*, p.S373

costs of audit and related services. The practicalities of these proposals need to be thoroughly examined before any steps are taken.

- 4.71 The Committee's response is to urge companies and their auditors to put in place risk management processes that enable better identification, and subsequent management of the risks involved in their relationships. By introducing more robust practices, companies and their auditors will be better placed to meet the Committee's Recommendation 9, in regard to the expectation that auditors are independent, and Recommendation 3 calling for corporate governance standards to be incorporated into the *Corporations Act 2001*.

Expectation gap

- 4.72 As indicated in chapter 2 there is a strong sense that much of the public disquiet regarding apparent audit failures in cases of corporate collapses stems from an 'audit expectation gap'.

- 4.73 The expectation gap might be described as the misalignment between what auditors understand should, or can be delivered and what stakeholders, including the general public, expect auditors to deliver. For example, Mr John Hammond told the Committee:

I believe the public at large has the perception that an external auditor should be attesting to the accuracy of the financial statements of a company...it would be an impossible task for an external auditor or a team of external auditors to examine every record and transaction entered into by a company during the year.⁴²

- 4.74 The Auditing and Assurance Standards Board (AuASB) told the Committee:

Too often, more is expected of the auditor than can be reasonably be expected...too often, misunderstanding and unrealistic expectations of the auditor's role within the corporate reporting framework occurs.⁴³

- 4.75 Australian Auditing Standard AUS 202 explains that audits are not, and cannot be designed to provide an absolute level of assurance given the existence of several inherent limitations, including:

42 Mr John Hammond, *Submission No.19*, p.S139

43 Auditing & Assurance Standards Board, *Submission No.12*, p.S96

- need for judgement regarding the accumulation of evidence, the timing and extent of audit procedure and in the drawing of conclusions;
 - use of testing procedures;
 - the existence of collusion or intentional misrepresentations to conceal irregularities from the auditor;
 - limitations on the operation of any internal control structures⁴⁴; and
 - the existence of factors and circumstances which affect the nature of the available evidence and go to the balance between persuasive rather than conclusive evidence.
- 4.76 CPA Australia told the Committee that the expectation gap has three components:
- performance gap – audit performance falling below the required professional and legal standards;
 - standards gap – although audit performance meets required standards, it still falls short of ‘reasonable’ expectations; and
 - unreasonable expectations gap – auditing not meeting all of the expectations placed on it.⁴⁵
- 4.77 The Committee agrees with CPA Australia when it suggested in its submission that the profession, government, regulators and business all have an obligation to address the first two areas. Reforms in these areas will help ensure the delivery of effective audits, which reflect the reasonable expectations of stakeholders and also comply with relevant standards to improve the confidence of investors in the capital market.
- 4.78 The third component is more problematic and requires a mix of responses including, continued reinforcement with the investing public about what the audit process can reasonably be expected to deliver. Continued monitoring of public expectations is also important so that public confidence in the audit process is not further weakened.

Enhancing the scope of audits

- 4.79 This report has previously canvassed the need for reform in the area of financial reporting and disclosure. A corollary to those reforms is the need to align the role of the auditor with any enhanced reporting regime and to ensure audits better deliver what is critical to the market. In this

44 The limitations of any internal control structure are detailed in *AUS 402 – Risk Assessments and Internal Controls* and *AUS 810 – Special Purpose Reports on the Effectiveness of Control Procedures*

45 CPA Australia, *Submission No.33*, p.S286

regard, the Committee notes that it has also been recently reported that, amongst other things, auditors ought to be required to offer a commentary on a company's financial health and provide companies with a rating against a range of pre-set criteria.⁴⁶

- 4.80 The increase in the breadth of share ownership in Australia, and therefore changed shareholder expectations has raised questions about the adequacy of the traditional audit model. The Association of Chartered Certified Accountants (ACCA) informed the Committee that due to changes in public expectations the traditional audit model that focuses on financial reports may be inadequate and as a result:

...the scope of the audit is certainly something that needs to be looked at.⁴⁷

- 4.81 There was general support for reforms to expand the scope of the audit in order to address the information demands of the public. For example, Deloitte Touche Tohmatsu told the Committee that:

Subject to liability considerations, we support revisiting the scope of the audit...for example...expanding the work to cover governance, risk management, internal controls aspects...other issues of ongoing and legitimate relevance to shareholders.⁴⁸

- 4.82 Ms Wolthuizen from the Australian Consumers' Association suggested that investors should be able to expect auditors to provide advance warnings of potential problems, particularly if the company was not making appropriate disclosure itself. She told the Committee:

...there is a role for auditors to flag particular risks where they see that, as I said, trouble indeed lies ahead.⁴⁹

- 4.83 While supportive of the proposal to expand the scope of audits into additional areas, the Australian Institute of Company Directors suggested to the Committee:

...there is a fair comment that there can be more quality injected with more effort and more money into auditing processes, including possibly expanding them to cover non-traditional areas, but there has to be a cost consequence and cost balancing.⁵⁰

- 4.84 The Australian Prudential Regulation Authority (APRA) advised the Committee that it considered many of the 'value-added' services provided
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46 'Check the Change', The Bulletin, April 30 2002, p.45.

47 Mr Richard Francis, *Transcript*, pa.123

48 Deloitte Touche Tohmatsu, *Submission* No.23, p.S196

49 Ms Catherine Wolthuizen, *Transcript*, pa.151

50 Mr Gavin Campbell, *Transcript*, pa.172

by auditors, for example, risk management reviews, should be an integral part of forming the statutory audit opinion. Further APRA told the Committee that under the prudential reporting requirements which it administers, auditors are required to report on whether entities have met APRA's prudential standards, including the establishment and maintenance of robust risk management systems and practices.⁵¹

- 4.85 To support an expansion in the scope of audits, auditing standards may need to be developed to assist and ensure consistency amongst auditors in the assessment and measurement of performance in these additional areas. In this regard, the Committee is encouraged by the comments of the AuASB who told the Committee:

...that is part of our work program: to provide standards that allow assurance to be provided on non-financial and other information.⁵²

- 4.86 The Committee notes that the AuASB has previously developed a comprehensive statement on the assessment of internal controls (*Auditing Standard AUS 402 – Risk Assessments and Internal Controls*). The AuASB advised the Committee that work is underway to develop a comprehensive framework to support auditors in the assessment of, and reporting on, corporate governance and risk management processes. However, the AuASB did identify that, due to a shortage in the level of resources currently available to it, some projects are not receiving the level of attention it would prefer.⁵³

- 4.87 The AuASB also advised the Committee that as part of its *Audit Risk* project, the International Auditing Standards Board is developing a set of comprehensive standards and guidance material covering auditors' responsibilities in relation to:

- understanding their audit clients, including the environment in which it operates, its internal controls and the risks it faces; and
- determining responses to the assessed risks.⁵⁴

- 4.88 The Committee understands these standards will require all audits to incorporate a formal risk assessment phase and that there should be clear links between these assessments and the audit procedures undertaken.

51 Australian Prudential Regulation Authority, *Submission No. 51*, p.S482 and *Prudential Standard APS 310 – Audit & Related Arrangements for Prudential Reporting*

52 Mr William Edge, *Transcript*, pa.86

53 Audit & Assurance Standards Board, *Submission No.58*, p.S537

54 Audit & Assurance Standards Board, *Submission No.58*, p.S540

- 4.89 The expansion of the scope of auditing discussed in this chapter is consistent with the Committee's suggested enhancements to the financial reporting framework discussed elsewhere in this report. In particular Recommendation 3, relating to the development of corporate governance standards and Recommendation 8, relating to increased disclosure of non-financial information.

Continuous auditing

- 4.90 The practice of the external auditor maintaining a continuous presence at their audit client or establishing a program of frequent, regular and formalised contact, as distinct from a series of periodic audit visits, might be described as continuous auditing.
- 4.91 The Committee explored this notion, in particular it considered whether auditors ought to be required to provide a form of assurance on a company's pronouncements and disclosures to the ASX, pursuant to the continuous disclosure requirements.
- 4.92 Ernst & Young suggested to the Committee that the effectiveness of the external audit process is greatly enhanced if it is undertaken as a continuous process. To that end it proposed that to improve the continuity of audits and also improve the credibility of the information being made available, that companies' half-yearly financial statements and disclosures under the continuous disclosure regime should be required to be subject to independent assurance.⁵⁵
- 4.93 In relation to information provided to the market by companies, KPMG told the Committee:
- ...it would be useful if that information was in some way subject to audit...and assurance that that information was appropriate and reasonable.⁵⁶
- 4.94 The Australian Consumers' Association told the Committee:
- ...an examination of the costs associated with that (continuous auditing) should be undertaken. If they are reasonable, those would certainly provide the benefit not only of having that information continuously disclosed but also of having that audit process on an ongoing basis.⁵⁷

55 Ernst & Young, *Submission No.45*, p.S414

56 Mr Michael Coleman, *Transcript*, pa.214

57 Ms Catherine Wolthuizen, *Transcript*, pa.153

Performance audits

4.95 On 21 June 2002, Mr Pat Barrett AM, Auditor-General for Australia said:

...our role includes providing independent assurance on the performance, as well as the accountability, of the public sector...⁵⁸

4.96 The Committee explored the issue of the conduct of performance audits (audits designed to evaluate outcomes and the achievement of objectives) in the private sector. In particular, the Committee explored the situation whereby ASIC or perhaps the ASX might have the ability to request a performance audit of a company when it became concerned as to that company's performance.

4.97 An alternative mechanism might be to give either of these bodies the power to request that a performance audit be undertaken of a company or of a cross section of companies, in order to assess the management of an identified or potential area of risk. In responding to that proposition, the ASX told the Committee:

The Value (Performance) audit is really a subjective judgement on whether or not the right management decisions have been made. This is a very difficult area to address.⁵⁹

4.98 The ASX subsequently advised the Committee that they did not agree with the notion of the conduct of performance audits in the private sector saying that they believed that performance criteria could not be readily developed, kept current and measured for companies. Alternatively they suggested that companies be required to develop review processes to assess their business risk management, including risk identification arrangements.⁶⁰

4.99 In contrast, there was support for the view that performance audits should be conducted in the private sector, but no clear evidence as to how this might be accomplished. For example, PricewaterhouseCoopers told the Committee:

I think the inclusion of performance audits is something that we should address. The role of the audit does need to be reviewed. The audit function can play a greater role in ensuring confidence...⁶¹

4.100 Similarly, Professor Ramsay told the Committee:

58 'Auditing in a Changing Governance Environment', Pat Barrett AM, Senate Occasional Lecture Series, June 2002

59 Mr Richard Humphry, *Transcript*, pa.45

60 Australian Stock Exchange, *Submission* No. 55, p.S518

61 Mr Anthony Harrington, *Transcript*, pa.146

In certain circumstances it may enhance confidence in information to have the auditor do performance audits, but I am not sure that one would mandate that.⁶²

The audit report

- 4.101 Guidance on the form and content of the audit report to be issued in connection with the audit of a general purpose financial report is contained in Australian Auditing Standard AUS 702 *'The Audit Report on a General Purpose Financial Report'*.
- 4.102 This standard recognises that the specific requirements of the *Corporations Act 2001* regarding the form and content of the audit report must be adhered to, over and above the general requirements of the standard.
- 4.103 Specifically, the *Corporations Act 2001* (section 307) requires an audit to form an opinion about the following matters:
- whether the financial report is in accordance with sections 296 or 304 (relating to compliance with accounting standards) and sections 297 or 305 (relating to the true and fair view);
 - whether the auditor has been given all information, explanation and assistance necessary for the conduct of the audit;
 - whether the company, registered scheme or disclosing entity has kept financial records sufficient to enable a financial report to be prepared and audited; and
 - whether the company, registered scheme or disclosing entity has kept other records and registers as required by this Act.
- 4.104 Although the Act requires the auditor to form four opinions, it only requires the auditor to report (section 308) as to whether the auditor is of the opinion that the financial report is in accordance with
- section 296 (compliance with accounting standards); and
 - section 297 (true and fair view).
- 4.105 The Committee received a number of suggestions for reform to the audit reporting process, for example, Mr John Shanahan told the Committee that audit reports are not effective in providing warnings of threats or concerns:

The auditing standards actually give you very few options for reporting. It is hard for an auditor to warn per se.⁶³

62 Professor Ian Ramsay, *Transcript*, pa.230

63 Mr John Shanahan, *Transcript*, pa.162

- 4.106 Currently if the auditor has concerns regarding corporate governance issues or shortcomings in the internal control arrangements but these matters do not impact on the opinion on the financial statements, they will not be referred to in the public audit report. The matters, depending on their significance, may be represented to management and to the Board or Audit Committee by way of a management letter or closing report. These documents are for internal consumption only, they are not made public, so investors may not be made aware of these issues, which, as indicated above, may be important to them.
- 4.107 In the Commonwealth public sector, the main issues from management letters are reported to the relevant Minister and the results of financial audits, including these issues are consolidated and summarised in separate reports to the Parliament.⁶⁴
- 4.108 Mr L. J. Scanlan, Auditor-General of Queensland told the Committee that the private sector could adopt the public sector practice of reporting significant matters to the Parliament by requiring auditors to report a summary of significant matters to shareholders at the AGM saying that the practice of direct and open reporting:
- ...facilitates accountability and transparency for the stewardship of public sector funds and assets.⁶⁵
- 4.109 The major accounting firms told the Committee they support the calls for reform. For example PricewaterhouseCoopers told the Committee:
- The audit report could well be expanded to ensure that that commentary (on corporate risk management policies and procedures)...is appropriate.⁶⁶
- 4.110 KPMG also agreed that reform was needed in the area of audit reporting, as the current format tended to perpetuate the 'expectation gap'. They proposed:
- adopting a more 'plain-English' style in order to make the report easier to understand; and
 - expand the report to include commentary on issues such as governance, risk management, internal controls and key indicators of financial health.⁶⁷
- 4.111 Another criticism of audit reports suggested to the Committee was in relation to the use of *emphasis of matter* disclosure. In certain circumstances
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64 Australian National Audit Office, *Submission* No.27, p.S245

65 Office of the Auditor-General of Queensland, *Submission* No.10, p.S76

66 Mr Anthony Harrington, *Transcript*, pa.141

67 KPMG, *Submission* No.34, p.S313

the audit report standard (AUS 702) provides for the inclusion of an *emphasis of matter* in the audit report to draw the attention of readers of the report to an issue(s) that is relevant, but is not of such a nature that it affects the audit opinion. The standard specifically provides that an *emphasis of matter* should only be used in limited situations.

- 4.112 The standard specifically indicates that the use of an *emphasis of matter* is not the same as a qualification of the audit opinion and does not affect the auditors' opinion. To reinforce this point, the standard requires the *emphasis of matter* to be placed after the audit opinion section of the report.
- 4.113 Mr John Shanahan queried, given the technical nature of audit reports and the proficiency of the users of financial reports, whether the *emphasis of matter* was an effective method of communicating auditors' concerns. He told the Committee:

...it now seems common practice for auditors to use an *emphasis of matter* rather than an audit qualification to raise and express their concern about contentious or difficult matters in financial statements.⁶⁸

- 4.114 KPMG also advised the Committee of their concerns with the use of the *emphasis of matter* in the audit opinion. They told the Committee that the *emphasis of matter* was not effective in highlighting significant uncertainties.⁶⁹

Conclusion

- 4.115 As discussed in Chapters 2 and 3 of this report the Committee considers that the level of financial reporting and disclosure by companies should be enhanced to provide more useful and comprehensive information to the market. Concomitantly, to ensure public confidence in this additional information and in the value of audit function, the Committee considers the scope of audits, including the extent of the reporting the results of audits, should also be reformed.
- 4.116 The Committee also considers that, on balance, the cost effectiveness and extent of benefits available, from the adoption of continuous auditing practices and the conduct of performance audits should be investigated further.
- 4.117 The Committee considers the professional accounting bodies should review the AuASB's resources and funding levels to ensure its work can effectively support expansions in the scope of the statutory audit. With a

68 Mr John Shanahan, *Submission* No.35, p.S323

69 Mr Michael Coleman, *Transcript*, pa.212

view to reforming the audit standard on *audit reporting*, it is also suggested the AuASB review the suggestions made to this Committee concerning the effectiveness of the *emphasis of matter* as a tool for reporting matters of significance and concern.

Recommendation 10

4.118 That the following sections of the *Corporations Act 2001* be amended:

- **Section 307 be amended to require that auditors form an opinion on whether the company has complied with Corporate Governance standards (see Recommendation 3);**
- **Section 308 be amended to require the auditor to report as to whether the company has complied with Corporate Governance Standards (see Recommendation 3); and**
- **Section 308 be amended to require the audit report to include comment on significant matters arising during the audit process.**

Recommendation 11

4.119 That ASIC explore the cost and benefits and alternative methods of introducing performance audits in the private sector and, in conjunction with the ASX, evaluate the costs and benefits of requiring pronouncements and other disclosures under the continuous disclosure listing rule to be subject to a credible degree of assurance and report its findings to the Treasurer.

Auditors' liability

4.120 A significant issue regarding the continued maintenance of an effective audit function is the matter of unlimited liability for loss and damages which attaches to the auditors' role. For example, the Committee was told by PricewaterhouseCoopers that:

...the future of the profession will necessitate dealing with the unlimited liability position...without addressing that position, the

ability to attract the best and brightest into the profession...might be affected.⁷⁰

- 4.121 Deloitte Touche Tohmatsu advised the Committee that the fact that auditors are required to maintain professional indemnity insurance often meant they have had to carry a disproportionate burden for financial loss when other relevant parties have been unable to meet damages.⁷¹ Similarly, Ernst & Young suggested to the Committee that auditors were targeted because they have 'deep pockets'.⁷²
- 4.122 This issue is of particular significance to the Committee's desire to enhance the nature and scope of auditing, including the level of reporting. The Committee acknowledges that broader commentary in audit reports has the potential to expose auditors to legal action which is designed to allocate responsibility to them for the negative impact of their comments on share prices and the value of companies.
- 4.123 It has also been suggested to the Committee that any proposal for an expansion in the scope of auditing (and in audit reporting) cannot be reasonably addressed in light of the present unlimited liability situation. For example, KPMG told the Committee:
- While this is a desirable outcome (expansion of the audit report), 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.⁷³
- 4.124 It has been suggested to the Committee that the current cost of professional liability risk for the major accounting firms globally represents at least 14 per cent of audit revenues and that it was becoming increasingly difficult for auditors to obtain sufficient professional indemnity insurance cover. Deloitte Touche Tohmatsu told the Committee:
- These circumstances threaten the ongoing viability of the large audit firms and, consequently, the best interests of national public welfare.⁷⁴
- 4.125 The professional accountancy bodies (ICAA and CPA Australia) have both been passionate and robust advocates for reform in the area of auditors' liability and both have made submissions to the Senate Economics

70 Mr Anthony Harrington, *Transcript*, pa.144

71 Deloitte Touche Tohmatsu, *Submission No.23*, p.S193

72 Ernst & Young, *Submission No.32*, p.S276

73 KPMG, *Submission No.34*, p.S313

74 Deloitte Touche Tohmatsu, *Submission No.23*, p.S193

References Committee which is inquiring into the impact of public liability and professional indemnity insurance cost increases.

- 4.126 The Committee was advised that the issue of the liability of auditors has been the subject of protracted discussions and consideration over many years. The ICAA told the Committee that the Federal and New South Wales Governments commissioned an inquiry into the law of joint and several liability in 1994. The report of that review, commonly known as the Davis report, recommended that the notion of joint and several liability in negligence actions should be replaced by a system of liability which is proportionate to each defendant's degree of fault.⁷⁵
- 4.127 However, the Committee understands that these reforms have not been enacted as Commonwealth and State Attorneys-General have been unable to concur on changes to relevant Commonwealth and State legislation to accommodate the replacement of the principle of 'joint and several liability' with the principle of 'proportional liability'.
- 4.128 The Committee has also been advised that in the area of auditors' liability, Australia is falling behind other countries, where reforms are occurring, for example:
- the notion of joint and several liability has either been abolished or modified in a number of states in the United States;
 - Canada has recently implemented a form of proportionate liability; and
 - audit firms in the UK (and in some US states) are able to operate as limited liability partnerships.
- 4.129 The Committee understands that NSW has a statutory framework in *The Professional Standards Act 1994* that permits the development of schemes enabling the legal liability of certain professionals to be capped. The Committee was advised that the schedule (in the Act) pertaining to accountants provides that, within a minimum of \$500,000, claims are limited to ten times the fees for the service up to a ceiling of \$20 million. This scheme also requires certain professional standards to be met and risk management training to be undertaken.

75 The Institute of Chartered Accountants in Australia, *Submission No.29*, p.S263

4.130 The following table provides a summary of auditors' exposure to professional indemnity costs across a number of jurisdictions.⁷⁶

Table 3 Risk reduction

Country	Can audit firms incorporate	Proportional Liability	Cap on liability
Australia	No	No	NSW only
Britain	Yes	No	Yes, but only on due diligence work
Canada	Yes, in four provinces	Yes	No, but under review
France	Yes	Yes	No
Germany	Soon	Soon	Yes
New Zealand	No	No	No
United States	Yes	Yes	Yes, but not in every state

Source Deloitte Touche Tohmatsu

4.131 The Committee considers that reform is important in order to ensure there is an appropriate balance between the risks associated with auditing and also in ensuring the public interest is protected and maintained. The three main areas of reform identified before the Committee are as follows:

- principle of *joint and several liability* replaced with the principle of *proportional liability*, so as to provide a more equitable basis for allocating damages;
- auditors should be able to operate in a limited liability environment, in order to provide greater protection for their personal assets; and
- introduce a cap for professional liability claims to limit the quantum of damages which can be awarded against auditors.

4.132 The Committee found that the audit firms clearly understood their duty of care and were advised that reforms to the liability situation should not affect the quality of their audits. For example, PricewaterhouseCoopers told the Committee, in their supplementary submission:

...what is being proposed is not a review of the grounds for proving an auditors' negligence nor any change to the auditor's

duty of care to shareholders but the introduction of a fairer system, that better reflects the degree of fault.⁷⁷

4.133 Other witnesses made similar statements, for example, Mr John Shanahan told the Committee:

...to operate sensibly as an auditor, we need some form of limitation of liability...I believe in a sensible limitation of liability. As auditors we have no problems with a proportionate share of the blame.⁷⁸

4.134 KPMG explained to the Committee:

In no way, shape or form would we be suggesting that the auditor reduces the level of care, but we are saying that the level of monetary responsibility that attaches to the auditor if something goes wrong should be capped because the size of the claims at the moment can be extraordinary.⁷⁹

Conclusion

4.135 The Committee's call for reform in the area of auditors' liability is not motivated by any desire to provide auditors with a more secure protective framework in the current financial reporting environment. Reform is essential in order to support an expansion in scope of auditing and the reporting of the results. As indicated at paragraph 4.131, reforms in this area should be addressed on several fronts.

Recommendation 12

4.136 **To support an expansion in the role of registered company auditors, the following reforms should be put in place to provide a greater level of protection for their personal assets:**

- **principle of *joint and several liability* replaced with the principle of *proportional liability*, so as to provide a more equitable basis for allocating damages;**
- **amend the *Corporations Act 2001* so that audit firms can operate within limited liability structures; and**
- **introduce a cap for professional liability claims to limit the quantum of damages which can be awarded against auditors.**

77 PricewaterhouseCoopers, *Submission* No. 60, p.S548

78 Mr John Shanahan, *Transcript*, pa.155

79 Mr Michael Coleman, *Transcript*, pa.210

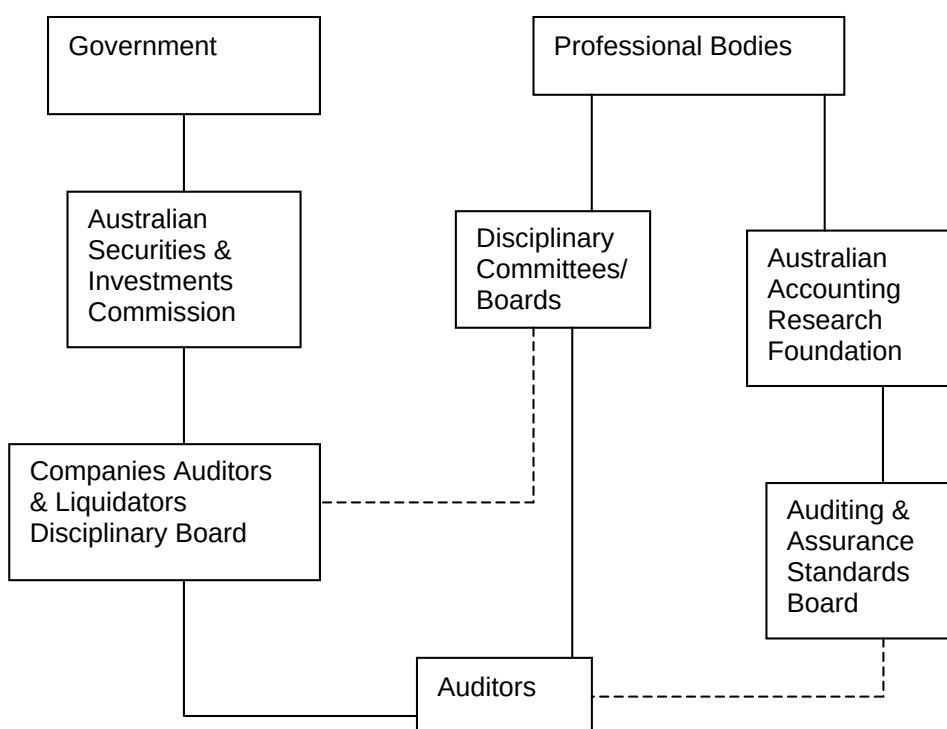
Oversight of the accounting profession

4.137 In Chapter 2 the Committee discussed ways of having audit firms report on their independence policies and practices. The Committee also considers it necessary to look at the need for reform of the processes for regulating the audit function. Mr J.W. Cameron, Auditor-General for Victoria, told the Committee:

...the fundamental and significant role of audit in the accountability process has been blurred by practice ...(and) the role of the auditor as registered statutory provider...appointed by statute and given statutory responsibility to report to shareholders and the Australian Securities and Investment Commission (in certain circumstances), has not been given adequate attention in the regulation of the audit function.⁸⁰

4.138 In Australia, the present arrangements for the monitoring and discipline of Registered Company Auditors may best be described as a system of co-regulation, with roles for both the government and the accounting professional bodies and may be represented as shown in Figure 1.

Figure 1 Oversight arrangements in Australia for Registered Company Auditors



Source JCPAA

- 4.139 The main oversight mechanisms in respect of the audit function is the monitoring of compliance with the auditing and professional (ethical) standards through the quality review programs of the professional bodies⁸¹ and a regime of peer review operated by the accounting firms. Disciplinary processes are shared between the Government, through ASIC, the Companies Auditors & Liquidators Board (CALDB) and the professional bodies.
- 4.140 Professor Ramsay recommended the establishment of a 12 member board with responsibility for monitoring the implementation of, and ongoing compliance with the auditor independence regime he has recommended. The Board would, among other things, be responsible for:
- advising the professional bodies on audit independence standards;
 - monitoring the processes used by audit firms to deal with auditor independence issues; and
 - monitoring compliance by companies with the new auditor independence requirements.⁸²
- 4.141 A number of submissions have suggested to the Committee that Professor Ramsay's proposal does not go far enough and indicated that the whole framework for monitoring and disciplining the accounting profession, including the extent to which the accounting profession is accountable should be reformed.
- 4.142 It is of particular concern to the Committee that much of the process, including the extent of the accountability of the accounting profession, is not well understood by the general public. For example, details of the evaluation of their performance are not readily observable nor are the outcomes from disciplinary processes sufficiently transparent to the investing public.
- 4.143 The cases for and against and the success or otherwise of the present, largely self-regulatory arrangements have received considerable comment in the submissions to the Committee. For example, the ACA told the Committee that there is a need to promote an enhanced culture of accountability and transparency and that:
- ...you do that with a strong regulator and with well-expressed principles.⁸³

81 Section 1280(2)(a)(i) of the *Corporations Act 2001*, dealing with the registration of company auditors, refers to members of the Institute of Chartered Accountants in Australia, CPA Australia and any other prescribed body.

82 More details on the functions of the proposed AISB can be found at pages 67–71 of the Ramsay Report

83 Ms Catherine Wolthuizen, *Transcript*, pa.152

4.144 Similarly, in its submission, the ACCA said:

...it is essential that the process of regulating accountants should have access to the expertise of practising accountants...it is no longer credible or acceptable for the process to be controlled by practitioners or by the professional bodies to which they belong.⁸⁴

4.145 A number of different models and suggestions for reform were presented to the Committee. These, together with details of recent reforms in the United Kingdom and the United States are summarised in the following paragraphs.

CPA Australia

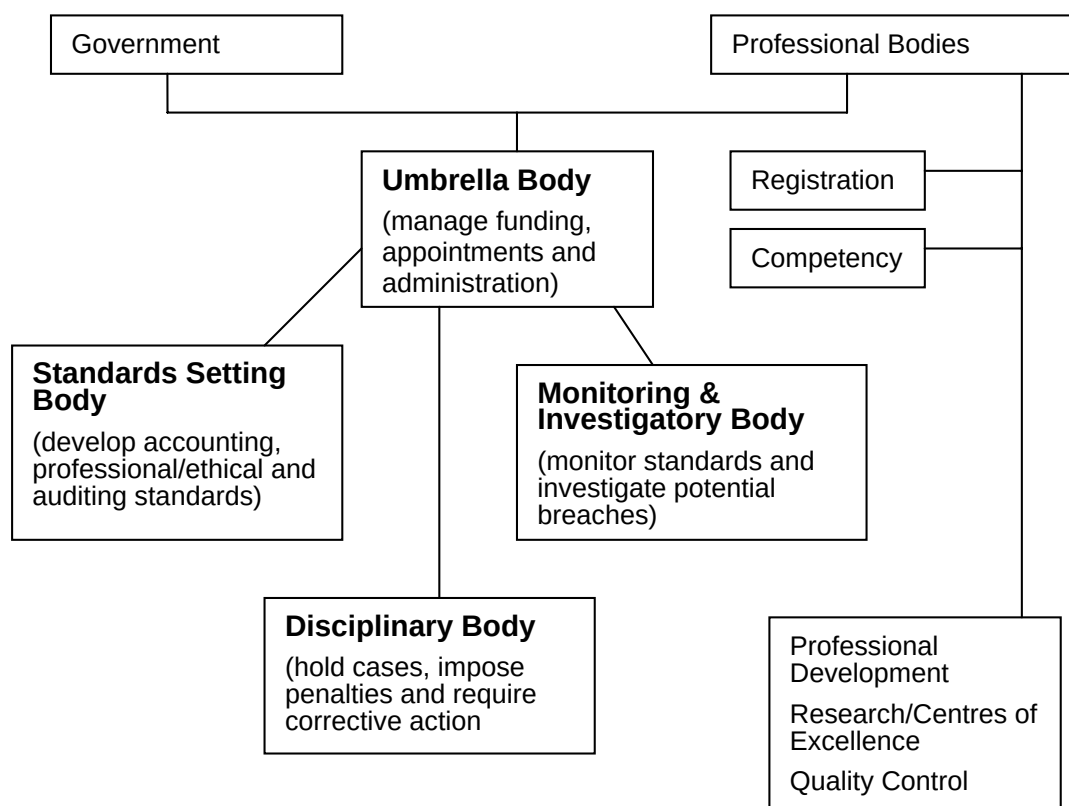
4.146 CPA Australia supports a comprehensive overhaul of the Financial Reporting Framework in Australia, including arrangements for the oversight of the auditing profession.⁸⁵ In defining its proposed model, CPA Australia considered the following three fundamental issues:

- functions are required to support an efficient reporting framework;
- degree to which these functions should be integrated or separated; and
- the strengths of regulation by the government and the profession can be best incorporated.

4.147 CPA Australia's model involves the establishment of a new oversight body, responsibility for which, is shared between government and the professional bodies. This oversight body would protect the independence of the three functional bodies. CPA Australia's proposal is outlined at Figure 2.

84 The Association of Chartered Certified Accountants, *Submission No.8*, p.S89

85 More details of CPA Australia's proposal are available from the paper it released in April 2002 titled, *'The Financial Reporting Framework – The Way Ahead'*

Figure 2 CPA Australia's model

Source CPA Australia

- 4.148 The new disciplinary body is designed to bring together the functions of the CALDB and the separate disciplinary processes within the accountancy bodies. CPA Australia proposes that the processes of this new body will be more transparent than current processes. CPA Australia told the Committee:

As constituted, the CALDB and the disciplinary processes of the leading accounting bodies are limited in their ability to deliver just and equitable outcomes...all three bodies need greater transparency in their processes.⁸⁶

Institute of Chartered Accountants in Australia

- 4.149 The ICAA suggested to the Committee that a Public Oversight (or Independence) Board should be established jointly by the Government and the Profession. The board would be responsible for overseeing the effectiveness of the processes for the setting and monitoring the professional standards, the conduct of quality reviews and the enforcement of compliance with the auditing standards. The ICAA

suggests that the current disciplinary arrangements are appropriate but suggests the new board should have a role in overseeing the adequacy of the separate disciplinary processes.⁸⁷

Audit firms

- 4.150 In their various submissions, the major accountancy firms (PricewaterhouseCoopers, Deloitte Touche Tomatsu, KPMG and Ernst & Young) all acknowledged that the process for monitoring and accountability of financial reporting, including the performance of auditors should be reformed. In a joint commentary on the Ramsay report⁸⁸ the firms suggest that the new body proposed by Professor Ramsay should be given a broader mandate, including responsibility for the oversight of the development of auditing standards and overseeing the enforcement and disciplinary activities. To overcome adding another layer to the current framework, they suggest the role of the FRC be expanded to incorporate the function of oversight of the auditing profession.

United Kingdom

- 4.151 Reforms overseas are far more expansive than those proposed to the Committee, for example, the United Kingdom has recently introduced a system of non-statutory, independent regulation of the accounting profession, commonly known as the Accounting Foundation. More details on this model, which involves the creation of five new bodies, can be found at pages 65 and 66 of Professor Ramsay's report.
- 4.152 In its submission, the ACCA described the UK model as:
- ...demonstrably more effective and independent than the widely used and much criticised system of peer review. The overall aims of the new system are to ensure that the (accounting) profession operates in the public interest and to secure public confidence in the impartiality and effectiveness of the accountancy bodies' systems of regulation and discipline....⁸⁹

United States

- 4.153 The *Public Company Accounting Reform and Investor Protection Act 2002* establishes the Public Company Accounting Oversight Board, to oversee

87 The Institute of Chartered Accountants in Australia, *Submission No.42*, p.S396

88 '*Independence of Australian Company Auditors*', letter to The Treasury, 15 March 2002, which was submitted as an attachment to PricewaterhouseCooper's *Submission No.18*

89 The Association of Certified Chartered Accountants, *Submission No.8*, pp.S69-70

the audit of public companies that are subject to the securities laws. This board, which is fundamentally independent of the accounting profession would, amongst other things, be responsible for :

- registering public accounting firms;
- establishment of auditing, quality control, ethics and independence standards;
- conducting inspections of registered public accounting firms;
- conducting investigations and disciplinary proceedings concerning, and impose appropriate sanctions on registered public accounting firms; and
- performing other duties or functions it considers necessary to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms.

4.154 These legislative reforms are likely to supersede reforms proposed by the SEC in June 2002, which were designed to replace the present self-regulatory system of peer review in the United States.

4.155 These reforms included the establishment of a private sector, independent board with the power to conduct periodic reviews of the quality control processes used by the accounting firms, conduct disciplinary proceedings and impose a range of sanctions on auditors for incompetent or unethical conduct. The SEC proposed the board also assume responsibility for issuing auditing and ethical standards either directly or through overseeing other designated bodies. The board, which was to be subject to SEC oversight was to be composed predominantly by independent members, unaffiliated with the accounting profession.⁹⁰

Conclusion

4.156 The Committee considers that reform to the oversight of the accounting profession is required in order to maintain the faith of the capital market and the public at large.

4.157 As indicated in Chapter 2, the Committee is not convinced of the need to establish a new regulatory body to oversee audit firms and considers, on balance, that the present model should be continued. It has, however, recommended that ASIC should take a broader and more vigorous role in ensuring audit independence.

90 'Written Testimony Concerning Accounting and Investor Protection Issues', Harvey Pitt, Chairman SEC, before the US Senate Committee on Banking, Housing and Urban Affairs, March 2002 and SEC Press Release, "Commission Formally Proposes Framework of a Public Accountability Board", June 2002

- 4.158 The Committee suggests therefore that ASIC, together with the professional accounting bodies, should assess the need for structural reform to the self-regulatory arrangements. In particular, they should identify if those arrangements can be reformed to better meet the public's expectation that the accounting profession is properly held accountable for their actions and conduct. As part of any review, the recent overseas experience of moving to put the process on a more independent footing should be explored.

Development of auditing standards

- 4.159 An issue integral to reform to the auditing framework is the question of the process for the development of the auditing standards. As indicated at paragraph 4.9, the auditing standards provide guidance and prescribe the minimum standards for the conduct of audit services.
- 4.160 Several submissions have canvassed issues associated with the development of auditing standards. For example, Mr Graeme Macmillan told the Committee:
- ...the auditing framework suffers from total confusion of responsibilities and roles mostly caused by the government not adopting the same model for auditing as they have for accounting standards.⁹¹
- 4.161 CPA Australia suggested there were efficiency benefits and synergies to be gained by bringing the auditing and accounting standards setting processes together (as described in their model shown at Figure 2) and told the Committee:
- ...you cannot keep totally separate issues of accounting and audit – they clearly feed off each other.⁹²
- 4.162 Professor Keith Houghton suggested to the Committee that the AuASB should be brought under the auspices of the FRC, similar to the arrangement for the AASB.⁹³ In addition, the NIA, while noting that there may be little to gain by developing the accounting and auditing standards together, told the Committee:

91 Mr Graeme Macmillan, *Submission No.7*, p.S62

92 Mr Brian Blood, *Transcript*, pa.20-21

93 Professor Houghton, *Submission No.16*, p.S118

The NIA does support the Auditing Standards being developed under a similar framework as the FRC that is independent but not exclusive of the professional bodies...⁹⁴

- 4.163 The AuASB when asked for their views on these suggestions indicated they doubted there were significant benefits from harmonising the accounting and auditing standards setting processes, although it acknowledged there may be some benefits in administration and in the research process.⁹⁵
- 4.164 A number of submissions have highlighted to the Committee the fact that, in contrast to the accounting standards, there is no support for the auditing standards in legislation and have suggested that the Corporations Law should contain the requirement that compliance with the auditing standards is mandatory.
- 4.165 For example, ASIC told the Committee the auditing standards should have the force of law and they (ASIC) should have the power to police them.⁹⁶ John Shanahan told the Committee:
- I believe that similar legislative authority should be given to Australian Auditing Standards...this would mean that non-compliance with the auditing standards would become an offence – which may make issues easier to prove in CALDB proceedings – and that the process of developing and drafting auditing standards would become more rigorous.⁹⁷
- 4.166 However, there is not total agreement that this would be an effective reform. CPA Australia advised the Committee there were only two other countries that have enshrined auditing standards in legislation⁹⁸ and Mr Tom Ravlic told the Committee that any reform to give the auditing standards legislative backing would be wasteful and cosmetic saying:

Statutory recognition of auditing standards already exists by inference because auditors must be registered. It is folly to assume...that there is some greater benefit in making the (auditing) standards delegated instruments in the same way as accounting standards.⁹⁹

94 National Institute of Accountants, *Submission* No.36, p.S339

95 Mr William Edge, *Transcript*, pa.83

96 Australian Securities & Investments Commission, *Submission* No.39, p.S374

97 Mr John Shanahan, *Submission* No.35, p.S327

98 Mr Arthur Dixon, *Transcript*, pa.21

99 Mr Tom Ravlic, *Submission* No.31, p.S273

Conclusion

- 4.167 The Committee is not convinced that there are clear advantages for reforming the process for the development of auditing standards nor, for giving them legislative backing. However, as outlined above, recent reforms overseas have moved the responsibility for the development of auditing standards away from the accounting profession.
- 4.168 It is suggested that the AuASB, in conjunction with ASIC or the FRC should monitor and report to the Government on the benefits and outcomes of these reforms before any action is considered in Australia.

Disciplinary processes

- 4.169 The Ramsay report addressed in detail the operation of the CALDB in disciplining registered company auditors, and made a number of recommendations to improve effectiveness of the board. These included proposals to ensure more transparency in the conduct of disciplinary proceedings and to promote more efficiency between the operations of the board and the disciplinary procedures in the professional accountancy bodies.¹⁰⁰
- 4.170 Based on the evidence before it, the Committee supports the adoption of the recommendations made by Professor Ramsay.
- 4.171 A number of submissions, however, have highlighted that the disciplinary processes of the professional bodies require reform. The Committee notes Mr David Knott, Chairman of ASIC, told a hearing of the Senate Economics Legislation Committee on 21 February 2002:

...we have been disappointed...by some of the attitudes that come out of the profession...I find that the action we take against auditors through the CALDB carries very little support from the profession and that we are constantly fighting the profession in that respect.¹⁰¹

- 4.172 Professor Ramsay explained to the Committee that:

...it seems to me, it is a privilege for Parliament to delegate to professional bodies the right to discipline. With that privilege being delegated to them comes the obligation to demonstrate back

100 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, pp.86 - 90

101 Mr David Knott, *Transcript*, e206

to Parliament and to the public generally that the mandate is being fulfilled...¹⁰²

4.173 The professional bodies have acknowledged this criticism. As indicated above, CPA Australia proposes a new body to replace the current disciplinary processes. Further, the ICAA, in its submission acknowledged its support for the role of the CALDB and for the recommendations in the Ramsay report for strengthening it. They also advised that, in recognition of its responsibility to ensure its policies and processes reflect the public interest and the division of responsibility between the statutory process and the profession, it has arranged a review of its disciplinary processes by an external consultant.¹⁰³

4.174 ASIC told the Committee that it had referred 251 matters to the CALDB in the ten years to 30 June 2001 ¹⁰⁴ (this figure was subsequently revised to 249).¹⁰⁵ This total was comprised of:

- 167 matters relating to a failure to lodge a triennial statement;
- 45 matters relating to a failure to adequately perform duties; and
- 37 matters relating to working while disqualified.

4.175 A summary of the results of these matters is shown in Table 4.

Table 4 Outcome of disciplinary matters provided by ASIC to CALDB

Outcome	Number
Registration cancelled	105
Registration suspended	41
Reprimands	11
Board refused to exercise discretion	10
Application withdrawn (generally after respondent voluntarily surrendered registration)	82
Total	249

Source ASIC ¹⁰⁶

4.176 On the other hand, it was recently reported in the media that no auditor has been expelled from the accounting profession in that time and the

102 Professor Ian Ramsay, *Transcript*, pa.226

103 The Institute of Chartered Accountants in Australia, *Submission* No.29, pp.S261-262 and 'Cracking the Whip', CACHarter, Stephen Harrison, July 2002

104 Mr Malcolm Rodgers, *Transcript*, pa.239

105 Australian Securities & Investments Commission, *Submission* No.66, p.S601

106 Australian Securities & Investments Commission, *Submission* No.66, p.S602

ICAA has only issued three serious sanctions against its members (figures from the CPA were not reported).¹⁰⁷

4.177 The CALDB's Annual Report for the year ended 30 June 2001 indicates that, in that time, it ordered the registrations of eight auditors to be cancelled and a further ten registrations to be suspended, for various failures in their duties.

4.178 When queried about the number of its members expelled from the professions for misconduct, CPA Australia told the Committee:

If the CALDB finds them (auditors) guilty...they can simply resign their membership; hence they are outside the realms of what we deal with. If they are not members anymore than we cannot discipline them.¹⁰⁸

4.179 The ICAA told the Committee that the Institute looks at each case on its merits and it does not necessarily impose further penalties if the CALDB has imposed sanctions but said:

...in every case (that goes to the CALDB), it goes to our disciplinary committee.¹⁰⁹

Conclusion

4.180 Implementation of the suggested reforms in the Ramsay Report can be expected to enhance the effectiveness of the CALDB. An integral part of the Committee's suggestion that the professional accounting bodies assess the need to reform the framework for the oversight of the accounting profession (para. 4.158) is consideration of the effectiveness of the disciplinary processes.

Whistleblowers

4.181 The Committee explored issues associated with corporate whistleblowers, that is individuals who voluntarily, outside of a company's formal disclosure or reporting mechanisms, raise concerns about misconduct or malfeasance, including to auditors and the regulatory bodies. The Committee considered firstly whether whistleblowers should be afforded greater protection to encourage them to come forward, and secondly,

107 'Who checks the checkers?', Australian Financial Review, 14 May 2002

108 Mr Brian Blood, *Transcript*, pa.24

109 Mr Stephen Harrison, *Transcript*, pa.29

whether the existence of confidentiality agreements within companies was acting to stifle such activity.

- 4.182 In their paper, *Financial Reporting Framework – The Way Forward*, CPA Australia suggested that formal mechanisms to protect whistleblowers would be useful to provide greater levels of support to auditors and subsequently told the Committee that creating a framework for the protection of whistleblowers was important in the public interest.
- 4.183 The Institute of Internal Auditors, when asked by the Committee for their views on whistleblower protection, told the Committee that the effectiveness of whistleblower protection measures depended on the ability of the protective regime to guarantee the anonymity of the whistleblower.¹¹⁰
- 4.184 Whistleblower protection arrangements currently exist in the public sector. In New South Wales, the *Protected Disclosures Act* establishes a scheme designed to assist public servants in NSW to report concerns they may have about the behaviour of a public official or the functioning of a public sector agency. Depending upon the nature of the matter, it may be referred to one of three bodies, The Independent Commission Against Corruption, the NSW Ombudsman or the Auditor-General. In addition, each agency is required to put in place internal mechanisms to deal with any disclosures by its employees.
- 4.185 In the Australian Public Sector, Section 16 of the *Public Service Act 1999*, provides an employee of the APS, who reports breaches (or alleged breaches) of the APS' Code of Conduct¹¹¹, which sets out the standards of behaviour and conduct expected to be observed by all APS employees, shall not to be victimised or discriminated against for their actions and are to be protected. To give effect to these requirements, Agency Heads are required to establish processes to be followed when a report alleging a breach of the Code of Conduct is received, including processes designed to protect the person(s) who made the disclosure.
- 4.186 ASIC have also suggested to the Committee that corporate whistleblowing should be addressed and indicated in its submission that individual employees of companies should be encouraged, and even obliged, to make known their concerns, including about financial misconduct. ASIC suggested a position in each corporation should be designated responsible for reporting these concerns and that adequate statutory protection needs to be in place.¹¹²

110 Mr William Middleton, *Transcript*, pa.196

111 Contained in Section 13 of the *Public Service Act 1999*

112 Australian Securities & Investments Commission, *Submission No.39*, p.S374

- 4.187 Finally it should be noted that Section 806 of the *Public Company Accounting Reform and Investor Protection Act 2002*, recently enacted in the United States, establishes a framework for the protection of employees of companies who willingly provide evidence of fraud or violation of securities law by their employer.

Conclusion

- 4.188 The Committee considers that the creation of a framework in which corporate fraud and other irregularities can be confidentially reported to an appropriate authority is a useful reform. Any framework must contain robust protection mechanisms in order to engender confidence and certainty in the process and encourage people to come forward.

Recommendation 13

- 4.189 **That a framework for protected (or whistleblower) disclosure be established in the *Corporations Act 2001*. Included in this framework should be clear accountability mechanisms over the administration and management of disclosures.**

Bob Charles MP
Chairman
August 2002