



**ASIC**

Australian Securities & Investments Commission

## **Auditors and audit committees — a regulator's view**

*An address by Ian Mackintosh, ASIC's Chief Accountant to a seminar by the Centre for Corporate Law and Securities Regulation, Melbourne, 28 May 2002.*

Thank you for inviting me to be involved in what promises to be a very interesting discussion of a very topical issue. Given the different background of each of the speakers we are sure to have diverse opinions and an active and constructive debate.

I propose to divide my 20 minutes into two parts. Firstly I would like to comment on Professor Ramsay's report entitled "Independence of Australian Company Auditors" and some issues emerging from it. And secondly I would like to spend some time discussing a paper given earlier this month by the Chairman of ASIC, David Knott, entitled "Protecting the Investor: the Regulator and Audit." That paper spells out 10 measures for accounting and audit reform and I think they are a very worthwhile contribution to the overall considerations.

### **The Ramsay Report, October 2001**

In general ASIC was supportive of the Ramsay Report and most of its recommendations. The report steered a commonsense middle path through a complicated and ever changing environment.

However, there were some areas that did not have our full support.

#### ***Auditor Independence Supervisory Board***

We have reservations about the Auditor Independence Supervisory Board as proposed in the report. We thought that the functions set out for it could be adequately covered by the profession or the regulators and that, if such a board was to be established, more discussion was required on:

- its role and membership,
- the allocation of responsibilities between such a board and ASIC and
- its relationship with the Financial Reporting Council and the CALDB.

***Legal services***

We did not support the suggestion in the report that a prohibition on audit firms providing legal services could not be adopted in Australia in any practical way. The IFAC standard on independence notes that legal services encompass a wide and diversified range of areas including both corporate and commercial services to clients and states that the provision of legal services by a firm to an audit client may create both self-review and advocacy threats. We agree with the IFAC view and consider that an audit firm providing legal services to an audit client should give serious consideration to the threats to independence that could arise before it decides that the work should be undertaken.

***Taxation services***

The report recommended that the regulation of non-audit services be dealt with in professional ethical rules, suitably up-dated to reflect the IFAC proposals and, if there are to be non-audit services to auditees (I will come back to this later), we did not disagree with this principle. However, it implicitly accepts the IFAC stance on providing taxation services and we do have some problems with this.

The IFAC standard covers the complex subject of taxation services and reaches a firm decision, in just three sentences. It says:

"In many jurisdictions, the firm may be asked to provide taxation services to an audit client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence."

I do not think this is adequate discussion on this topic. Nor do I think the conclusion is correct.

First of all, as with any non-audit service to an audit client, tax work can give rise to a self-interest threat. Further, it is acknowledged that client tax work can cover a very broad range of services and include:

- Compliance work which may not, generally, of itself cause a conflict (apart from a consideration of fee dependency), except where it calls upon the tax adviser to decide on the assessability of income or the deductibility of expenditure. In this situation there may be some degree of self-review in the audit.
- Determining broader strategies for the business including perhaps the structuring of the group and its geographical and financial location. This could lead to a familiarity threat.
- Providing appraisal and valuation services for the client in relation to its tax asset or liability. This can lead to a self-review threat.

- Advocacy where any of the client's tax treatments or planning are challenged in any way. This is very similar to providing legal services and could lead to an advocacy risk.

The IFAC conclusion has not been properly argued and ignores some real threats to independence.

### *Events since the report*

Extraordinary as it may seem, the events that have occurred since the publication of the report, just over six months ago, have meant that in some areas it is already out of date. Thinking and attitudes have changed since the collapse of Enron and the various collapses in Australia. There is much stronger support now for the view that the overall framework needs some basic restructuring and that perhaps something stronger than a commonsense middle course is required.

An example of this changed thinking is in a letter recently sent to IFAC from IOSCO. In that letter, just six months after IFAC finalised its ethical standard on auditor independence, IOSCO notes that the debate on auditors' independence has moved forward significantly and urges IFAC to conduct an ongoing review of the standard to ensure that it is consistent with current expectations.

### **Ten measures for accounting and audit reform**

As I mentioned earlier, ASIC's Chairman gave a paper earlier this month, which included a section on the regulatory environment. He opined that it is too early to come to considered conclusions on the reasons for the recent rash of crashes in the corporate community. However, he did venture preliminary views on what some of the reasons might be.

The first is a view that we had entered a period of complacency in corporate governance after many years of sustained growth and our remarkable survival of the Asian crisis.

Secondly, it could be that the seeds of failure were planted long ago but remained undetected because of buoyant market conditions and easy access to both equity and debt.

Thirdly, there appears to be emerging evidence of management neglect or misconduct.

Fourthly and most importantly, in the context of this seminar, is the view that there has been a failure of accounting and auditing processes to deliver acceptable outcomes. There are many complex issues behind this view, including the content, style and setting of accounting standards and the quality and rigour of the audit process.

But at the very centre of this minefield, is the paradox that auditors are expected to reconcile a commercial service provider/client relationship with a watchdog/whistleblowing responsibility. All of the commercial incentives support their

service provider/client relationship; and there is very little legislative or other incentive to support their public responsibility role. No one would accept that a regulator could properly function in such circumstances, yet we hold an expectation that auditors will perform as ‘contracted regulators’ of financial reporting. Not only that, but we permit this to take place under a regime where audit standards and their application are almost entirely self-regulatory; where those standards do not have the force of law; where the audit market for listed entities is dominated by a small number of major firms; and where the disciplinary and enforcement avenues available to the official regulator are limited and complex.

Against that background, and with the strong agreement that we should guard against knee jerk responses and take time to consider these issues from a first principle perspective, the paper set out ten measures for accounting and audit reform. It is emphasised that there was no desire to be inflexible or dogmatic in relation to these measures and that there is room for a range of possible outcomes.

The measures were:

1. Australia should remain committed to the development and adoption of a complete and consistent package of international accounting standards. Those standards must address key areas of current international disparity and plug holes that currently exist.

I do not think too many will argue with this first measure. Some would prefer the adoption of US GAAP and some would espouse the adoption of any GAAP, but I would remain firmly behind the newly constituted IASB and its efforts to build a set of truly international standards.

2. Those international accounting standards should redress the current dominance in some jurisdictions of form over substance – and reintroduce to the law an overriding qualitative accounting consideration and audit opinion that the accounts truly and fairly report the financial condition of the corporation. The ‘true and fair override’ was removed in Australia some years ago because it was perceived that it was abused by preparers, who simply used it to avoid standards they did not agree with. If, as we hope, it is reintroduced here through the international harmonisation process, it must be accompanied by enforcement sanctions to prevent the repetition of past abuses.
3. Australia should commit to the *wholesale* adoption of these updated international accounting standards. It is not acceptable that the efficacy of international standards should be undermined by selective fine-tuning by user countries. Our commitment to adoption should be unconditional. The AASB should, by the end of this decade, be almost entirely concerned with providing input into the international accounting standard setting process and only in extremely rare circumstances be issuing national standards that deal with uniquely Australian situations.

4. 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 service provider/client relationship.

ASIC has previously stated that firm rotation should be seriously considered. We hold that view because we believe that partner rotation, while useful during the life of an audit engagement, will not achieve the same result as firm rotation. It is not credible that one partner will seriously challenge the established audit practice and advice previously provided by his firm through another partner. Rotation of firms, as encouraged by CPA Australia, and more recently by Roger Corbett of Woolworths, is the more credible process.

Nevertheless, we do accept the significant pragmatic obstacles that confront firm rotation, particularly in light of increased concentration of the profession. We accept that this is a worldwide issue and that Australia's interests would not be served by adopting a unilateral reform.

This therefore is one of those 'first principle' issues which we place on the table for serious discussion and consultations, but without pre-judging of the outcome.

This rotation doesn't have to be all or nothing. For example, one might contemplate firm rotation every seven years for listed companies as a 'default' position, but one which could be deferred by shareholder vote at the annual general meeting in the year preceding rotation. It is, after all, the shareholders we are trying to protect. If they are persuaded by their Directors that compulsory rotation might do more harm than good – taking into account the company's particular circumstances – then their voice should be heard. But at least a default position of rotation would ensure active shareholder participation in the decision. In our view it is something that should be put to shareholders at each AGM after the rotation period has expired until a replacement firm is appointed. Voluntary adoption of this process by companies would send strong signals to their shareholders and the market about a genuine commitment to increased standards of governance and shareholder protection.

This is the most contentious of the ten measures and there are many who disagree with the notion entirely. Rob Ward of PWC, for instance, has written an article on the subject in which he claims that the idea is a candidate for the title "world's worst practice", that there is overwhelming evidence against its usefulness and that the compelling conclusion is that mandatory audit firm rotation is a bad idea.

I hope he is still able to agree with our Chairman's comment that in many of these issues there is no absolute right or wrong and that there is room for a range of possible outcomes!

Rob's arguments (I hope I summarise them properly) are that the knowledge and understanding of client companies would be regularly lost, that rotation would encourage a compliance mentality and undermine the authority of audit committees and

that research does not show much investor support for it. He says Italy is the only country using it, but I was under the impression that Brazil has just begun a firm rotation regime.

Rob conceded that firm rotation might help overcome the familiarity threat to independence, but said that partner rotation would have the same effect. He did not address our major reason for proposing firm rotation which was to help break the paradox of the audit firm being in a commercial service provider/client relationship with a watchdog/whistleblowing (contracted regulatory) responsibility. Firm rotation does not solve the problem completely. We think changes that would solve it completely, such as the auditor being appointed and having remuneration set by an outside body, are too radical. But the knowledge by the audit firm that a rotation will take place over a predetermined period of time will go a fair way to reducing their commercial dependence on their client and the self-interest threat to their independence.

On Rob's arguments, I think that the loss of knowledge is a price worth paying, I really don't understand his comment on a compliance mentality and I disagree that it is necessarily in the shareholders' interests that audit committees remain responsible for deciding whether a change of audit firm is appropriate.

5. Audit and consultancy services should not be provided to the same clients. This is not the same as saying that audit firms should be banned from being engaged in consultancy. There is validity to the argument that diversity of service is desirable in order to maintain the attractiveness of firms to future generations of accountants. An ability to generate revenue streams across different business lines should not be readily dismissed.

However, there is no denying the conflict that arises when audit and consultancy services are provided to the *same* clients. In such circumstances, it is natural and predictable that the firm will seek to optimise its overall financial return from the relationship. No amount of disclosure or Chinese walls will alter the dynamic of that commercial relationship. What is most likely to suffer? The rigour and independence of audit.

For these reasons, we believe that firms should be precluded from providing consultancy services to their *audit* clients, but should be permitted to consult to other clients.

It has been gratifying to see the Group of 100 and the ANZ supporting the general thrust of this proposed measure.

6. The law needs to more clearly set out its expectations for corporate whistleblowing. Consideration should be given not only to strengthening current reporting obligations of auditors to the regulator, but extending those obligations to a nominated officer of the corporation itself. Financial misconduct within

corporations usually requires the transactional assistance of staff who know that things are wrong, but who feel unable to influence the outcome. The law should encourage, even oblige, such people to make known their concerns to the Board, the auditor and even directly to the regulator. One possibility that could be seriously considered is to impose such a reporting obligation on the most senior line financial manager of the corporation who is not a Board member. At first blush this may seem radical, yet in the insurance sector direct reporting obligations by the auditor to the regulator and by the in-house actuary already exist. Indeed, those obligations are being extended under general insurance reforms.

Such obligations should be accompanied by adequate statutory indemnity to ensure full protection against recrimination by the corporation or other parties.

The almost total absence of misconduct reports to ASIC by auditors in the past reflects the ambivalent nature of their existing legal obligation and the absence of incentive and protection. It is time to do something about it.

7. Existing auditing standards need to be reviewed to increase the rigour of audit. Those standards should have the force of law (as with accounting standards) and ASIC should have effective powers to police them.

There appears to be a consensus in the profession that auditing standards are adequate and their framework is conceptually sound and properly based. I think this needs to be tested. IOSCO are taking some steps in this regard.

8. At least for the listed sector, it should be compulsory for the Board (in the absence of full-time management representatives where the company structure permits) to agree to the audit mandate and to review audit issues with the auditors at least six monthly. Whether this is achieved through Audit Committees or not does not seem crucial. The much more important imperative is to reinforce the need for active dialogue between the Board and auditors, independent of management sanitisation. In most cases an Audit Committee may well be the best way to manage that dialogue.
9. It should be compulsory that auditors attend AGMs of listed companies and that they be available to answer questions from shareholders. When this was last considered seven years ago objections were raised on the grounds that Directors are not themselves obliged to attend meetings. In our opinion, that is an anomalous situation which should be rectified. In the absence of valid excuse by reason of ill-health or other indisposition, directors and auditors should be present to account to shareholders on their one day of the year. This proposal should be back on the table.
10. Rather than mandating quarterly reporting, as recommended by CPA Australia, the current continuous disclosure regime should be reviewed to ensure that it captures the timely publication of relevant information to shareholders and the broader market. That review should examine the subjectivity inherent in the current ASX

Rules; and the sanctions available to the Regulator. A robust regime of continuous disclosure, supported by proportionate and timely sanctions, remains the best means of sustaining a well-informed and transparent market.

## **Conclusion**

In conclusion I would like to quote our Chairman in the end piece to his speech on the ten measures. He said:

The accounting profession is going through a testing time during which the vast majority of hard working and diligent members of the profession are under scrutiny. Most would agree that any recent failures of the profession have to be assessed in the context of the more culpable shortcomings of corporate managers who have been in the driver's seat.

Yet this is a wake up call about the need for all professions to be vigilant in safeguarding their traditional values.

A culture which places optimisation of financial reward above all else is inconsistent with professional values and endangers professional ethics.

Now is the time for all individual accountants who value the profession's history of integrity and honour to reclaim lost ground. If I am right, the biggest battles lie not with the public policy makers or regulators, but with the profession itself and within corporate Australia. Don't be passive. Take up this fight. This is your reputation we are talking about."

I totally concur with his comments.