→ Position paper — audit governance

Audit governance is an important issue and has been the focus of attention with major corporate collapses in Australia and the United States. The need for audit governance is not a new issue — there are many Australian and international reports and best practice guidelines that address audit governance. Recently there have been strong calls from a range of stakeholders for the separation of the audit and the non-audit functions sourced from the same provider. However, regulatory over-reaction could be contrary to the best interests of companies and those that invest in them. Greater transparency of audit processes and strong audit committee governance in accordance with best practice guidelines are immediate and practicable responses to audit independence.

'Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and stature.'[1]

Audited financial statements are an important tool for the assessment of companies by regulators and capital markets. They form an important part of effective corporate governance. The auditor's role is to provide a disinterested and objective view of the financial statements of a company in line with generally accepted accounting standards. The external audit is undertaken by an independent, external party in order to give stakeholders comfort as to the integrity of the published financial statements. In Australia this is to meet the requirements of ASIC and ASX for public companies in annual reporting.

Independence is fundamental to the validity and reliability of an auditor's reports. Investors and creditors would have little confidence in company financial statements if auditors were not independent in both fact and appearance. Auditors constitute the principal external check on the integrity of financial statements. However, the parts of the Corporations Act that refer to auditor independence have not been updated for 40 years.[2] The Act refers to financial and employment independence but it is silent on the relationship between audit and non-audit work. It does not consider the growth of the large accounting firms and the increase in non-audit work undertaken by those firms. Accounting Standard AASB 1034 requires disclosure of auditor remuneration for audit services and non-audit services. However, there is no requirement for a break down of those numbers to enable an understanding of the relationship (if any) between them.

1_John L Carey, The Rise of the Accounting Profession: To Responsibility and Authority, 1937–1969 (New York, 1970), p182.
2_Ian Ramsay, Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform. October 2001.

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How do we define audit governance?

Audit governance refers to the vigilance with which shareholders scrutinise management performance in relation to audit. A key area of audit governance is consideration of the structures and processes that company boards have established to ensure the independence of audits through their audit committees. In this regard, this paper takes into account the current practices of companies as identified through publicly available information — the most recent annual reports, web site searches and live financial markets data. Consideration has been given to the recommendations made in the Ramsay Report on Auditor Independence, IFSA and AICD/IIA & AARF guidelines on audit committee composition, The UK Cadbury Report and the US Blue Ribbon Committee Report. All have similar positions on the issue of audit independence, the provision of non-audit services to the audit client and the role and importance of a strong and independent audit committee. The findings of a comprehensive WIM[1] study of the S&P/ASX 200 audit governance practices are summarised in the attached table.

The major points addressed by WIM from the Ramsay Report (2001) — the most prominent recent Australian review of audit governance relating to independence — are outlined below:

- → provision of non-audit services by the auditor
- → audit committee presence and composition
- → appointment and removal of auditors.

These major points were considered based upon acceptance of the following observations:

- → robust audit is vital to investment confidence and trust
- → following prominent company collapses, audit confidence has deteriorated markedly
- → audit is complex and the responsibilities of the auditor and companies are not clearly understood
- → this lack of understanding of audit risks a policy response to correct a perceived rather than a real audit concern. The provision of other services by the auditor can in many cases be reasonable if explained effectively
- → there is a risk that policy over reaction could lead to significant company costs.

Risk

There is risk that poor audit governance can lead to impaired ability for investors and markets to trust the integrity of company financial statements. Ineffective audits will affect the ability of capital markets to allocate valuable resources by impairing the decisions of users of financial statements.[2] Publicly reported financial statements are the basis of decision-making for institutional and individual shareholders.

Position on Audit Governance

Non-Audit Services

There can be practical advantages to a company where the audit firm also provides certain other services to that company. Further, there is a lack of solid evidence that the size of the non-audit fees detrimentally affects the independence of the external audit. Making generalisations based on perceptions of inequity may prove costly and unnecessary. However, improved company disclosure of the other services provided by the external audit firm could mitigate perceived risks to auditor independence.

1_Westpac Investment Management
2_Independence Standards Board, A Conceptual Framework for Auditor Independence, Feb 2000.

Board Audit Committees

Board audit committees should be mandatory whether an investee entity is a company or a Trust. The presence of a board audit committee is standard best practice. Addressing audit governance through a strong and independent audit committee is a means of ensuring the integrity and reliability of the external audit.

The board audit committee should be comprised entirely of Non-Executive Directors. However, Executive Directors should be invited to attend as required. Having Executive Directors on the board audit committee could produce a perceived or actual bias that compromises the process of independent audits. More specifically, having the Chief Financial Officer as a member of the audit committee raises immediate concerns regarding conflict of interest. However, the expertise and knowledge of the CFO and other executives should be a resource that the board audit committee draws upon to make sound analysis and decisions.

Board audit committees should disclose in the annual report whether they have ensured the independence of the external audit. Similar to the declaration of the auditor, the board audit committee should state it has followed process to ensure the integrity and independence of the external audit.

Audit Partner Rotation

Audit firm partners should change at least every seven years. Although no Australian companies have been observed to exceed the seven-year limit during the past 10 years, it is recognised that over-familiarity may lead to conflicts of independence.

Conclusion

Lack of audit independence represents a risk to the long-term value of institutional investments. Following detailed examination of company practices across the S&P/ASX benchmark, the position is taken that much of the audit independence risk to shareholder value can be significantly addressed by improved transparency of non-audit services and through board audit management processes. Significantly, such processes already exist as best practice. It is the execution of those practices that appears to be lacking. Adoption of existing guidelines and best practice management is preferable to additional regulation.

Measure	Recommendation	Data Researched	Current Practice ASX 200	Position
Provision of non-audit services by audit firm	Disclosure of non audit services.	Proportionality of nonaudit/audit amounts. To look at the relationship of size of non-audit and audit amounts.	Average proportionality of nonaudit/audit was 150% across ASX 200. 8 companies paid the audit firm 500% or more (7.83% by market weight). 17 companies had 300–500% proportionality and represented 9.5% of ASX200 by market weight. In total the market weight of those companies with a proportionality non-audit/audit greater than 300% is 17.3%.	There is no evidence that proportionality is of itself a risk. Each company is unique and has different requirements for the provision of non-audit services. Looking solely at the size of non audit services relative to the audit amount is misleading.
	Accounting Standards → Financial Report for the year must disclose dollar amount of all non-audit services provided by the audit firm.	Breakdown of non-audit amounts in notes of Financial Statements — whether an explanation was provided.	180 companies (80% by market exposure ie $ value) do not disclose a breakdown of the audit amounts.	Disclosure requirements should be tightened. Companies should strive for greater transparency to restore market and investor confidence in the integrity of the of financial statements.
Audit Committees	Mandate the existence of a qualified audit committee.	Existence of audit committee.	17 companies do not have an audit committee. 11 of these are Listed Property Trusts that lodge a compliance plan with ASIC and fall under Trust Law Provision of Corporations Law.	Audit committees should be mandatory for all listed entities.

Measure	Recommendation	Data Researched	Current Practice ASX 200	Position
	Specify the composition of the audit committee.	Examination of composition of audit committee (where present) to determine[1] Independence of the Audit committee. Factors → presence of Non Executives as members → Proportion of Non Executive to Executive Directors Presence of CFO on audit committee.	25 companies have executives on their audit committee (13.3% by market weight), 9 companies have the Chief Financial Officer as a member of their audit committee (2 companies have the CFO as the chair of the Audit Committee). The combined market weight of these companies represent 18.9% by market weight of the ASX200.	Board audit committees should comprise solely of non-executive directors with an independent chairperson. The presence of the CFO on the audit committee is not appropriate as it could compromise the impartiality of the review of management's work. Company audit committees should be, and be seen to be, independent.
	→ The financial report for the year must disclose whether the audit committee of the board… has considered whether the provision of nonaudit services is compatible with maintaining auditor independence.	Reference to independence of audit in annual report in Corporate Governance section (ASX 200).	20 companies refer to independence of audit in their annual report. This represents 37.8% by market weight.	Audit committees should address independence in their Statement of Corporate Governance in the annual Report and outline processes in place to ensure Audit Independence. This should include an assurance (where appropriate) that the provision of non-audit services by the audit firm has not compromised its independent review of financial documents.
Appointment and removal of the auditor	Rotation of audit firm partner at least every 7 years.	Review ASX top 160 companies (by size) over 10 year period to determine the extent of audit partner rotation.	100% of companies changed audit partners at least every 7 years.	Audit firm partners should change every 7 years to prevent a bias borne of over familiarity.

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1_Independence defined as independence from Management — so executive vs non-executive directors as members of the Board's Audit Committee. Therefore WIM looked for the presence of executives on the audit committee and particularly the CFO.

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