Parliamentary Joint Committee on Corporations and Financial Services

CLERP (Audit Reform and Corporate Disclosure) Bill 2003

PART 2

Financial reporting and audit reform

June 2004

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The Committee's first report *CLERP (Audit Reform and Corporate Disclosure) Bill 2003: Enforcement, executive remuneration, continuous disclosure, shareholder participation and related matters* was tabled out of session on 4 June 2004.

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DUTIES OF THE COMMITTEE

Section 243 of the *Australian Securities and Investments Commission Act 2001* sets out the duties of the Committee as follows:

The Parliamentary Committee's duties are:

(a) to inquire into, and report to both Houses on:

(i) activities of ASIC or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of the corporations legislation (other than the excluded provisions), or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

TERMS OF REFERENCE

On 8 October 2003, the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into and report on the exposure draft bill, CLERP (Audit Reform and Corporate Disclosure) Bill, and relevant related matters.

The Committee was aware that legislation based on the exposure draft might be introduced into Parliament before it could complete its inquiry. In calling for submissions, the Committee explained that should the draft bill be superseded by the introduction of legislation into Parliament, the Committee would welcome additional comments on the differences between the exposure draft bill and the legislation.

As anticipated, on 4 December 2003, the CLERP (Audit Reform & Corporate Disclosure) Bill 2003 was introduced into Parliament. On 11 March 2004, the Committee resolved that it would broaden its terms of reference to examine this Bill.

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ACRONYMS AND ABBREVIATIONS

AARF	Australian Accounting Research Foundation
AASB	Australian Accounting Standards Board
ACCA	Association of Chartered Certified Accountants Australia and New Zealand
ACCI	Australian Chamber of Commerce and Industry
ACF	Australian Conservation Foundation
ACSI	Australian Council of Super Investors Inc
AICD	Australian Institute of Company Directors
ASA	Australian Shareholders' Association Ltd
ASFA	The Association of Superannuation Funds of Australia Limited
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
ASX	Australian Stock Exchange Ltd
AuASB	Auditing & Assurance Standards Board (existing Board)
AUASB	Auditing & Assurance Standards Board (Board proposed in the Bill)
BDO	BDO Chartered Accountants and Advisers
CALDB	Companies Auditors and Liquidators Disciplinary Board
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CLAAL	Commercial Law Association of Australia Limited
CLERP	Corporate Law Economic Reform Program
CPAA	CPA Australia
CSA	Chartered Secretaries Australia
CSR	Corporate social responsibility

Deloittes	Deloitte Touche Tohmatsu
FRC	Financial Reporting Council
FRP	Financial Reporting Panel
FSU	Finance Sector Union of Australia
CGI	Corporate Governance International Pty Ltd
HIHRC	HIH Royal Commission
IASB	International Accounting Standards Board
IAASB	International Auditing & Assurance Standards Board
ICAA	The Institute of Chartered Accountants in Australia
IFSA	Investment and Financial Services Association Limited
JCPAA	Joint Committee of Public Accounts and Audit
LCA	Law Council of Australia
LSSA	Law Society of South Australia
MD&A	Management discussion and analysis
NIA	National Institute of Accountants
OFR	Operating and Financial Review
PCAOB	Public Company Accounting Oversight Board (United States)
Telstra	Telstra Corporation Limited
UIG	Urgent Issues Group

PART 2

This report is Part 2 of a two-part report into the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 and covers the Bill's proposals to:

- require a Chief Executive Officer/Chief Financial Officer sign-off on financial reports and the inclusion of an Operating and Financial Review;
- strengthen auditors' independence through:
  - the imposition of cooling-off periods for auditors taking up positions with former audit clients;
  - audit partner rotation;
  - restrictions on former audit partners taking up positions with audit clients;
  - requirements for disclosure of auditors' provision of non-audit services to audit clients;
- improve auditors' accountability by requiring their attendance to answer shareholders' questions at annual general meetings of listed companies;
- strengthen audit oversight by reconstituting the Auditing & Assurance Standards Board as a Commonwealth authority and placing it under the oversight umbrella of the Financial Reporting Council;
- add auditor independence to the Financial Reporting Council's responsibilities;
- reorganise the Companies Auditors and Liquidators Disciplinary Board;
- convert auditing standards into disallowable instruments to assist enforcement of auditing matters;
- add to the matters which auditors must report to ASIC.

Part 1 of the report was tabled on 4 June 2004 and covered CLERP 9 proposals dealing with, among other things, protection for employees reporting breaches; directors' and executives' remuneration; infringement notices for alleged contraventions of continuous disclosure requirements; changes to criminal and civil penalties for directors; shareholder participation at company meetings; management of conflicts of interest by financial services licensees and improvements to disclosure requirements in specified disclosure documents.

EXECUTIVE SUMMARY

Introduction

On 8 October 2003, an exposure draft of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (CLERP 9 Bill) was released for consultation. Announcing the release, the Treasurer commented that:

> The Bill takes a balanced approach to corporate regulation, containing measures to enhance auditor independence, achieve better disclosure outcomes and improve enforcement arrangements for corporate misbehaviours, whilst still fostering innovation and wealth creation. The Bill will significantly improve the overall regulatory framework for auditors.[1]

On 4 December 2003, the CLERP 9 Bill was introduced into Parliament with the intention that it would be passed for a 1 July 2004 commencement.

The CLERP 9 proposals were first discussed in the policy paper, *Corporate Disclosure, strengthening the financial reporting framework*, released for public comment in September 2002. The paper's release coincided with widespread and heated public interest in corporate governance issues following the spate of corporate collapses in the United States and, to a lesser extent, in Australia.

Australia's corporate failures were nowhere near the magnitude of those in the United States. Nonetheless, the fall-out from just one—the HIH Insurance Group—had a huge impact on individuals and the broader community. Confidence in capital markets was shattered.

Among other things, HIH raised serious questions about the reliability of corporate financial reporting. Were the rules governing its content in need of an overhaul? Could external company auditors be relied on as an assurance mechanism for financial reports?

In this second part of the Committee's two-part report, the Committee looks at the measures in the Bill which seek to improve the content and reliability of financial reporting and to safeguard auditor independence.

In chapter 1, the Committee examines the CLERP 9 proposals for a Chief Executive Officer/Chief Financial Officer sign-off on financial reports and the addition of an Operating and Financial Review. The Committee also reviews submissions advocating a requirement for auditors' reports to include a discussion of alternative accounting treatments and proposals for clarification of true and fair view requirements.

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1 The Commonwealth Treasurer Press Release, *Government releases exposure draft legislation on audit reform and corporate disclosure*, 8 October 2003.

The quite extensive reforms to safeguard the independence of external company auditors are discussed in chapters 2 to 11.

Overview

Submissions to the Committee's inquiry indicated widespread general support for the objectives of the financial reporting and auditor independence reforms although there was some disagreement about how these objectives might best be achieved. Among the Bill's more contentious proposals were those to impose mandatory rotation requirements on lead and review auditors; the employment restrictions applying to former audit partners—the 'multiple-officer' restraint; the restrictions placed on auditors' provision of non-audit services to auditing clients; the creation of a Financial Reporting Panel and the conversion of auditing standards into disallowable instruments.

Evidence on the Bill's proposed reconstitution of the Auditing & Assurance Standards Board into a Commonwealth authority attracted a great deal of comment on the standard-setting framework as a whole and, in particular, the Financial Reporting Council (FRC). The Committee has made several recommendations to ensure the independence of the standard-setting institutions and to improve the transparency and functioning of the FRC.

The following summarises the Committee's conclusions about some of the more contentious issues examined during the inquiry.

Summary of main issues

Financial reporting—true and fair view requirement

The exposure draft of the Bill proposed amendments to improve the application of true and fair view requirements to financial reports. The amendments were based on the recommendations of the Joint Committee of Public Accounts and Administration (JCPAA)[2] and were endorsed by the HIH Royal Commissioner.

For reasons unknown to the Committee, these amendments were dropped from the Bill.

The Committee agrees with the findings of the JCPAA and the HIH Royal Commissioner that the significance of the true and fair view requirement for financial reporting appears to have been forgotten.[3]

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2 JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, Canberra, August 2002, pp. 83-4.

3 The HIH Royal Commissioner says in this regard that, 'If as I suspect, preparers of accounts have forgotten the significance of true and fair view, they ought to be reminded'. *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 139.

To correct this shortcoming, the Committee has recommended that a definition of 'true and fair view' should be inserted into the *Corporations Act 2001*. This definition should emphasise the rationale behind the true and fair view requirement that financial statements must provide users with information they would reasonably need in order to make informed decisions regarding their securities or other interests.

The Committee has also recommended that the true and fair view requirements advocated in the JCPAA report be adopted.

Financial Reporting Council

The Bill's proposal to add the Auditing & Assurance Standards Board (AUASB) to the institutional standard-setting framework set out in Part 12 of the *Australian Securities and Investments Act 2001* (ASIC Act) attracted widespread criticism of the FRC's performance.

The Committee was satisfied that the evidence reflected definite problems with the FRC's transparency and accountability which raised questions about its suitability as the oversight body for the Australian Accounting Standards Board (AASB) and the reconstituted AUASB. In addition, the Committee identified problems with the existing legislation and funding arrangements which the Committee saw as posing a threat to the independence of standard-setting arrangements.

The Committee has consequently made recommendations to safeguard the independence of the FRC and the standard-setting bodies for which it has oversight. More particularly, the Committee has recommended that:

- the FRC should conduct its meetings in public and seek public submissions on proposals having a public interest element;
- the FRC should have an independent secretariat;
- FRC membership should be appropriately qualified and experienced;
- the Government should commit to funding the FRC, AASB and AUASB on a permanent basis; and
- the FRC's ability to influence the standard-setting functions of the AASB and AUASB should be limited.

Mandatory rotation of audit partners

The rotation requirements provide that an auditor who plays a significant role in the audit of a listed entity[4] for five successive financial years (or for more than five out of

4 The rotation obligation applies to individual auditors (i.e. sole practitioners) and, for audit firms and authorised audit companies, the lead and review auditors.

any seven successive financial years) must retire from that role for at least two successive financial years.

Although this proposal was generally well received, the Committee accepted the evidence that rotation requirements went further than was needed for small- to middle-tier firms and, in fact, would threaten their viability.

The rotation requirements are intended to promote auditor independence by limiting the impact of fee dependence and the familiarity threat. The Committee accepted that for some firms, usually the small- to middle-tier firms, these threats are minimal at best because audit partners generally manage several clients, all who pay relatively small fees.

Furthermore, the application of the rotation requirements to review auditors—as the term is defined in the Bill—did not reflect that review auditors perform very different roles from firm to firm. In small- to middle-tier firms in particular, review auditors are likely to perform a merely technical role in an audit and have little face-to-face client contact. The likelihood that the independence of review auditors in these circumstances could be compromised through fee dependence or the familiarity threat is considered to be negligible.

Despite this, the rotation requirements apply across all firms, regardless of their size and regardless of whether auditor independence—real or perceived—is in issue.

The fact that some firms will not have enough lead and review auditors to meet the rotation obligations and thus continue to provide auditing services is of great concern to the Committee. For some firms, the *auditor* rotation requirements will amount to audit *firm* rotation which the Explanatory Memorandum for the Bill said was not an acceptable option.[5] Furthermore, the evidence strongly suggests that in Western Australia and South Australia particularly, suitable alternative services will not necessarily be available to clients of displaced firms.

To ensure the legislation is appropriately directed and does not go further than is required, the Committee has recommended that the definition of 'review auditor' should be amended to reflect the rationale underlying the rotation requirements. The Committee has also recommended that the rotation requirements should only apply to the top 300 listed entities by market capitalisation to protect the interests of smaller audit firms and their clients.

'Multiple-officer' restraint

The Bill provides that a person who has been a member of an audit firm or director of an audit company cannot become an officer of an audited body if another person who

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5 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 20-21.

is or was a member or director of the auditor at a time when the auditor undertook an audit of the audited body is also an officer of the audited body.[6]

No evidence was produced to the Committee to indicate that the benefits to be gained from this provision—if any—would outweigh the restrictions placed on auditors' career opportunities and the availability of suitably experienced and qualified former auditors to occupy senior corporate positions.

The Committee has recommended the deletion of this proposed provision from the Bill.

Auditors' provision of non-audit services

The Bill's proposal to require listed companies to disclose in the annual directors' report details of all non-audit services provided by their external auditors and the fee paid for each service attracted diverse views. Of the proposal's critics, some favoured a blanket ban while others were prepared to accept legislative prohibition of specific non-audit services such as valuations, tax advice and internal auditing.

The Committee was not satisfied on the evidence before it that a blanket ban could be justified. Furthermore, the Committee did not favour selective legislative prohibition mainly because of the likelihood that it might be over- or under-inclusive and fail to accommodate instances where the threats posed by self-review might be non-existent.

The Committee concluded that the Bill's disclosure requirements presented a workable and cost-effective safeguard of auditors' independence in this area. The Committee believes that the 'threats and safeguards' approach advocated in *Professional Statement F1—Professional Independence*[7] will provide a useful supplement to the legislation.

Financial Reporting Panel

The Committee supports the Bill's proposal to establish the Financial Reporting Panel as a useful alternative dispute resolution mechanism.

The Committee rejected arguments for the Panel to have a pre-publication jurisdiction. Among other things, the Committee considered this could limit the Panel's post-publication jurisdiction while posing threats to auditors' independence and professionalism.

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6 Proposed section 324CK Corporations Act.

7 This statement is based on the internationally harmonised standard for professional auditor independence agreed by the 120 nations who are members of the International Federation of Accountants. The CPAA and ICAA have adapted this standard 'to reflect Australian community expectations'. See *New Australian standard for audit independence*, CPA news release 23 May 2002.

The Committee could see no reason for requiring a company to obtain the consent of the Australian Securities and Investments Commission's consent as a precondition for referring a matter to the Panel and recommended that this precondition be deleted from the Bill.

The precedent value of the Panel's rulings was the subject of quite extensive discussion. Although the Committee's view on a reading of the relevant provision in the Bill is that the Panel's rulings were not intended to have precedent value, the Committee believes that the Bill should clarify this and has made a recommendation accordingly.

On the basis that auditors have a stake in reports that come before the Panel, the Committee has recommended that auditors should be entitled to attend and make submissions at Panel hearings which concern reports they have audited.

Auditing standards

The Committee heard a great deal of evidence that auditing standards as disallowable instruments would not necessarily improve audit quality and would pose a considerable threat to Australia's program of convergence with International Standards of Auditing.

In addition to these concerns, questions were raised about whether the auditing standards as a whole could be successfully converted into a format compatible with enforcement under corporations legislation.

The Committee is not opposed to auditing standards having legislative force. However, it has recommended that introduction of amendments giving auditing standards legislative force be postponed until the changes can be effected without threatening international convergence and audit quality. The Committee believes a thorough review is necessary to resolve these issues.

Conclusion

The Committee would have liked the opportunity to conduct a more wide-ranging review of corporate governance matters as part of its inquiry. However, time constraints did not allow for this.

Nonetheless, the Committee believes the Bill, incorporating the amendments recommended by the Committee, will help to restore confidence in corporate communications to the market and provide shareholders with more extensive opportunities for participation in corporate affairs.

RECOMMENDATIONS

RECOMMENDATION 1

1.34 The Committee recommends the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) sign-off requirement should be amended to accommodate practical contingencies and allow for the CEO's and CFO's reasonable reliance on information provided by others when making the certification.

RECOMMENDATION 2

1.65 The Committee draws the Government's attention to the apparent inconsistency between the proposed Operating and Financial Review requirements, concise reports and AASB 1039 and recommends that the necessary amendments be made to avoid a duplication of requirements.

RECOMMENDATION 3

1.90 The Committee recommends that where alternative accounting treatments are possible in an accounting standard, and where the alternative/s not selected could have resulted in the company recording a loss for the financial year, or substantial losses rather than gains, or have materially affected its solvency, then the reason for the choice of the more favourable alternative over the less favourable alternative must be disclosed by the external auditor.

RECOMMENDATION 4

1.134 The Committee recommends that the Bill should insert a definition of 'true and fair view' into the *Corporations Act 2001* to clarify that its purpose is to ensure that the financial reports of a disclosing entity or consolidated entity represent a view that users of the reports (including investors, shareholders and creditors) would reasonably require to make an informed assessment of matters such as investment in the entity or the transaction of business with the entity.

RECOMMENDATION 5

1.135 The Committee recommends that sections 297 and 305 of the *Corporations Act 2001* should be amended:

- to provide that, in undertaking the assessment of a true and fair view, directors must consider the objectives contained in section 224(a) of the ASIC Act and must include a statement in the financial report that they have done so;
- to delete the footnote that states: If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view,

additional information must be included in the notes to the financial statements under paragraph 295(3)(c);

- to add new subsections for the following:

  (a) In the case of conflict between sections 296 (compliance with accounting standards) and 297 (true and fair view), the notes to the financial statements must indicate why, in the opinion of the directors, compliance with the accounting standards would not give a true and fair view of the financial performance and position of the company;

  (b) The notes to the financial statements must include a reconciliation to provide additional information necessary to give a true and fair view.

RECOMMENDATION 6

3.18 The Committee recommends that the Government explore ways in which the administrative functions and statutory obligations of the Australian Accounting Standards Board and the Auditing & Assurance Standards Board can be managed so as to avoid duplication of costs and effort.

RECOMMENDATION 7

3.19 The Committee recommends that the Government explore ways of combining the administrative and technical teams of the Australian Accounting Standards Board and the Auditing & Assurance Standards Board to provide a working environment that meets the expectations of suitably qualified professionals.

RECOMMENDATION 8

3.38 The Committee recommends that Note 2 be deleted from proposed subsection 227B(1) of the Bill so that the Auditing & Assurance Standards Board will not be required to divert resources on unnecessary work.

RECOMMENDATION 9

4.24 The Committee recommends that the *Australian Securities and Investments Act 2001* should be amended to ensure that the Financial Reporting Council:

(a) is required to conduct its meetings in public. This should not prevent meetings occasionally being held as closed proceedings where the matters are of such sensitivity that that is appropriate.

(b) conducts public consultation on proposals within its functions and responsibilities that have a public interest element.

RECOMMENDATION 10

4.31 The Committee recommends that urgent provision should be made for an adequately staffed and funded secretariat, independent of the Department of the Treasury and other Government departments, for the Financial Reporting Council.

RECOMMENDATION 11

4.52 The Committee recommends that the *Australian Securities and Investments Act 2001* should be amended so that members appointed to the Financial Reporting Council must have knowledge of, or experience in, business, accounting, auditing or law; or can demonstrate a sufficient involvement in the investment community or interest in corporate reporting to bring a user's perspective to the Council.

RECOMMENDATION 12

4.53 The Committee recommends that the membership mix of the Financial Reporting Council should be evenly weighted between preparers of financial statements; accountants and auditors; and business and public interest representatives and users.

RECOMMENDATION 13

4.70 The Committee recommends that the Government should confirm that it will provide the funding for the Financial Reporting Council, the Australian Accounting Standards Board and the Auditing & Assurance Standards Board on a permanent basis beyond 2004-05.

RECOMMENDATION 14

4.93 The Committee recommends that the Bill should be amended so that the Financial Reporting Council will not have a function of 'determining the Auditing & Assurance Standards Board's (AUASB's) broad strategic direction'. Instead, the Financial Reporting Council should produce and make public its critique of the AUASB's strategic direction as part of the Financial Reporting Council's oversight function.

RECOMMENDATION 15

4.94 The Committee recommends that the Bill should be amended so that the Financial Reporting Council will not have a function of 'approving' the Auditing & Assurance Standards Board's (AUASB's) priorities, business plans and budgets. Instead the Financial Reporting Council should produce and make public its critique of the AUASB's priorities, business plans and budgets.

RECOMMENDATION 16

4.95 The Committee recommends that the *Australian Securities and Investments Act 2001* should be amended so that the Financial Reporting Council will no longer have a function of 'determining the Australian Accounting Standards Board's (AASB's) broad strategic direction'. Instead, the Financial Reporting Council should produce and make public its critique of the AASB's strategic direction as part of the Financial Reporting Council's oversight function.

RECOMMENDATION 17

4.96 The Committee recommends that the *Australian Securities and Investments Act 2001* should be amended so that the Financial Reporting Council will no longer have a function of 'approving' the Australian Accounting Standards Board's (AASB's) priorities, business plans and budgets. Instead the Financial Reporting Council should produce and make public its critique of the AASB's priorities, business plans and budgets.

RECOMMENDATION 18

4.137 The Committee recommends that the professional accounting bodies should liaise with the Australian Securities and Investments Commission (ASIC) to ensure that their complaints-handling procedures meet benchmarks which ASIC considers are necessary for effective complaints handling.

RECOMMENDATION 19

4.140 The Committee recommends that the Bill should be amended to ensure that the new responsibilities for the Financial Reporting Council should not come into force until:

- the Financial Reporting Council has an adequately staffed and funded secretariat that is independent of the Department of the Treasury and other Government departments; and
- the Government confirms that the Financial Reporting Council will be government-funded beyond 2004-05.

RECOMMENDATION 20

5.39 The Committee recommends that an auditor attending the annual general meeting of an entity should be required to answer shareholders' reasonable questions about:

- critical accounting policies adopted by management and the basis upon which the financial statements were prepared; and

- the auditor's independence.

RECOMMENDATION 21

5.40 The Committee recommends that the chairman of an entity should allow shareholders a reasonable opportunity to ask the auditor reasonable questions about:

- critical accounting policies adopted by management and the basis upon which the financial statements were prepared; and
- the auditor's independence.

RECOMMENDATION 22

5.42 The Committee recommends that an auditor attending an annual general meeting should be permitted to table written answers to shareholders' questions which have been lodged in accordance with proposed section 250PA of the Bill if the auditor has prepared answers in this form.

RECOMMENDATION 23

6.52 The Committee recommends the deletion of the provision in the Bill (proposed section 324CK) prohibiting more than one former audit firm partner or audit company director from becoming an officer of a body audited by the audit firm or audit company.

RECOMMENDATION 24

6.109 The Committee recommends that purposive definitions for 'lead auditor' and 'review auditor' should be adopted to reflect the rationale underlying the rotation requirements. In particular, the Committee recommends that the definition of 'review auditor' should be amended to ensure that a rotation obligation will not apply to a review auditor in circumstances where:

- the review auditor performs a merely technical role in the audit; and
- the review auditor's contact with the audit client could not be regarded as material to the day-to-day conduct of the audit as a whole.

RECOMMENDATION 25

6.112 The Committee recommends that the Bill should be amended so that the rotation requirements only apply to the top 300 listed entities by market capitalisation. In arriving at this cut-off point, the Committee took into account the various suggestions made by witnesses and the statistics provided by The Institute of Chartered Accountants of Australia on the auditing market in Australia.

RECOMMENDATION 26

6.115 The Committee recommends that amendments should be made to the Bill accommodate short-term postponement of auditor rotation by the Australian Securities and Investments Commission if this is not already provided for elsewhere in the *Corporations Act 2001*.

RECOMMENDATION 27

8.15 The Committee recommends that the relevant provisions with respect to the registration of an authorised company auditor be amended to remove the Australian Securities and Investments Commission's power to impose restrictions and conditions retrospectively and to limit the exercise of its discretion in this regard by the prescription of appropriate criteria.

RECOMMENDATION 28

9.19 The Committee recommends that, in relation to the membership of the Companies Auditors and Liquidators Disciplinary Board, some of the members from the accounting profession should be appointed on an individual basis rather than as representatives of a professional association; auditors and/or liquidators should be included in the selections from the accounting profession; and consideration should be given to including users of financial reports appointed from the public, private and not-for-profit sectors.

RECOMMENDATION 29

10.39 The Committee recommends that the role of the Financial Reporting Panel should be restricted to making determinations on financial reports after their publication. The Committee does not support proposals for the Panel to have a 'pre-publication' jurisdiction.

RECOMMENDATION 30

10.41 The Committee recommends that lodging entities should be able to refer matters to the Financial Reporting Panel without having to obtain the consent of the Australian Securities and Investments Commission (ASIC). The notification and referral procedures presently in the Bill would have to be amended to accommodate a lodging entity referral and would include the requirement for a lodging entity to notify ASIC of a referral. In particular, the lodging entity should be subject to the same notification procedures (amended as appropriate) that presently apply when ASIC refers a matter to the Panel.

RECOMMENDATION 31

10.51 The Committee recommends that the Bill should clarify that the determinations of the Financial Reporting Panel should not have a wider application as precedents for the interpretation of financial reporting requirements.

RECOMMENDATION 32

10.76 The Committee recommends that an auditor should be entitled to attend the proceedings of the Financial Reporting Panel if the financial reports audited by that auditor are in dispute. The Committee recommends that the auditor should have rights to be notified of a referral, to have its response included with the Australian Securities and Investments Commission's referral and to make submissions to the Panel.

RECOMMENDATION 33

10.91 The Committee recommends that the Government should amend the Bill to require the Financial Reporting Panel to provide a copy of its determinations including reasons for these determinations to the Australian Accounting Standards Board.

RECOMMENDATION 34

11.51 The Committee recommends that the provisions in the Bill under which auditing standards will be disallowable instruments should not be proceeded with until a thorough review determines how legislative backing can be achieved without threatening international convergence and audit quality. Once these issues are resolved, the Committee would support the conferral of legislative backing on auditing standards.

CHAPTER 1

FINANCIAL REPORTING

Introduction

1.1 *Ford's Principles of Corporations Law* says of financial record keeping, financial reporting and external auditing requirements that they are 'fundamental measures of protection for both investors and creditors…[and] set a minimum standard of corporate financial management'.[1]

1.2 Financial record keeping, reporting and auditing requirements are set out in Chapter 2M of the *Corporations Act 2001* (Corporations Act).

1.3 The first requirement with which all companies, disclosing entities and registered managed investment schemes must comply is to keep proper financial records that enable true and fair financial statements to be prepared and audited.[2]

1.4 In addition, all public companies, disclosing entities, large proprietary companies and registered schemes must prepare a financial report and a directors' report each financial year which are audited by a registered company auditor.[3]

1.5 The financial reports, directors' report and auditor's report must be lodged with the Australian Securities and Investments Commission (ASIC) and sent to members.[4] Public companies must also produce these reports at the annual general meeting (AGM).

1.6 These mandatory financial reporting obligations are intended to provide investors, creditors and other stakeholders with accurate information about a company's business performance and financial position. The Corporations Act sets out to achieve this by:

- stipulating the content of the reports[5];

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1 Harold Ford AM, Robert Austin, Ian Ramsay, *Ford's Principles of Corporations Law*, 1999, Ninth Edition, Butterworths, Australia, 1999, p. 413.

2 Section 289 Corporations Act.

3 In addition to annual reporting requirements, disclosing entities must prepare and lodge with ASIC half-year financial reports audited by a registered company auditor and directors' reports.

4 Section 314 Corporations Act allows a disclosing entity to provide shareholders with a 'concise report' drawn up in accordance with accounting standards made for the purposes of the provision. The relevant accounting standard is AASB 1039 *Concise Financial Reports*.

5 Corporations Act: sections 295 (annual financial report) and 303 (half-year financial report).

- requiring adherence to accounting standards;[6] and
- requiring the inclusion of additional information in the notes to the accounts if adherence to accounting standards does not give a true and fair view.[7]

Proposed amendments to the financial reporting requirements

1.7 Perhaps because of the significant market events unfolding at the time of the final policy formulation for CLERP 9, the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (the Bill) contains proposals to improve the quality and reliability of financial reporting.

1.8 One proposal requires the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), or persons performing these roles, to certify to the directors of a listed company, disclosing entity or registered scheme that the financial statements comply with the Corporations Act and accounting standards and give a true and fair view.[8] This requirement is intended to enhance the accountability of senior management for the information contained in an entity's financial reports. The Explanatory Memorandum indicates that the proposal 'will promote the reliability of financial statements' and 'effectively formalise what is best practice'.[9]

1.9 A second proposal requires the directors' report to contain an Operating and Financial Review (OFR).[10] The review is intended to provide 'users of financial statements with an analysis of a company's business as seen through the eyes of the directors' and 'is increasingly being accepted in the world's capital markets as an integral part of good corporate governance and high-quality financial reporting'.[11]

1.10 Evidence to the Committee was generally supportive of these proposals although a number of modifications were considered necessary to ensure their effective practical implementation. Some witnesses were critical that amendments to the true and fair view requirement contained in the exposure draft of the Bill had been dropped. It was their view that the requirement would benefit from clarification and several proposals were made on how this would be best achieved.

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6 Corporations Act: sections 296 (annual financial report) and 304 (half-year financial report).

7 Corporations Act: sections 297 (annual financial report) and 305 (half-year financial report).

8 Proposed section 295A Corporations Act.

9 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 67.

10 Proposed section 299A Corporations Act.

11 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 144.

1.11 Professors Frank Clarke and Graeme Dean made more far-reaching proposals which they considered would make financial statements more serviceable to consumers of those statements. It was their contention that the surprise factor characterising major corporate collapses such as Enron, WorldCom and HIH Insurance Group (HIH) should be the primary focus of regulators because it pointed to fundamentally deficient reporting. It was their view that, if financial reporting were reliable and serviceable, a drift in a company's fortunes could be identified long before its descent into insolvency with accumulated billion dollar losses.[12]

1.12 In this chapter, the Committee will examine submissions received from witnesses regarding the CEO/CFO sign-off and OFR. The Committee will also discuss proposals for improved financial reporting not included in the Bill but raised during the inquiry. The following framework for discussion will be used:

- the CEO/CFO declaration;
- the directors' Operating and Financial Review;
- the auditor's report on alternative accounting treatments;
- the true and fair view requirement.

Declaration by CEO and CFO

Background

1.13 The *Sarbanes-Oxley Act 2002* (Sarbanes-Oxley Act) provides for the CEO and CFO to certify in relation to annual and quarterly reports that, based on their knowledge, the report is not misleading and fairly presents the financial condition of the company.

1.14 During its review of independent auditing, the Joint Committee of Public Accounts and Audit (JCPAA) observed that the strength of the relationship between management and boards and the flow of information between them was an essential factor in good corporate governance. Noting developments in United States law that placed greater accountability on company executives, the JCPAA concluded that:

> [i]t is simply not good enough for senior executives of large corporations to claim that they are unaware of the financial situation of the firm for which they are responsible.[13]

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12 *Submission* 59 (Professors Frank Clarke and Graeme Dean), p. [3]; copy of opening statement tabled on 11 March 2004 with attachment, 'Auditor Independence Reforms—Recycled Ideas', Graeme Dean, Frank Clarke and Peter Wolnizer, *Abacus*, March 2002, Vol 38, No 2, pp. i-vi.

13 JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, p. 40.

1.15 To ensure a clear flow of information from management to the board and in recognition that management as well as the board should be accountable for information released to the market, the JCPAA recommended that CEOs and CFOs should be required by the Corporations Act to:

- sign a statutory declaration that the company's financial reports comply with the Act and are 'materially truthful and complete'; and
- attach the declaration to the financial reports whenever they are lodged with ASIC and provided to the company's members and market operator under the Act.[14]

1.16 Drawing on developments in the United States and the JCPAA's recommendation,[15] the Bill proposes to require persons who perform a CEO function and a CFO function to certify to the directors of a listed entity that:

- the entity's financial records for the financial year have been properly maintained as required by section 286 of the Act;
- the financial statements and notes comply with accounting standards; and
- the financial statements and notes give a true and fair view.[16]

1.17 The declaration must be written, dated, specify the capacity in which the person is making the declaration and be signed by that person.

1.18 Under the Bill, the provision of the declaration will not derogate from directors' responsibilities to ensure that financial statements comply with the Act. The directors must state in their declaration in the financial report that they have been given the CEO's and CFO's declaration.[17]

Comments

1.19 This proposal was widely accepted although amendments were suggested to cater for practical contingencies, widen the scope of the matters covered by the certification and allow for the CEO's and CFO's reasonable reliance on information provided by others when making the certification.

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14 Recommendation 1, JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, p. 40.

15 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 141-2.

16 Proposed section 295A Corporations Act.

17 Proposed paragraph 295(4)(e) Corporations Act.

1.20 With regard to the practicalities raised in the evidence, probably the major concern was that the CEO/CFO certification should allow for qualifications. These included the need to:

- protect CEOs and CFOs who provide a certification in good faith against any implications arising from directors' subsequent changes to the financial report on which the certification was based;[18]
- cater for situations where a new CFO might disagree with a predecessor's accounts;[19]
- give directors the option of including material qualifications in the statement in which they are required to confirm that they have been given the CEO/CFO declaration;[20] and
- require the declaration for half-yearly as well as yearly accounts so that directors have the necessary assurance to meet their obligation to ensure that both sets of accounts present a true and fair view.[21]

1.21 As for comments on the scope of the matters to be covered by the CEO/CFO certification, there was some debate over whether the certification should cover the risk management matters specified in the ASX Corporate Governance Council's best practice recommendation 7.2 (R7.2).[22] This recommendation requires the CEO and CFO to state in writing to the board that:

- the statement given in accordance with best practice recommendation 4.1 (the integrity of financial statements) is founded on a sound system of risk management and internal compliance and control which implements the policies adopted by the board
- the company's risk management and internal compliance and control system is operating efficiently and effectively in all material respects.[23]

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18 ANZ Banking Group, *Submission* 14, p. 9.

19 Ms Julie Burke, Securities Institute, *Committee Hansard*, 6 April 2004, pp. CFS 21-2.

20 ANZ Banking Group, *Submission* 14, p. 9.

21 *Supplementary submission* 24B, p. 2.

22 This appears in the ASX's *Principles of Good Corporate Governance and Best Practice Recommendations*, prepared by the ASX Corporate Governance Council, 31 March 2003.

23 ASX Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations*, March 2004, p. 45. This requirement is not mandatory. However ASX Listing Rule 4.10 requires listed entities to identify in their annual report those recommendations not followed and to provide an explanation why.

1.22 Although some witnesses contended that the CEO and/or CFO sign-off was widely implemented according to R7.2,[24] the general view was that the scope of the sign-off in the Bill should remain unchanged. They proposed that compliance with R7.2 should be monitored and difficulties with its practical implementation identified and resolved before extending the scope of the provision.

1.23 Mr Michael Coleman, KPMG, was one who favoured a 'wait and see' approach. He said that a distinction needed to be drawn between 'the processes that are designed to arrive at the financial statements and the entire risk management structure'. In his view, R7.2 required a sign-off 'about all the risks within the entity' which he thought would be 'an extremely difficult thing for CEOs and CFOs to do'. He said the sign-off in the United States applied to 'the risk management systems related to the preparation of the financial statements' but cautioned that even in this more constrained environment, sign-offs had proved difficult. He thought it might be preferable for Australia not to follow the United States' example until it could be properly assessed in the future.[25]

1.24 Mr Harley McHutchison, Deloitte Touche Tohmatsu (Deloittes), and Mr Ralph Evans, Australian Institute of Company Directors (AICD), expressed similar reservations about extending the content of the CEO/CFO sign-off and also thought it would be prudent to see how the R7.2 requirement operated in practice.[26]

1.25 According to Ms Karen Hamilton, Australian Stock Exchange Ltd (ASX), the main problem with R7.2 concerned the parameters of the sign-off. She said the ASX Corporate Governance Council and the Group of 100 Inc had prepared additional guidance for companies on the requirement and thought this would 'alleviate the concerns'.[27]

1.26 The Group of 100 told the Committee that they had developed a set of guidelines to clarify ASX R7.2 and said its advice to membership would be that:

> …[CEOs and CFOs] should be signing off on the financial controls and/or if the board of the company expands that risk then they should take all necessary steps to ensure that the control processes are in place for risks beyond the set of financial statements.[28]

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24 See, for example, *Submission* 30, p. 6 from Deloitte Touche Tohmatsu.

25 *Committee Hansard*, 16 March 2004, pp. CFS 40-1.

26 Mr Harley McHutchison, *Committee Hansard*, 11 March 2004, p. CFS 22. Mr Ralph Evans, *Committee Hansard*, 18 March 2004, p. CFS 97.

27 Ms Karen Hamilton, ASX, *Committee Hansard*, 16 March 2004, p. CFS 90. The Group of 100 publication referred to is *Guide to Review of Operations and Financial Condition*, 2003.

28 Mr John V Stanhope, *Committee Hansard*, 18 March 2004, pp. CFS 105-6.

1.27 The Securities Institute of Australia disagreed with those witnesses who opposed the broadening of the sign-off requirements to meet R7.2 criteria. Mr Scott Marshall said in this regard that:

> Risk management, I would have thought, would be a standard requirement so the board has confidence that the procedures that have been put into place are being followed.[29]

1.28 The Law Council of Australia (LCA) was concerned that the extent of the CEO's and CFO's responsibility for the matters covered by the sign-off should be limited in accordance with the realities involved. The LCA proposed that the declaration should be expressed as the CEO's and/or CFO's opinion 'based on their knowledge after due enquiry' and referred to similar requirements under the Sarbanes-Oxley Act. In addition, the LCA argued that the CEO and CFO should be permitted to place reasonable reliance on others in recognition that the 'roles of CEO and CFO of listed companies do not permit, and should not require, those officers to have direct and detailed personal knowledge of each of the matters which are to be certified'.[30]

1.29 Section 189 of the Corporations Act was suggested as providing a useful template for a 'reasonable reliance' amendment.[31]

The Committee's view

1.30 The Committee agrees with the Securities Institute that the sign-off requirement is a positive development because it brings home to management and the board their accountability for the financial statements:

> …In clearly identifying who is accountable for the information contained within the financial reports, it may work to increase directors' focus on the quality and content of management's assessment of the company's financial performance, internal reporting process and compliance controls, as well as the auditor's evaluation.[32]

1.31 However, the Committee is satisfied that the requirement as proposed in the Bill is sufficient at this stage. The Committee does not agree that the sign-off should incorporate the ASX best practice recommendation 7.2 until there has been a reasonable opportunity to assess whether it would present difficulties in its practical application.

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29 *Committee Hansard*, 6 April 2004, p. CFS 21.

30 *Supplementary submission* 24B, p. 2.

31 The LCA expanded on their comments regarding the CEO/CFO sign-off at the hearing on 16 March, 2004, *Committee Hansard*, p. CFS 51.

32 *Submission* 11, p. 2 of attachment.

1.32 The Committee believes there is a need for the sign-off to cater for the qualifications raised by witnesses. These practical contingencies may be summarised as the need to:

- protect CEOs and CFOs who provide a certification in good faith against any implications arising from directors' subsequent changes to the financial report on which the certification was based; [33]
- cater for situations where a new CFO might disagree with a predecessor's accounts;[34]
- give directors the option of including material qualifications in the statement in which they are required to confirm that they have been given the CEO/CFO declaration;[35] and
- require the declaration for half-yearly as well as yearly accounts so that directors have the necessary assurance to meet their obligation to ensure that both sets of accounts present a true and fair view.[36]

1.33 The Committee also believes there is a need to provide for the signatories' reasonable reliance on information supplied to them.

Recommendation 1

1.34 The Committee recommends the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) sign-off requirement should be amended to accommodate practical contingencies and allow for the CEO's and CFO's reasonable reliance on information provided by others when making the certification.

Directors' report—Operating and Financial Review (OFR)

Background

1.35 Following its review of auditor independence in 2002, the JCPAA concluded that:

> [t]here was clear evidence…calling for improvements in financial reporting and disclosure requirements so as to provide a more comprehensive view of the state of affairs and value of the reporting company.[37]

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33 *Submission* 14 (ANZ Banking Group), p. 9.

34 Ms Julie Burke, Securities Institute, *Committee Hansard*, 6 April 2004, pp. CFS 21-2.

35 *Submission* 14 (ANZ Banking Group), p. 9.

36 *Supplementary submission* 24B (Law Council of Australia), p. 2.

1.36 The JCPAA recommended that entities should be required by the ASX Listing Rules to report on the following matters:

- internal controls including risk management systems;
- the main factors affecting reported financial performance and financial position;
- key judgements made in the application of accounting policies;
- results for a set of key performance indicators pointing to the health of the entity; and
- details of the directors' and executives' performance appraisal management or management systems.[38]

1.37 In addition, the JCPAA recommended the inclusion, also through ASX Listing Rule requirements, of a management discussion and analysis in the reporting regime.[39]

1.38 Recommendation 13 of the HIH Royal Commission (HIHRC)[40] proposed, among other things, amendments to the Corporations Act to require an OFR as part of an annual report. It was envisaged that the OFR would be audited. According to the HIH Royal Commissioner, an OFR:

> …would significantly assist in addressing the short-comings of audited accounts presented in accordance with the historical cost convention and other standards which can impede the ultility of the accounts as a transparent assessment of the financial progress of the company.[41]

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37 JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, p. 65.

38 JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, p. 91.

39 JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, pp. 89-90.

40 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 183. Apart from the proposal for the OFR, Recommendation 13 proposed that audit reports should disclose (1) 'the impact of the position taken by the reporting entity where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material' and (2) 'the significant matters arising in the audit process'.

41 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 182.

1.39 In proposed section 299A of the Bill the annual directors' report for a public listed company must contain information 'that members of the company would reasonably require to make an informed assessment of' the company's:

- operations;
- financial position; and
- business strategies and future prospects.[42]

1.40 Content requirements have been broadly framed, according to the Explanatory Memorandum, to allow for flexibility and to give directors scope to tailor the OFR according to their assessment of the information needs of company members. The Explanatory Memorandum endorses the Group of 100 best practice guidance material[43] and suggests the following as potential issues for discussion in an OFR:

- corporate overview and strategy;
- review of operations;
- investments for future performance; and
- review of financial condition.[44]

1.41 Importantly, the Bill allows information about the company's business strategies and future prospects to be omitted if it 'is likely to result in unreasonable prejudice' to the company and such omission is disclosed.[45]

1.42 This exception should allay the concerns raised by the Australian Chamber of Commerce and Industry (ACCI) about the disclosure of information 'which would properly be considered commercial-in-confidence—for example, new investments, or product or market diversification strategies'.[46] Furthermore, the Group of 100 best practice guide for OFR reporting says in relation to 'prejudicial information and confidentiality' that:

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42 Provision is made for the operating and financial review requirement to apply to consolidated financial statements.

43 *Guide to Review of Operations and Financial Condition*, 2003.

44 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 144-5. The Explanatory Memorandum notes that the ASX Listing Rules and accounting standard AASB 1039 *Concise Financial Reports*, have similar requirements.

45 Proposed subsection 299A(3) Corporations Act. The Explanatory Memorandum indicates that this provision is based on existing subsection 299(3).

46 *Submission* 60, p. 10.

> Overseas experience indicates that a company can provide a comprehensive and informative Review without needing to disclose financial forecasts or make other disclosures of a commercially prejudicial or sensitive nature. There is no reason to believe that Australian experience will differ from that overseas.[47]

1.43 In a departure from the HIHRC's recommendation, the OFR will not be audited because its contents are considered not to 'readily lend themselves to audit'.[48]

Comments

1.44 The proposed OFR received widespread in-principle support. However, a great deal of this support was qualified regarding the content requirements of the provision. Some witnesses thought the OFR largely duplicated existing reporting requirements under subsection 299(1) of the Corporations Act and claimed this would be a source of confusion. For other witnesses, the source of confusion was ASX Listing Rule 4.10.17 which required disclosure in terms of section 299 and the Group of 100 best practice guidance material.[49]

1.45 Probably one of the most important issues raised about the content requirements of proposed section 299A was whether they were specific enough.

1.46 Professor Ian Ramsay welcomed the OFR as potentially 'one of the really important developments in the CLERP 9 Bill'. However, he thought there were difficulties involved in arriving at a level of prescription that would produce useful and informative—as opposed to boilerplate—disclosure. On this point, he commented that:

> I have an open mind as to how one should tackle this; in other words, whether you should leave it open ended at the moment—to use the jargon, 'principles based'—and allow companies full capacity to reflect and come up with good quality disclosure, or whether you give them some hints and guidance as to the sorts of things we might typically expect. There may be merit in giving companies a bit more guidance, but at the same time we would not want people to think that if they have done the five things, that is it, because a good quality MD&A must be different for every company, because each company faces different challenges and must be different each year as the challenges unfold. I feel that this is an opportunity to really progress quality disclosure, and there must be a bit of concern that there might be some boilerplate hawked around by some of the accounting firms

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47 *Guide to Review of Operations and Financial Condition*, 2003, p. 8.

48 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 144.

49 See *Submission* 14 (ANZ Bank), p. 10, *Submission* 35 (Australian Institute of Company Directors), p. 15 and *Submission* 41 (Telstra Corporation Limited), p. [3] of attachment.

> to satisfy this—although I think the tenor of things has changed significantly in recent years. Some additional guidance might be appropriate, but you must fully understand that this additional guidance does not cover all the bases and could not ever be expected to.[50]

1.47 According to the ASX, the Bill would benefit from a more prescriptive approach. Ms Karen Hamilton referred to the similarities between the requirements proposed for the OFR and existing requirements under subsection 299(1) of the Corporations Act. She described disclosures made under subsection 299(1) as a 'relatively useless form of reporting in terms of being a valuable tool to shareholders' and was not convinced that the proposed requirements would lead to improved reporting.[51]

1.48 In its submission, the ASX suggested that, to remedy these problems, the proposed section should include a 'list of required minimum disclosure topics'. Although the ASX was 'hopeful that the promised International Financial Reporting Standard (IFRS) on "management discussion and analysis" [might] provide the framework needed to produce this particularly useful information', it noted that its adoption in Australia was likely to be some years away.[52]

1.49 Perhaps anticipating the possibility of boilerplate disclosures, the Securities Institute argued that:

> [t]he 'crucial issue is not the mere provision of an MD&A in the directors' report—it is the quality and reliability of the information that is provided in the MD&A. [53]

1.50 It was the Institute's view that, if these benchmarks were met, the OFR would add value to reporting by substantially improving transparency and meeting the information needs of various report users. The Institute proposed that the Bill or practice notes issued by ASIC or the Financial Reporting Council (as appropriate) should require adherence to the Group of 100 best practice guidelines as a means of ensuring 'quality and reliability' of information in OFRs.[54]

1.51 The Group of 100 discussed its guidelines at a Committee hearing and pointed out that they were not intended to be prescriptive and were based on the operating and financial review guidelines issued in the United Kingdom by the Accounting Standards Board. Mr Geoff Harris said the G100 guidelines covered the following matters for comment or explanation by a company:

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50 *Committee Hansard*, 18 March 2004, p. CFS 14.

51 *Committee Hansard*, 16 March 2004, p. CFS 92.

52 *Submission* 48, p. 5.

53 *Submission* 11, p. 3.

54 *Submission* 11, p. 3.

> ...company overview and strategy, its objectives, performance indicators, dynamics of the business, review of operations, operating results for the period, shareholder returns, investments for future performance—so that is not just capital expenditure but promotional expenditure—review of financial condition, capital structure and treasury policy, cash from operations and other sources of cash, liquidity and funding, resources of the company, impact of legislation and other external requirements, and risk management. [55]

1.52 The Group of 100 referred to an inconsistency between OFR requirements and those governing concise financial reports. By operation of section 314 of the Corporations Act and AASB 1039 *Concise Financial Reports*, a discussion and analysis must be included in concise reports and the auditor must report on this. In contrast to this, the proposed OFR is to form part of the directors' report and so will not be subject to audit.

1.53 To remedy this inconsistency, the Group of 100 proposed amendments to subsection 314(2) of the Corporations Act and AASB 1039 to replace the discussion and analysis in the concise report with the requirement for an OFR. This, they proposed, 'would avoid unnecessary duplication of requirements and the need for discussion and analysis to be audited'.[56]

1.54 Two submissions made specific proposals to widen the content of OFR disclosures.

1.55 The Australian Conservation Foundation (ACF) argued that provision should be made for annual sustainability reporting in accordance with the Global Reporting Initiative. It argued that the environmental reporting requirements in paragraph 299(1)(f) of the Corporations Act produced disclosures which left 'much to be desired'. To illustrate this point, the ACF cited the following excerpt from Woolworths' 2002 Annual Report as typical:

> Except as set out below, the operations of the Group are not subject to any particular and significant environmental regulation under a law of the Commonwealth of Australia or of any of its States or Territories.
>
> The 'Woolworths Plus Petrol' operations are subject to regulations and standards governing the construction and operation of the facilities relating to the storage and dispensing of petroleum products.
>
> The Group may also from time to time be subject to various State and Local Government food licensing requirements and environmental and town planning regulations .incidental to the development of shopping centre sites.

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55 *Committee Hansard*, 18 March 2004, p. CFS 107.

56 *Submission* 46, p. [1].

> As outlined on pages 21 and 22, the Supermarket Division has implemented a number of environmental initiatives.
>
> The Group has not incurred any significant liabilities under any environmental legislation.[57]

1.56 The Association of Chartered Certified Accountants (ACCA) thought OFR content should be widened to require commentary on issues of corporate social responsibility (CSR). This, it said, was in line with the 'UK approach' and recognised the 'global trend towards encouraging greater CSR' and the increasing reliance of institutional investors on CSR as an indicator of corporate value.[58]

1.57 Apart from concerns about the content of the OFR, there was some debate about its placement in the financial statements and whether it should be audited. Mr Harley McHutchison, Deloittes, did not think it was appropriate to require the OFR to be audited although he commented that 'auditors commonly read that stuff to make sure it is not inconsistent with the financial report…[and] if it is, the auditor has an obligation to do something about it'.[59]

1.58 For Telstra Corporation Limited, placement of the OFR in the directors' report was not necessarily desirable given that the directors' report 'already contain[ed] a range of other disclosures'.[60]

1.59 The National Institute of Accountants (NIA) shared the concerns expressed in many submissions that mandating disclosures in an OFR would not necessarily result in quality reporting. However, the NIA departed from the majority view in arguing for voluntary reporting on the grounds that companies taking up the option to disclose would be more likely to produce quality reports. The NIA considered that better and more useful disclosure could be achieved by encouraging companies to post on their web sites or a central repository site 'regularly benchmarked Key Performance Indicators' which could include information about a company's:

- performance over the last 12 quarters;
- market share; and
- key goals for the next three years and its performance over the past three years towards achieving those goals.[61]

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57 *Submission* 55, pp. 2-3.

58 *Submission* 42, p. [4].

59 *Committee Hansard*, 11 March 2004, p. CFS 30.

60 *Submission* 41, p. [3] of attachment.

61 *Submission* 25, p. 35.

1.60 A similar proposal had been made by the JCPAA as one of several measures to provide more comprehensive and meaningful reporting to stakeholders.[62]

The Committee's view

1.61 The Committee notes the comments of the HIH Royal Commissioner that an OFR:

> …would significantly assist in addressing the short-comings of audited accounts presented in accordance with the historical cost convention and other standards which can impede the utility of the accounts as a transparent assessment of the financial progress of the company.[63]

1.62 The Committee agrees that, if boilerplate disclosures do not become the norm, the requirements proposed in the Bill for an OFR are worthwhile. This is something that should be monitored.

1.63 The Committee considers that a prescriptive approach could be counter-productive and result in 'tick-the-box' compliance. On the other hand, the Bill's principles-based approach allows for greater flexibility and would seem to encourage a more thorough consideration of the matters to be reported. This is the model preferred by the Committee.

1.64 The Committee notes the apparent anomaly identified by the Group of 100 and agrees that this should be corrected.

Recommendation 2

1.65 The Committee draws the Government's attention to the apparent inconsistency between the proposed Operating and Financial Review requirements, concise reports and AASB 1039 and recommends that the necessary amendments be made to avoid a duplication of requirements.

1.66 With regard to the submissions advocating broader environmental reporting and commentary on issues of corporate social responsibility, the Committee believes that the OFR provides scope for such reporting. Furthermore, the Committee does not depart from its previous position on this issue that market forces should be the determinants of the extent to which a company provides information in these areas.

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62 JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, pp. 87-91. Recommendation 8 of the JCPAA report proposed that the ASX Listing Rules require additional reporting by companies in several areas including internal controls and risk management; MD&A; main factors affecting financial performance and position; key judgements made in the application of accounting policies and information about directors' and executives' performance appraisal or management systems.

63 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 182.

Disclosure of alternative accounting treatments

Background

1.67 As discussed earlier, the Corporations Act endorses the importance of effective disclosure and, among other things, requires financial reports to comply with accounting standards.[64] Furthermore, directors must make a declaration that financial reports comply with accounting standards[65] and the company's external auditor must state in the auditor's report whether the auditor is of the opinion that the financial report complies with accounting standards.[66]

1.68 What is it that accounting standards do or are intended to do that mandates compliance with them in financial reporting? The following excerpt from the CLERP 1 discussion paper on accounting standards provides a useful explanation:

> The basic purpose of accounting standards is to facilitate the provision of financial information about entities to enable investors, analysts, creditors and the entities themselves to make informed decisions about the allocation of resources. Accounting standards are essentially about disclosure and, in many respects, are at the heart of market efficiency.
>
> Clearly, while accounting standards assist preparers of financial statements by providing a framework within which to construct the statements, their prime importance is to assist users of the statements to make meaningful assessments about the financial position of an entity. Users of financial statements range from directors to investors, through to credit rating agencies.[67]

1.69 Whether or not accounting standards used in Australian financial reporting actually do promote 'meaningful assessments' about an entity's financial position is a matter of considerable ongoing debate.

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64 Subsection 296(1) applies to the annual financial report and section 304 applies to the half-year financial report. In addition, the financial statements and notes must give a true and fair view of the entity's (or consolidated entity's) financial performance. If compliance with accounting standards would not give a true and fair view, the legislation provides that additional information must be included in the notes (sections 296-7).

65 Subsections 295(4) (annual financial report) and 303(4) (half-year financial report). (The directors' report must also state that the financial reports comply with the true and fair view requirements and whether, in their opinion, there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable.)

66 Section 308 (annual financial report) and 309 (half-year financial report). (The auditor's report must also state whether the auditor is of the opinion that the financial report complies with the true and fair view requirement.)

67 *Accounting Standards, Building international opportunities for Australian business,* Corporate Law Economic Reform Program, Proposals for Reform, Paper No. 1, Department of the Treasury, Canberra, September 1997, p. 13.

1.70 HIH, for example, released financial statements in June 2000 which gave no indication that in March the following year, the company would collapse with estimated losses exceeding $5.3 billion.

1.71 The HIH Royal Commissioner, noting that alternative treatments available under an accounting standard could significantly alter a company's financial results, referred to a particular instance with HIH as follows:

> …additional pre-acquisition claims deterioration that had been identified as a result of management or actuarial reviews resulted in a substantial increase in the amount of goodwill brought to account in respect of the acquisition of FAI at 30 June 2000. This treatment was said to be in accordance with mandatory accounting standards. Evidence before the Commission suggested that on an alternative and appropriate view of the same accounting standards the deterioration should have been recognised as an expense for the year ended 30 June 2000, which would have resulted in HIH reporting substantial losses.[68]

1.72 Given the opportunities available for the manipulation of results, the HIHRC considered there was a need to promote 'a better understanding of an entity's financial position' and proposed in Recommendation 13 that audit reports should disclose the following:

- the impact of the position taken by the reporting entity where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material; and
- the significant matters arising in the audit process.[69]

1.73 A similar recommendation made by the JCPAA in the previous year was for the ASX's Listing Rules to require companies to provide 'commentary on key judgements made in the application of accounting policies'.[70]

Comments

1.74 As the Bill does not contain a provision adopting this recommendation, the Committee was interested to hear from witnesses whether they considered the proposal worthy of implementation.

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68 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 182.

69 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 182.

70 Recommendation 8, JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, p. 91.

1.75 According to Mr Geoff Dunsford, it was 'hard to disagree'[71] with the recommendation.

1.76 Professor Robert Walker, appearing on behalf of the Australian Council of Super Investors Inc (ACSI), took this opportunity to illustrate how accounting standards could be used to achieve a particular outcome. Remarking that it was 'possible within the repertoire of accounting standards to pick particular methods which maximize reported profits', he illustrated his point thus:

> People are expressing dismay about the sudden reversal in the fortunes of some of our leading wine producers, but you need to look carefully at their accounts over a period. Southcorp generated 49 per cent of its reported profits by revaluing grapevines, which are not saleable assets. The difficulty with that is that, having revalued them upwards under accounting standards, you then have to write them down over a period. This is perfectly acceptable in terms of Australian accounting standards, but I think it is a joke, because one cannot sell a grapevine.[72]

1.77 Although commenting that 'full disclosure of the financial impact of adopting some [distinctly unsound] accounting standards would be more informative to readers', Professor Walker had some reservations that requiring auditors to discuss material impacts of differences between accounting practices adopted by management and those preferred by the auditor, would result in 'great disclosures…because experience suggests that auditors and finance directors negotiate outcomes'. He added that:

> In practice, many auditing firms actually do write up the books at the end of the year. It is often not a case of the directors making the choice of accounting methods; it is often a case of auditors actually being engaged in part to do the adjusting entries and finalise the accounts. Often, as we say in the submission, that is okay, if it is a small private company; but it is something that you would not, I think, expect of the major listed companies.[73]

1.78 Professor Ian Ramsay was concerned about the omission of Recommendation 13 from the Bill and commented that:

> On 26 July 2002 I gave evidence before the Joint Committee of Public Accounts and Audit in relation to its inquiry on the independence of auditors. I said:
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> The increased focus in the United States on disclosure of what might be termed 'critical accounting policies' in the reports of companies is a

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71 *Committee Hansard*, 16 March 2001, p. CFS 45.

72 *Committee Hansard*, 16 March 2004, p. CFS 77.

73 *Committee Hansard*, 16 March 2004, p. CFS 78.

> welcome development … As noted by the … Securities and Exchange Commission:
>
> ... critical accounting policies are those that are both most important to the portrayal of a company's financial condition and results, and require management's most difficult, subjective or complex judgements, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.
>
> In brief (as I said before the committee in July 2002) there is a need to improve accounting disclosure.
>
> I suggest that a focus upon critical accounting policies—where good faith differences of opinion may have a significant impact, if you like, on the financial results of the company and how they are reported—should be considered.[74]

1.79 Upon questioning by the Committee, Professor Ramsay confirmed his agreement with the HIH Royal Commissioner's recommendation and said provision for this would provide 'meaningful information to shareholders of a company'. He noted the 'focus on this issue' in other countries, particularly in the United States, and said this was one matter that required further consideration. He supported the proposal that auditors should report on alternative treatments specifically to shareholders and the audit committee. Although he was not sure of the best location for this information, he proposed that it should be where it would be 'most meaningful for shareholders'.[75]

1.80 Of the remaining witnesses who commented on HIHRC Recommendation 13, the response was generally negative. The most commonly expressed view was that to include information about alternative accounting treatments in the auditor's report would confuse shareholders.

1.81 Mr Harley McHutchison, Deloittes, was one who thought the additional information would confuse shareholders. He was also of the view that such a requirement would be likely to undermine confidence in financial reporting and merely add to the complexity of auditor's reports at a time when they were already being criticised for their lack of clarity. In his view:

> …if there is an alternative accounting treatment, the place to deal with it is at the audit committee and potentially at the board level. If the treatment is not acceptable, the auditor's response, if he cannot talk the client out of it, is to qualify his or her report.[76]

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74 *Committee Hansard*, 18 March 2004, pp. CFS 4-5.

75 *Committee Hansard*, 18 March 2004, p. CFS 5.

76 *Committee Hansard*, 11 March 2004, p. CFS 25.

1.82 Mr Stuart Wilson, Australian Shareholders' Association (ASA), was equivocal and commented:

> …I guess the question is: how far do we go? Do we put in the minutes of the audit committee report? Do we put in the minutes of the board considerations? I would be cautious of backing a line along those lines.[77]

1.83 While Mr Stephen Harrison, The Institute of Chartered Accountants in Australia (ICAA), was another critic, he considered there was a need to deal with the issues involved but thought these would best be handled by the audit committee.[78]

1.84 Mr Keith Reilly, also from the ICAA, referred to pending accounting standard, AASB101 which he said required disclosure where a particular accounting treatment gives rise to 'particular estimation issues or judgements'. He suggested that the application of this standard would be a means of bringing these issues to the company's and then the audit committee's attention.[79]

1.85 Mr Keith Alfredson did not see it as the auditor's role to disclose the impact of one as against another accounting standard. He referred to a new IASB standard, IAS 1, under which the preparers of accounts would be required to disclose 'key decisions that are fundamental to the accounts'. In his view, this was an important development that would 'put the heat on some boards'. He commented further that:

> [IAS 1] has been deliberately written in terms of the principle in direct response to Enron and all the other ones in the US, to flush out key decisions that boards make in the interpretation of standards if they have had a significant impact on the report of financial position and results of operations. I believe that sort of approach is much better than the one you mentioned. And this amendment to the accounting standard postdates Justice Owen's report. I believe it does, anyway.[80]

1.86 The Committee was interested to hear auditors' views on how they might be best protected from client pressure to change an accounting treatment. The proposition was put to BDO Chartered Accountants and Advisers (BDO) that this might be achieved by requiring the auditor to indicate in the audit report that a change of treatment had been sought, the auditor's preferred treatment and the material effect of that treatment compared with the one chosen by the client.

1.87 BDO made the following comments in respect of this proposal:

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77 Mr Stuart Wilson (ASA), *Committee Hansard*, 9 March 2004, p. CFS 22.

78 *Committee Hansard*, 11 March 2004, p. CFS 37.

79 *Committee Hansard*, 11 March 2004, p. CFS 37.

80 *Committee Hansard*, 14 April 2004, pp. CFS 58-9.

- Information about preferred treatments would have to be accompanied by a representation by the board to ensure the bona fides of their selected approach.
- It would be more appropriate to include the information in the company accounts—given that it is an alternative and not a qualifiable position. This would also place responsibility on the board for the position taken.[81]

The Committee's views

1.88 The Committee agrees with the HIH Royal Commissioner that a discussion of alternative accounting treatments in an auditor's report (or wherever it is considered to be more appropriately placed), should help users of financial statements to derive a fuller picture of an entity's financial position.

1.89 The Committee is mindful that new accounting standards should go some way towards providing users of financial statements with information about accounting treatments adopted. Nonetheless, because the use of one accounting treatment over another can have a material impact on a company's reported profits or losses, the Committee agrees with the views of the HIH Royal Commissioner, Professor Ian Ramsay and the JCPAA that users should be informed of the effect of the selected treatment over another.

Recommendation 3

1.90 The Committee recommends that where alternative accounting treatments are possible in an accounting standard, and where the alternative/s not selected could have resulted in the company recording a loss for the financial year, or substantial losses rather than gains, or have materially affected its solvency, then the reason for the choice of the more favourable alternative over the less favourable alternative must be disclosed by the external auditor.

True and fair view requirements

Background

1.91 Corporate financial reporting during the years leading up to the 1987 share market crash, was beset by a proliferation of misleading accounting practices which ensured shareholders were often ignorant of a company's financial position.[82]

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81 Messrs Jeff Knott and Geoff Brayshaw, *Committee Hansard*, 14 April 2004, pp. CFS 81-2.

82 See, for example, chapter 4.7 of the House of Representatives Standing committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders*, November 1991.

1.92 Some indication of the extent of this defalcation can be gleaned from the following commentary:

> An article written for the journal of CPA Australia in 1992 by Warren McGregor, the then executive director of the Australian Accounting Research Foundation, pointed to the fact the Australian Accounting Standards Board had received 114 notifications from company auditors about breaches of approved accounting standards.
>
> McGregor listed 16 different accounting standards that auditors had said were not complied with by companies. These included the accounting standards on depreciation of non-current assets, tax effect accounting, accounting for the revaluation of non-current assets, the standard on profit and loss reporting (now referred to as the statement of financial performance), and accounting for goodwill.[83]

1.93 At that time, annual financial reports had to comply with accounting standards but with a true and fair override.

1.94 The true and fair override was widely regarded as providing a means for companies to avoid complying with accounting standards.[84] Its use in the 1980s and early 1990s has been characterised by one financial commentator as:

> …the 'beauty case' approach to accounting where the most aesthetically pleasing accounting treatment is applied to the financial data.[85]

1.95 Certainly this accords with the view expressed by the then Attorney-General, the Hon. Michael Duffy MP, when introducing the *Corporations Legislation Amendment Act 1991* which sought to put an end to reporting abuses. In particular, he commented:

> Currently, the law provides that the directors need not ensure that financial statements are made out in accordance with an accounting standard if to do so would fail to give a true and fair view. This has provided the scope for some companies to use some dubious accounting treatments in reliance on the more general, and vaguer, true and fair test, rather than to comply with a relevant appropriate accounting standard.[86]

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83 Tom Ravlic, 'You've got to be joking', *CFO*, Fairfax 2001, May 2002. A copy of this article can be obtained at http://www.cfoweb.com.au/stories/20020501/14193.asp.

84 See, for example, J Hoggett, *The Continued Politicisation of Accounting Standards in Australia*, paper presented at BEA Conference, Perth, December 1998, p. 5. This article is available at http://www.pa.ash.org.au/afssse/members/bea/conference/papers/hoggett.htm.

85 Tom Ravlic, 'You've got to be joking', CFO, Fairfax 2001, May 2002. A copy of this article can be obtained at http://www.cfoweb.com.au/stories/20020501/14193.asp.

86 *House Hansard*, 29 May 1991, p. 4213.

1.96 Amendments consequently mandated compliance with accounting standards and, if this did not give a true and fair view, additional information had to be provided. This new requirement was considered by both the government and the opposition as a positive step towards better disclosure to investors and other stakeholders.[87]

1.97 As requirements now stand under the Corporations Act, financial statements and notes for a financial year must comply with accounting standards and give 'a true and fair view of the financial position and performance of the company'.[88] The Act makes it clear that the true and fair view requirement 'does not affect the obligation…for a financial report to comply with accounting standards'. It also provides that, if the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements'.[89]

1.98 While perhaps clearly stated, it appears there is no consensus about the way these requirements should be implemented.

1.99 In its review of independent company auditing, the JCPAA found widely divergent views on the application of these requirements.[90] Some contended that compliance with accounting standards was the paramount consideration with the true and fair view requirement of only secondary importance. Others interpreted the true and fair view requirement as an override to correct any shortcomings created by the accounting standards. Others still, saw both requirements of equal importance.[91]

1.100 Although the JCPAA heard evidence that application of the accounting standards would ordinarily produce financial statements presenting a true and fair view, it was concerned that this result would not be universal and commented that:

> …the subjectivity and exercise of judgement, necessarily involved in the interpretation of accounting standards, and…the deficiencies in those standards…means that compliance with accounting standards cannot

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87 See, for example, the comments of The Hon. Peter Costello MP, *House Hansard,* 5 June 1991, p. 4774.

88 Sections 296 (compliance with accounting standards) and 297 (compliance with true and fair view requirements) Corporations Act.

89 Corporations Act: sections 296 (accounting standards for annual reports), 297 (true and fair view for annual reports); 304 (accounting standards for half-year reports) and 305 (true and fair view for half-year reports).

90 *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, pp. 78-84.

91 Discussion of these views is on pp. 78-80 of the JCPAA Report.

guarantee that overall, financial statements will reflect a true and fair position in all cases.[92]

1.101 To counter such an outcome, the JCPAA recommended amendments to the Corporations Act:

- To require directors, when 'undertaking the assessment of a true and fair view…[to] consider the objectives contained in section 224(a) of the ASIC Act and…include a statement in the financial report that they have done so';[93] and

- To delete the footnotes in sections 297 and 305 of the Act and replace with:

  In the case of conflict between sections 296 (compliance with accounting standards) and 297 (true and fair view), the notes to the financial statements must indicate why, in the opinion of the directors, compliance with the accounting standards would not give a true and fair view of the financial performance and position of the company.

  The notes to the financial statements must include a reconciliation to provide additional information necessary to give a true and fair view.[94]

- To require the auditor to form an opinion and report on any additional disclosure made under section 297.[95]

1.102 The HIH Royal Commissioner considered that the JCPAA's recommendation would 'clarify the effect of the Act and [was] worthwhile'.

1.103 The Royal Commissioner noted, as a 'fundamental issue' in the HIH inquiry, 'the interpretation and application of several accounting standards'. He concluded that 'misinterpretation' of the standards and the true and fair view requirement had 'allowed HIH to publish financial statements that did not truly or fairly represent the financial position or performance of the HIH group'.[96] With regard specifically to the application of the true and fair view requirement, the Royal Commissioner concluded that:

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92 *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, p. 81.

93 *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, Recommendation 8, p. 83.

94 *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, Recommendation 6, p. 84.

95 *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, Recommendation 7, p. 84.

96 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 138.

> It may be that because the accounting standards have the force of law those who are responsible for the preparation of accounts have, over time, effectively forgotten about the 'true and fair view' requirement. This may seem strange in view of the fact that both the directors' declaration and the audit opinion contain clear reference to the words. If, as I suspect, preparers of accounts have forgotten the significance of [the] true and fair view, they ought to be reminded.[97]

1.104 The Committee notes that the exposure draft of the Bill endorsed the recommendations of the JCPAA and proposed amendments to provide that:

> …where compliance with accounting standards would result in the financial statements and notes together not giving a true and fair view, the directors' report should set out:
>
> - the directors' reasons why compliance with accounting standards would not result in the financial statements giving a true and fair view; and
>
> - the additional information and explanations needed to give a true and fair view.[98]

1.105 In addition, the proposed amendment required the auditor to form an opinion and report on whether the additional information provided by the directors was needed to give a true and fair view.[99]

1.106 The proposed amendments were dropped from the actual Bill but no reasons were supplied for this.

Comments on exposure draft amendments to the true and fair view requirement

1.107 Ernst & Young argued that the principles-based, substance-over-form approach of Australian accounting standards meant that 'the true and fair objective should always be achieved'. Ernst & Young saw 'very real problems' with 'elevating a particular note to the directors' report (which is outside the financial report) and then requiring that the information be specifically addressed in the auditor's report'. They proposed that including the directors' reasons with the additional information in the notes to the financial statements would help to remedy this.[100]

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97 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 139.

98 CLERP (Audit Reform & Corporate Disclosure) Bill, Commentary on the Draft Provisions, Corporate Law Economic Reform Program No. 9, Canberra, October 2003, p. 74. (See also pp. 117-118 of exposure draft Bill, 30/9/2003.)

99 CLERP (Audit Reform & Corporate Disclosure) Bill, Commentary on the Draft Provisions, Corporate Law Economic Reform Program No. 9, Canberra, October 2003, p. 75. (See also pp. 117-118 of exposure draft Bill, 30/9/2003.)

100 *Submission* 34, attachment.

1.108 The ICAA and CPA Australia (CPAA) similarly saw problems with the placement of the directors' reasons and additional information in the directors' report and the requirement for auditors to include comment on this in their report. In this regard, they said:

> The financial reports, in the notes to the statements, should be explicit as to reason for inclusion and the directors should provide a sufficiently detailed explanation as to why that information is necessary. Making additional comment in the directors' statement may confuse or complicate the issues being addressed, or at best simply be duplication.
>
> …
>
> We do not believe it is appropriate for auditors to specifically address additional information that the directors' determine to include in the notes, in isolation from the balance of the financial report. That may unduly emphasise one aspect of the report.[101]

Comments—general

1.109 In their joint submission, Professors Frank Clarke and Graeme Dean proposed that the Bill should clarify the primacy of the true and fair view requirements and articulate as part of this the 'dominant principle…that [financial] data [should be] serviceable for the purposes for which they are ordinarily used'.102 In their view, the directors and the auditor should be required to explain why the financials showed a true and fair view or did not. They characterised the exposure draft amendment as a 'halfway-house' towards providing more serviceable financial statements, and queried why it had been dropped from the Bill.

1.110 In answer to the proposition that the absence of a legislative requirement mandating compliance with accounting standards had led to 'the disaster of the 1980s', Professor Clarke said:

> I think the criticism generally runs along the lines that a large number of people were not complying with the prescribed accounting standards as they were at the time. Consequently, it was very difficult to regulate. In fact that, in a sense, is the proof in the pudding. Not everyone who did not comply with the accounting standards and chose alternative interpretations or methods…was out to gip the system. Not all of them were out to mislead…We have to accept that some of them were sincerely of the view that complying with the accounting standards did not show a true and fair view. Indeed, we would argue at the moment that that is really the situation. By and large, complying with the accounting standards will not show

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101 *Submission*s 31 and 36, p. 94 of attachment.

102 *Committee Hansard*, 11 March 2004, pp. CFS 51-9. (For the quoted material, refer to p. CFS 52, Professor Frank Clarke.)

> financial performance of financial position in any sensible, serviceable sort of fashion without any intention to mislead or deceive and with the best of intentions.[103]

1.111 The primary focus of regulators, Professors Clarke and Dean argued, should be on developing a fundamental quality criterion of serviceability with which financial statements should be required to comply. In this regard, they stated:

> Our analysis shows that the *surprise* element is the major problem with corporate failures and their fallout. No good financial criterion supports the continuation of companies using resources ineffectively. Were financial disclosure truly indicative of a company's *financial performance* and *financial position*, the financial consequences of company directors' and managers' behaviour would be a matter of the public record promptly. Accounting manipulations have not *caused* corporate collapses, but they have *masked* their financial difficulties from regulators and the market, allowed failing companies to operate long after remedial and turnaround action was feasible, and in consequence exacerbated losses.[104]

1.112 They contended that the objectives of the Bill to promote transparency, accountability and shareholder activism could not be achieved until the statements of financial performance and financial position—'the primary means of communicating…the outcomes of a company's activities'—were fit for the purposes for which they were created. To meet this requirement, financials had to give shareholders and other users enough data to enable them to assess:

- 'the measure of a company's wealth or how it has changed over time';
- 'the rate of increase in its wealth from its performance';
- 'its solvency';
- 'the relationship of the amount of its debt to the amount of its net wealth'; and
- 'how it has complied with its debt covenants'.

Unless these requirements were met, they claimed, financials were not serviceable and could not be regarded as 'true and fair'.[105]

1.113 They referred to the 'principles-versus-rules' debate regarding the relative merits of different sets of accounting standards and commented that '[w]e are yet to see any explanation of to what *principles* the AASB, IFRS or FASB conform'. In their

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103 *Committee Hansard*, 11 March 2004, pp. CFS 54.

104 *Submission* 59, p. [3].

105 *Submission* 59, p. [4].

opinion, the 'rules' effectively had become the 'principles' and compliance with current AASB or FASB accounting standards or with IFRSs would not produce serviceable data 'indicative of the wealth and progress of companies'.

1.114 They proposed that:

> …if you are going to have a true and fair view criterion sitting on top of whatever standards we adopt, we should be doing our best in either legislation or through the profession to ensure that we have a systematic approach to deriving and arriving at a market value system. It is only under that sort of system that, for example, the concept of solvency makes any sense.[106]

1.115 Mr Geoff Dunsford expressed similar views to those espoused by Professors Clarke and Dean. His main contention was that a company's statements of financial performance and financial position did not provide the information that shareholders and other interested parties would ordinarily expect from such statements. In particular, he indicated that compliance with accounting standards did not provide 'sufficient information to be able to make a genuine judgement of solvency' or takeover offers 'where balance sheet values bear no relationship to current market values'.[107]

1.116 Noting that the focus of the CLERP 9 Bill was to establish 'a vision of promoting transparency, accountability and shareholder activism', he argued that the use of 'historical cost-based valuations in Statements of Financial Position, with adjustments only in specified circumstances' was untenable if these statements were also to present a true and fair view.

1.117 Referring to what he considered were shortcomings with current financial reporting requirements, Mr Dunsford said:

> Somewhat surprisingly to many shareholders, the accounting standards (both those current and those proposed) do <u>not</u> claim that a statement of financial position (i.e. balance sheet) based on those standards would (or even could) provide a 'true and fair view' of the company's financial position!
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> This is in part because the values of the assets and liabilities adopted for the accounting standards are not usually required to be current market or fair values.[108]

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106 *Committee Hansard*, 11 March 2004, p. CFS 55.

107 *Submission* 2, p. 2 and *Committee Hansard*, 11 March 2004, p. CFS 44.

108 *Submission* 2, p. 1.

1.118 When asked at the hearing for his comments on whether there was an inconsistency between accounting standards and the true and fair view requirement, Mr Dunsford responded that there was a 'definite conflict'. Although he thought this could be remedied in the statement of financial position by the allocation of current values to all assets and liabilities, he proposed an alternative way of providing shareholders and other interested parties with the information they needed.[109]

1.119 The alternative was a requirement for companies to include in the notes to the accounts information about the current market values of their assets and liabilities sufficient to enable users to compare them with values adopted in the statement of financial position. He considered this proposal to be 'within the bounds of the way in which the international accounting standard has been developed' and generally acceptable.[110]

1.120 He noted that proposals for the use of market or fair values in financials had 'often foundered…due to the alleged difficulty of determination, variance of valuations due to subjective factors, and additional costs involved in obtaining independent values'. He dismissed these arguments and proposed that independent valuations should only be necessary for 'big ticket items' material to the solvency or strength of a company. He also suggested that:

> If legislation demanded market or fair values, the relevant professions would have the necessary focus to develop suitable guidance for practitioners, directors and auditors.[111]

1.121 Invited to comment on Mr Dunsford's proposal, Mrs Catherine Mulcare, CPAA, said:

> I think that issue is being explored—for example, by the value measurement reporting collaborative, in which CPA Australia is involved. The question, though, has to come back to the fact that the information presented in financial reports has to be reliable. Those notes also require that assurance be provided through the audit process. It is that reliability of measurement that is currently being explored. I believe there was some discussion by the committee about what is fair value. Is it a market price? There was one extreme view that if there is no market—if there is no ability to sell it—there is no benefit in that asset; there is a counter view that if there is value in the use of the asset that value should also be reflected. The profession is working very hard to find those solutions as quickly as possible to provide the answers that the users need in financial reporting.[112]

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109 *Committee Hansard*, 16 March 2004, pp. CFS 43-4.

110 *Committee Hansard*, 16 March 2004, pp. CFS 42, 44 and 45, and *Submission* 2.

111 *Submission* 2, p. 3.

112 *Committee Hansard*, 18 March 2004, pp. CFS 23-4.

1.122 Professor Robert Walker, appearing on behalf of ACSI, referred to what he considered were anomalies in the Corporations Act which, on the one hand, mandated the provision of information in prospectuses and takeover documents tailored to be of use to investors and other interested parties when deciding whether to invest in securities or to accept or reject a takeover offer and, on the other hand, information required in financial reporting which could not be used in any meaningful way by the target audience. Professor Walker commented in relation to financial reporting that:

> We have a requirement for financial statements to provide a true and fair view without what I think is the necessary step of saying that that means providing information which will enable investors or prospective investors to make decisions about whether they sell or hold securities. Until we establish that principle in the Corporations [Act] we are likely to continue to see people playing games with accounting standards to try to reflect the best possible result consistent with the incentives they face either through bonus or incentive schemes or anything else.[113]

1.123 He was not convinced that the shortcomings he identified could be remedied through additional statements or other material provided in the notes to the accounts purportedly in satisfaction of the true and fair view requirement. In his view, the true and fair view requirement was so vague that it was considered to be 'unenforceable'. Furthermore, he considered that the provision of market values for assets and liabilities for comparative purposes would not overcome the classification of some items as assets notwithstanding that they could not be sold:

> …when you look at, say, the collapse of WorldCom—a large proportion of the assets listed in the financial statements of WorldCom were things that could not be sold. They were recorded as assets because that is allowed under accounting standards, yet it was quite misleading to describe any of those assets in that way.
>
> The same could be said of many other corporate listed companies. I notice, for example, that the National Australia Bank is proposing to write $300 million off capitalised software. I have just done some calculations, and it may amuse the committee to learn that there are 51 million methods of accounting for software in terms of accounting standards, ranging from capitalising the lot to writing the lot off, with many variations in between. All of those would be consistent with accounting standards but, if that software is a dud and does not run and it is unlikely that organisations will generate cash flows from applying it, then it makes no sense to keep it and record it as an asset.[114]

1.124 He proposed that there should be 'an overarching requirement that financial statements should not be misleading' to allow for the inclusion of 'explanations to

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113 *Committee Hansard*, 16 March 2004, p. CFS 74.

114 *Committee Hansard*, 16 March 2004, p. CFS 75.

remediate any risk that they may mislead'.[115] Referring to a 'very deficient' level of compliance with accounting standard AASB1001 which requires companies' disclosure of key accounting policies adopted, he said:

> …in practice about 80 per cent of what gets reported is just quotes from accounting standards; they are not disclosing the policies they are adopting at all—whether they are capitalising software or writing it off or whatever. These are pretty basic deficiencies in our current reporting framework and it is not something that our regulators—either the professional bodies or ASIC—have really addressed.[116]

1.125 In its November 2002 submission to the CLERP 9 discussion paper,[117] ASIC proposed an amendment to the Act to ensure that choice in accounting treatments was 'guided by a requirement to reflect the substance of transactions or balances, irrespective of their legal form'.[118]

1.126 ASIC did not agree that the notes to the accounts was the appropriate place to provide users with information about the substance of a transaction 'because often users focus primarily on the information provided on the face of the financial statements'.[119] In ASIC's view:

> A substance over form requirement would not be subject to the same abuse as the superseded true and fair 'override' because it affects how an accounting standard is applied, rather than *whether* the standard should be applied.[120]

1.127 ASIC considered that this more narrowly interpreted criterion, when applied to the preparation of the financial statements, would result in 'accurate, meaningful, consistent and comparable financial information to users of financial reports'.

The Committee's views

1.128 When appearing before the Committee, the CPAA was invited to comment on amendments to the true and fair view requirements proposed by the JCPAA, HIHRC and witnesses to this inquiry. Ms Catherine Mulcare, CPAA, responded that:

> …the Australian Shareholders Association correctly pointed out that there are a number of different users of the financial reports and, because of that,

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115 *Committee Hansard*, 16 March 2004, p. CFS 76.

116 *Committee Hansard*, 16 March 2004, p. CFS 77.

117 *Corporate Disclosure, Strengthening the financial reporting framework—Corporate Law Economic Reform Program, Proposals for Reform: Paper No 9*, September 2002, Canberra.

118 *ASIC Submission on CLERP 9,* November 2002, p. 25.

119 *ASIC Submission on CLERP 9,* November 2002, p. 25.

120 *ASIC Submission on CLERP 9,* November 2002, p. 25.

> what is true and fair for one purpose may not be for another. There are many people calling for fair value measurement, for instance, and they believe that would be a better representation of what a true and fair view is; there are others who believe the historic cost and reliability of that information must also take precedence. I think that one of the things the committee probably should be made aware of is that, internationally, significant work is happening, as we speak, to deal with a financial reporting methodology that meets the needs of the various users, which I believe will be the way forward to finding an appropriate balance between accounting standards and a true and fair view.[121]

1.129 And on several criticisms that it is difficult to divine a company's solvency from the financial reports, Ms Mulcare said:

> The purpose of the financial report is very much to reflect the position and performance of the company as a going concern, and it is appropriate for the accounting standards to deal with that very issue. The problem comes in at the point when solvency might be brought into question. Whilst we acknowledge that shocks to the system undermine the confidence that investors have in financial reports, it is vitally important that that underlying premise of being a going concern is withheld in the financial reports. It should also be pointed out that it is absolutely the responsibility of the directors, under the Corporations Act, to consider the solvency of the company and those reports. At any time that the going concern principle is brought into question, that and the reasons for that concern should be disclosed in the financial statements.[122]

1.130 The Committee agrees with the witnesses who claimed that corporate financial reports are not giving users of those reports the information they need to make fully informed decisions about the financial position of a company or entity. As Professor Robert Walker said, there is an inconsistency in the Corporations Act between the information to be disclosed in periodic financial reporting compared with, for example, prospectuses—'***different standards for the quality of information that is to be made available to investors in "new" and "second-hand" securities'***.[123]

1.131 The Explanatory Memorandum says of the reforms that the 'underlying objective…is to improve the operation of the market by promoting transparency, accountability and shareholder activism'. The Committee questions whether these objectives are fairly achievable if the financial reporting with which they are integrally connected does not truly serve the needs of the average user who does not have access

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121 *Committee Hansard*, 18 March 2004, p. CFS 23.

122 *Committee Hansard*, 18 March 2004, p. CFS 24.

123 *Submission* 5, p. 12. (The bold, italicised type was used in the submission and has not been inserted by the Committee.)

to more informative financial information. On the Bill's objective of greater transparency, the Committee notes the comments of Professor Graeme Dean:

> …with transparency, it is hard to imagine that something can be transparent if in a solvency setting…the data you are using does not give you indicators of solvency. That cannot be a transparent outcome. We feel that there needs to be a recognition that there are certain financial characteristics, salient features, that are supposedly derivable from [the Act's] financial reporting regime…They are things like solvency, rate of return and liquidity. At the present time, those salient characteristics are not determinable under either the existing conventional standard setting or under the proposed CLERP bill.[124]

1.132 The Committee endorses Recommendation 6 of the JCPAA report on independent auditing. The Committee also agrees with proposals for clarification of the meaning of 'true and fair view' to take into account the perspective of the average user.

1.133 The Committee therefore proposes that, consistent with the principles-based approach of the legislation, a definition of 'true and fair view' be inserted to supplement these requirements. As a starting point, the Committee favours a definition that takes into account the purposes for which the Corporations Act requires the publication of financial reports to the market.

Recommendation 4

1.134 The Committee recommends that the Bill should insert a definition of 'true and fair view' into the *Corporations Act 2001* to clarify that its purpose is to ensure that the financial reports of a disclosing entity or consolidated entity represent a view that users of the reports (including investors, shareholders and creditors) would reasonably require to make an informed assessment of matters such as investment in the entity or the transaction of business with the entity.

Recommendation 5

1.135 The Committee recommends that sections 297 and 305 of the *Corporations Act 2001* should be amended:

- **to provide that, in undertaking the assessment of a true and fair view, directors must consider the objectives contained in section 224(a) of the ASIC Act and must include a statement in the financial report that they have done so;**
- **to delete the footnote that states: If the financial statements and notes prepared in compliance with the accounting standards would not give a**

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124 *Committee Hansard*, 11 March 2004, p. CFS 57.

true and fair view, additional information must be included in the notes to the financial statements under paragraph 295(3)(c);

- **to add new subsections for the following:**

  (a) In the case of conflict between sections 296 (compliance with accounting standards) and 297 (true and fair view), the notes to the financial statements must indicate why, in the opinion of the directors, compliance with the accounting standards would not give a true and fair view of the financial performance and position of the company;

  (b) The notes to the financial statements must include a reconciliation to provide additional information necessary to give a true and fair view.

CHAPTER 2

FRAMEWORK FOR DISCUSSION OF THE BILL'S AUDIT REFORMS

Introduction

2.1 As the HIH Royal Commissioner noted, 'the point of an audit is to provide independent assurance of the integrity of the way in which the company has reported'.[1] It is essential, therefore, that auditors have the expertise to perform their role competently. They must also be free of conflicts of interest and perceived to be so.

2.2 On this second point, the Royal Commissioner commented:

> That an auditor must be independent both in fact and in appearance is fundamental to an effective audit.
>
> The concept of 'appearance' of independence has to be given meaning. It is similar to the well-known adage that justice must not only be done but be seen to be done. It is fundamental that the auditor be independent and be free of conflicts and other impediments which create the risk of his or her independence being compromised. Appearance of independence is important because, again to resort to an old adage, many people judge books by their covers. In the context of audit, matters that affect the appearance of independence can undermine the confidence that a user of the accounts may place on the audit opinion.[2]

2.3 Perhaps because HIH shared the same auditor as Enron and WorldCom, it was inevitable that HIH's demise would intensify debate about auditor independence and the quality of financial reporting in Australia. It is an understatement to say that there

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1 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol I, Canberra, April 2003, p. 162.

2 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol III, Canberra, April 2003, p. 85.

has been no shortage of academic papers, media commentaries, reviews, inquiries[3] and ASIC investigations[4] concerning the issues involved.

2.4 The CLERP 9 Bill draws on the findings of several inquiries which had been prompted by the loss of confidence in the auditing profession and, more generally, corporate governance. Among these were the recommendations of the HIH Royal Commission[5] which, itself, drew on recommendations made in two reviews into corporate auditing in Australia—*Independence of Australian Company Auditors, Review of the Current Australian Requirements and Proposals for Reform—Report to the Minister for Financial Services and Regulation* (Ramsay Report) published in October 2001, and *Report 391, Review of Independent Auditing by Registered Company Auditors*, published in August 2002 by the Joint Committee of Public Accounts and Audit (JCPAA Report).

2.5 The Ramsay Report was the culmination of a review into the regulation of Australian company auditors by Professor Ian Ramsay, Director of the Centre for Corporate Law and Securities Regulation, University of Melbourne. The Government had commissioned this report in August 2001 in response to its concerns that the Australian regulation of company auditor independence had fallen behind developments in the United States and Europe. There was the additional concern that Australian corporate failures in early 2001 had prompted a loss of confidence in the auditing profession that called for a remedy.[6]

2.6 Professor Ramsay examined ways of limiting opportunities for conflicts of interest to arise in the performance of audits and proposed several measures to restrict employment and financial relationships between auditor and client. He made recommendations to manage the threat to auditor independence posed by business relationships, mainly involving auditors' provision of non-audit services to their clients. Recommendations were also to improve auditor supervision, disciplinary arrangements, auditor appointment and removal, and auditor accountability.

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3 See, for example, Professor Ian Ramsay, *Independence of Australian Company Auditors, Review of the Current Australian Requirements and Proposals for Reform—Report to the Minister for Financial Services and Regulation*, Canberra, October 2001; Joint Committee of Public Accounts and Audit's *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra.

4 In the year of HIH's collapse, ASIC initiated a survey into auditor independence—see ASIC media release 02/13 *ASIC announces findings of auditor independence survey*, 16 January 2002. In 2002, ASIC continued its focus on corporate governance matters with a targeted review of the financial reports for over 1,000 listed companies and a surveillance program into research analyst independence—see ASIC media release 02/460 *ASIC releases stage one results of accounting surveillance;* 18 December 2002; ASIC media release 03/125 *ASIC releases stage two results of accounting surveillance*, 10 April 2003 and ASIC media release 03/268 *ASIC releases surveillance report on research analyst independence*, 22 August 2003.

5 *The Failure of HIH Insurance*, The HIH Royal Commission, Canberra, April 2003.

6 Ramsay Report, October 2001, p. 6.

2.7 Professor Ramsay told the Committee that he welcomed the CLERP 9 Bill and noted that many of his recommendations had been incorporated into its reforms. He indicated that his recommendations to strengthen auditor independence had been founded on the 'key principle' that a 'multi-pronged' approach to audit regulation was essential. He summarised the main features of this approach:

> Firstly, there must be a focus upon audit firms, ensuring that they have appropriate internal procedures to deal with conflicts and that there are appropriate restrictions on relationships between audit firms and clients that can jeopardise independence. Secondly, there must be a focus upon audit clients. The recommendations in my report include an enhanced role for audit committees and improved disclosure of non-audit services. In this respect, I regard it as desirable that the Auditing and Assurance Standards Board, following the recommendations in my report, has announced guidance on enhanced disclosure of non-audit services. I also regard as highly desirable the increased and important focus on the role of audit committees. Thirdly, there must be a focus on professional accounting associations. In my report, I called upon the professional associations to move quickly to update their ethical requirements in this area and they have indeed done so. Finally, there needs to be a focus on disciplinary bodies, and I made recommendations in my report for the improved operation of the Company Auditors and Liquidators Disciplinary Board. [7]

2.8 Notwithstanding his enthusiasm for the Bill, Professor Ramsay did see 'room for improvement'. One area for improvement, he thought, concerned the Financial Reporting Council. Noting that the Council had been given the task of overseeing auditor independence, he queried whether it had the resources and the right membership mix to carry out this task.[8] These issues are the subject of further discussion in chapter 4.

2.9 Another source of the Bill's reforms is the JCPAA Report. This report endorsed many of the Ramsay Report's recommendations but 'extended the examination of audit independence to include broader corporate governance and financial reporting, including accounting standards and disclosure issues'. The JCPAA's 13 recommendations were aimed at imposing greater accountability on directors and senior company executives, improving corporate disclosure and strengthening auditor independence. As the Chairman's foreword stated, the recommendations were intended 'to provide a framework enabling a broadening of the audit function to include…corporate governance, risk management, internal control issues or other performance-type issues' and, as an integral part of this, to enhance ASIC's oversight role.[9]

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7 *Committee Hansard*, 18 March 2004, p. CFS 2.

8 *Committee Hansard*, 18 March 2004, p. CFS 3.

9 JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, Canberra, Chairman's Foreword.

Framework for discussion of the Bill's auditor independence proposals

2.10 The Committee's discussion of the Bill's auditor independence proposals will follow the framework set out below. Recommendations of the Ramsay Report, the JCPAA Report and the HIH Royal Commission will be referred to where appropriate. Certainly, where the Committee believes there are notable departures from recommendations made, these will be discussed.

Chapter 3: Audit reform—reconstitution of the AUASB

Chapter 4: Corporate accounting and auditing—proposed changes to the standard-setting framework

Chapter 5: Audit reform—general auditor independence provisions

Chapter 6: Audit reform—minimising conflicts of interest—employment restrictions

Chapter 7: Audit reform—minimising conflicts of interest—services restrictions

Chapter 8: Audit reform—risk allocation and management

Chapter 9: Audit reform—enforcement—disciplinary measures

Chapter 10: Audit reform—enforcement—the Financial Reporting Panel

Chapter 11: Audit reform—enforcement—auditing standards and auditors' reporting obligations

CHAPTER 3

AUDIT REFORM—RECONSTITUTION OF THE AUASB

Introduction

3.1 Part 12 of the *Australian Securities and Investments Commission Act 2001* (ASIC Act) establishes the institutions and the processes behind accounting standard setting in Australia.

3.2 At the head of the standard-setting framework is the Financial Reporting Council (FRC) whose membership is appointed by the Treasurer. The FRC has principal oversight of accounting standard-setting in Australia and, in this regard, oversees the activities of the Australian Accounting Standards Board (AASB) which is the standard setter.

3.3 The Bill proposes amendments to the ASIC Act which will widen the scope of the Part 12 regime to cover auditing standards and auditor independence.

3.4 The existing Auditing & Assurance Standards Board (AuASB)[1] will be reconstituted as a Commonwealth authority with responsibility for:[2]

- making auditing standards for the purposes of the Corporations Act;
- formulating auditing and assurance standards for other purposes;
- formulating guidance on auditing and assurance matters; and
- participating in the formulation of international auditing standards.[3]

3.5 The AUASB will have power to engage staff and consultants; establish committees, advisory panels and consultative groups; receive money contributed towards its operating costs; and to do anything else needed for the performance of its

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1 In this report, the existing Auditing and Assurance Standards Board is referred to as the AuASB with the reconstituted body proposed under CLERP 9 referred to as the AUASB.

2 Proposed section 227B ASIC Act.

3 Proposed section 227B ASIC Act. The Explanatory Memorandum for the Bill at p. 90 refers to the distinction in the meaning of 'making' and 'formulating' in relation to auditing standards. The AUASB makes a standard for the purposes of the Corporations Act and formulates a standard for other purposes. Also the proposed section intends that auditing standards will have legal force but guidance on auditing and assurance matters will not. This will allay the AuASB's concerns that legal backing would apply to guidance notes contained in the appendices to standards.

functions.[4] Under the *Commonwealth Authorities and Companies Act 1997*, the AUASB must meet specified reporting, accounting, auditing, banking, investment and record-keeping requirements.[5]

3.6 The AUASB's activities will be overseen by the FRC as part of the FRC's proposed new responsibilities for auditing standard setting and auditor independence. The FRC's new responsibilities will closely mirror its existing ones for oversight of the AASB and the setting of accounting standards.[6]

3.7 The Bill's proposal to reconstitute the AuASB as the standard setter for auditing standards attracted widespread support. A few suggestions were made about arrangements that could be put in place to streamline the administration of the standard setting bodies. The staffing of the AUASB, its membership and functions also attracted comment.

3.8 These are among the issues to be reviewed in this chapter.

3.9 In the next chapter, the Committee will review the many submissions which queried whether the FRC had the requisite independence, resources and competency to oversee the activities of an additional standard-setting body, the AUASB, and to take on auditor independence functions. Responses to the proposal that the FRC should oversee the Financial Reporting Panel (FRP) are also considered.[7]

Streamlining the administrative framework

3.10 The Bill does not indicate how the administrative framework for the FRC, AASB and AUASB is intended to be structured. However, suggestions were made to the Committee on how the AASB and AUASB could be set up to attract the calibre of professionals needed and to achieve greater efficiencies.

3.11 Mr Keith Alfredson, former Chairman of the AASB,[8] observed that:

> …if the auditing standards board is going to be a mirror image of the AASB, it is going to have a staff of five people. It is going to need all the

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4 Proposed subsection 227B(2) ASIC Act.

5 Proposed section 227A ASIC Act. See note to section.

6 Proposed subsection 225(1) ASIC Act.

7 CLERP (Audit Reform & Corporate Disclosure) Bill, Commentary on the Draft Provisions, Corporate Law Economic Reform Program No. 9, Canberra, October 2003, p. 85. Issue 2.1 of the Commentary indicated that '[s]ome stakeholders have suggested that the Financial Reporting Council should oversee the operation of the FRP' and invited comments on 'potential oversight arrangements'.

8 Mr Alfredson was Chairman of the AASB for three years until 7 May 2003.

> same things that the AASB needs, such as personnel policies and all of the things that go with it.[9]

3.12 Noting also the additional administrative and reporting requirements applicable to statutory bodies, he proposed a model to '[simplify] the bureaucracy that will result out of duplicating a system that currently exists and could be easily duplicated'. In particular, he proposed the establishment of a statutory body, the Australian Financial Reporting and Assurance Institute (or a similar name), comprising the technical and administrative support for the AASB and the proposed AUASB. Mr Alfredson outlined to the Committee how this arrangement would work:

> You could have the FRC on top, and underneath it you could have one body that was the employing body that did all the accounting and policies, employed all the staff and had a simple process to do all those sorts of things. The AASB and the auditing standards board would not have bank accounts themselves and would not have to produce accounts and go through that exercise. This other body would do a set of accounts that would be clearly broken down into segments: the cost of financial reporting panel, the cost of the auditing standards board and so on.[10]

3.13 Apart from being a more streamlined and cost-effective arrangement, Mr Alfredson saw it as overcoming the possibility that the AUASB might be too small to attract the type of high-quality professionals needed for standard setting who, he said, preferred to work in larger, more 'collegiate style' environments which fostered the exchange of ideas.[11]

3.14 The Committee asked Professor David Boymal, Chairman, AASB, whether he thought there were potential benefits in a merged structure. He endorsed such a proposal and said in this regard that:

> I have a staff of 24. The auditing standards board, it is envisaged, might have a staff of five. If it is a separate employer, as the AASB is, there will be duplication of that administrative effort for very few people. Whilst the rules might be quite appropriate for large organisations, they are quite burdensome for organisations that employ either 24 or five people, and therefore there would be some administrative relief if the staff of both of these boards could be employed by the one entity. I think that is what Keith Alfredson is driving at. I would have to agree that it seems inappropriate that this newly established audit and assurance standards board ought to be the employer of only five people and then has to go through the administrative burden of being a Commonwealth employer. I too would suggest that there might be a more efficient way of dealing with this.[12]

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9 *Committee Hansard*, 14 April 2004, pp. CFS 57-8.

10 *Committee Hansard*, 14 April 2004, pp. CFS 57-8.

11 *Submission* 52, p. [2].

12 *Committee Hansard*, 29 April 2004, p. CFS 90.

3.15 Mr Bill Edge, Chairman, AuASB, thought that 'structurally, there would be advantages in administration, IT and so forth' in a merged body and agreed with Mr Alfredson's comments on the difficulties facing smaller organisations in providing the types of working environments that foster 'greater interaction and collegiate behaviour'. While he thought there would be some benefits in the 'potential for interaction and sharing of some resources', he did not regard this as a 'large advantage'. Mr Edge's main concern was in attracting good staff. He said in this regard that:

> …Attracting good people to standard setting bodies is tough, whether it be auditing, accounting or anything else at all. It is a difficult market. It is difficult to get good people there. What is underestimated is the amount of time. We use work of the big four or others as a means of providing a further resource for the board…[13]

3.16 Mr Richard Mifsud, in his capacity as the senior staff member working for the AuASB and as executive director of the Australian Accounting Research Foundation (AARF), saw benefits in co-location of the two bodies and told the Committee that this option was being explored:

> …We have already had informal discussions—obviously, they have been informal, because the legislation has not been passed yet—with the chairman of the Australian Accounting Standards Board and senior staff of that board about the prospect of co-location and liaison with Treasury, and we are quite confident that the arrangements as currently proposed, albeit informally, will be a positive step.[14]

The Committee's views

3.17 The Committee fully endorses the adoption of a model that will avoid unnecessary duplication of administrative functions and provide the type of working environment to attract people with the expertise needed in standard setting.

Recommendation 6

3.18 The Committee recommends that the Government explore ways in which the administrative functions and statutory obligations of the Australian Accounting Standards Board and the Auditing & Assurance Standards Board can be managed so as to avoid duplication of costs and effort.

Recommendation 7

3.19 The Committee recommends that the Government explore ways of combining the administrative and technical teams of the Australian Accounting

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13 *Committee Hansard*, 18 March 2004, p. CFS 44.

14 *Committee Hansard*, 18 March 2004, p. CFS 44.

Standards Board and the Auditing & Assurance Standards Board to provide a working environment that meets the expectations of suitably qualified professionals.

3.20 The Committee is encouraged by Mr Mifsud's comments suggesting that steps have already been taken to streamline arrangements.

3.21 Also, changes proposed in the Bill to give the AASB and AUASB the flexibility to share payment of their expenses should go some way towards promoting greater efficiency—assuming, of course, that they will be revised, if necessary, to accommodate a new AASB/AUASB structure.[15]

3.22 The Committee notes that the Explanatory Memorandum refers to the payment provisions, among other things, as being intended to:

> …allow the sharing of contributions made by government, the accounting profession and business towards the cost of the standard setting arrangements where the payment is made to one body but is intended to be for the three bodies.[16]

3.23 As part of its review of the FRC's independence in the next chapter, the Committee will examine submissions calling for an overhaul of the tripartite funding arrangements referred to in the Explanatory Memorandum.

3.24 Should the Government decide on new funding arrangements for the standard-setting bodies that do not require amendment to the Bill's provisions, the Committee suggests that the reference in the Explanatory Memorandum to the tripartite arrangements be deleted.

Membership

3.25 Members of the AUASB are to be appointed by the FRC except for the Chair who will be appointed by the Minister. Membership of the Board cannot exceed five years although re-appointment is possible.

3.26 The Bill does not specify any minimum or maximum membership. It also does not indicate whether members are to occupy their positions on a full- or part-time basis.

3.27 The Bill requires members to have knowledge of or experience in business, accounting and auditing, law or government.[17]

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15 Proposed paragraphs 238(b) to (3) (the AASB) and proposed subsection 238(2) (the AUASB).

16 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 94.

17 Proposed section 236F ASIC Act.

3.28 The Committee asked Mr Bill Edge whether he saw any benefit in broadening the membership of the AUASB to include non-practitioners who were users of financial statements. Mr Edge was supportive of this proposal and commented that:

> …we have looked at whether, if CLERP 9 comes in, there should be a reconstitution of the type of membership. The board's view is yes, there should be involvement of users and other interested parties. However, the majority of the board would need to be technically strong in the area of auditing, so there would always be a majority of practitioners.[18]

3.29 When asked how a wider membership could be selected, for example, through stakeholder organisations or other means, Mr Edge said:

> We have not come up with a definitive answer…as to whether you invite people based on merit or whether you invite people as representing a particular constituency. Our preference would be to get people who come with a different point of view but at the board table we will use their merit on a decision. They may be from a shareholder association or representing shareholders; they may represent directors or management. They may even represent regulators, but I think we will find it very difficult to get the regulators to commit to that sort of thing. As to the other users, I think the main two would be management and shareholders, with public interest always being the overriding goal of the board.[19]

The Committee's views

3.30 The Committee agrees with proposals to broaden the membership of the AUASB to include shareholders and other users of financial reports.

3.31 Further discussion of the issues involved is included in the next chapter where the Committee reviews, among other things, the membership of the FRC and the standard-setting bodies generally.

Oversight of the AUASB

3.32 As with the AASB, the AUASB must follow the broad strategic and general policy directions given by the FRC and also take into account the FRC's advice or feedback on general policy.[20]

3.33 These provisions, as they apply to the AASB, have attracted substantial criticism since their adoption as they are considered to be inconsistent with the independence of the standard-setting function. Similar criticisms were levelled at the new provisions.

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18 *Committee Hansard*, 18 March 2004, p. CFS 43.

19 *Committee Hansard*, 18 March 2004, p. CFS 43.

20 Proposed section 234C ASIC Act.

3.34 As these issues form part of the broader concerns regarding the independence of the standard-setting function, they will be discussed in the next chapter.

The AUASB's functions—the conceptual framework for auditing standards

3.35 Note 2 to proposed subsection 227B(1) of the Bill refers to the 'framework within which the AUASB is to formulate and make auditing standards'.

3.36 The AuASB said in their submission that Note 2 was unnecessary and should be deleted. The reasons given for this were that:

- AUS 106 and AUS 108 already served as a type of conceptual 'framework' for auditing and assurance standards.
- The IAASB[21] was revising its equivalent documents and might develop a conceptual framework to form part of these in the future. If the AUASB adopted these as part of its international harmonisation and convergence program, the framework developed by the AUASB could become redundant.
- The AUASB's standard setting functions implicitly include the development of a conceptual framework which 'should not be distinguished from those functions'.[22]

3.37 Mr Bill Edge explained to the Committee that, unless Note 2 was deleted, the AUASB could devote 'a lot of resources to determine a conceptual framework that may not replicate itself within the [international auditing] standards'.[23]

Recommendation 8

3.38 The Committee recommends that Note 2 be deleted from proposed subsection 227B(1) of the Bill so that the Auditing & Assurance Standards Board will not be required to divert resources on unnecessary work.

The AUASB and international auditing standards

3.39 The Bill provides for the AUASB to make or formulate auditing standards by issuing the text of an international auditing standard although modification is permitted 'to the extent necessary to take account of the Australian legal or institutional environment'.[24]

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21 International Auditing & Assurance Standards Board.

22 *Submission* 53, p. 4.

23 *Committee Hansard*, 18 March 2004, p. CFS 44.

24 Proposed subsection227B(4) ASIC Act.

3.40 In addition, the AUASB must comply with the Minister's direction 'about the role of international auditing standards in the Australian auditing standard setting system'. Such a direction may only be given after the Minister's consideration of a report from the FRC about the desirability of doing so.[25] The Explanatory Memorandum says that the Minister's power in this regard is 'intended to provide a mechanism for the Minister…to require the AUASB to move towards greater adoption of international standards if it is considered appropriate and the AUASB has not moved in that direction of its own accord'.[26]

3.41 These provisions did not attract comment and will not be specifically reviewed by the Committee. However, in chapter 11, the Committee discusses international convergence during its examination of submissions about the conversion of auditing standards into disallowable instruments.

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25 Proposed section 234D ASIC Act.

26 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 95.

CHAPTER 4

CORPORATE ACCOUNTING AND AUDITING— PROPOSED CHANGES TO THE STANDARD-SETTING FRAMEWORK

Introduction

4.1 The Bill reconstitutes the existing AuASB (Auditing & Assurance Standards Board)[1] as a Commonwealth authority under the *Commonwealth Authorities and Companies Act 1997*[2] with the primary role of making auditing standards under the *Corporations Act 2001* (Corporations Act) for the purposes of the corporations legislation.[3]

4.2 This proposal was generally well received. However, the proposal that the Financial Reporting Council (FRC) oversee the AUASB's activities met with extensive opposition.

4.3 The main allegation was that the FRC did not have the requisite independence to perform its present functions and should not, therefore, be given any additional responsibilities. Related concerns were current funding arrangements; the FRC's reliance on a secretariat based in a government department; its lack of transparency and poor governance; and the tenure and basis of appointment of its members.

4.4 The Committee received several submissions commenting on the proposal to include the Financial Reporting Panel (FRP) within the FRC's oversight umbrella.[4] While there was widespread support for this proposal, much of it was qualified, again, the main concerns being the FRC's independence and the adequacy of funding.

4.5 The FRC's powers in relation to the AUASB were considered to pose another threat to the AUASB's independence and, in effect, amount to the FRC's appropriation

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1 In this report, the existing Auditing and Assurance Standards Board is referred to as the AuASB with the reconstituted body proposed under CLERP 9 referred to as the AUASB.

2 Proposed section 227A *Australian Securities and Investments Commission Act 2001* (ASIC Act).

3 Proposed section 227B ASIC Act.

4 Issue 2.1 of the Commentary on the Draft Provisions (released with the exposure draft of the Bill) indicated that '[s]ome stakeholders have suggested that the Financial Reporting Council should oversee the operation of the FRP' and invited comments on 'potential oversight arrangements'. See CLERP (Audit Reform & Corporate Disclosure) Bill, Commentary on the Draft Provisions, Corporate Law Economic Reform Program No 9, Canberra, October 2003, p. 85.

of the AUASB's standard-setting function.[5] More problematic were the FRC's proposed powers to:

- approve and monitor the AUASB's priorities, business plans, budgets and staffing arrangements (including level, structure and composition); and
- determine the AUASB's broad strategic direction and advise or comment on general policy or AUASB procedures.[6]

4.6 Evidence submitted to this inquiry by Mr Keith Alfredson, former Chairman of the AASB,[7] encapsulated the concerns of many witnesses. Mr Alfredson claimed the FRC had serious problems with transparency and accountability which needed to be resolved before the FRC was given any additional responsibilities. He proposed that 'as a matter of urgency' the Australian National Audit Office should conduct an efficiency and effectiveness audit concentrating on:

- the FRC's 'governance arrangements';
- the 'preparation and the timeliness of the distribution of Board papers on key issues supporting decisions made (including the decision to mandate International Accounting Standards by 2005 and the decision to harmonise GFS with Australian Accounting Standards)';
- the 'adequacy of consultation (including the lack of invitations to the public for comments on key AASB strategy decisions, as compared to the process following in countries such as New Zealand and the UK in regard to the adoption of International Accounting Standards)';
- 'failure to raise adequate corporate funding of the AASB'; and
- 'adequacy of the procedures for the evaluation of the performance of its membership and other related matters'.

4.7 As a further safeguard of the FRC's accountability and transparency, Mr Alfredson proposed that the FRC should be required by legislation:

- to hold its meetings in public;[8] and
- to prepare cost/benefit analyses regarding strategies set for the AASB and AUASB, and to consult publicly and hold public hearings to assist with strategy formulation.[9]

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5 Proposed subsection 225(2A) ASIC Act.

6 Proposed subsection 225(2A) ASIC Act.

7 Mr Alfredson was Chairman of the AASB for three years until 7 May 2003.

8 Mr Alfredson said the requirement for public meetings would conform with 'best practice (such as that followed by the Trustees of the International Accounting Standards Board)'. *Submission* 52, p. [2].

4.8 It is widely accepted that the standard setters for corporate financial reporting must be able to perform their roles independent of influences that would not serve the interests of Australian capital markets and the public interest as a whole.

4.9 The Committee has been disturbed at the level of dissatisfaction with the FRC's performance to date. As this has implications regarding the FRC's proposed oversight of the AUASB, the Committee believes an examination of the FRC's present and proposed responsibilities is necessary. The Committee will review the evidence under the following headings:

- Governance
- Membership
- Funding
- Powers
- The FRC's role regarding auditing standards and auditor independence
- The FRC—other functions and powers
- Conclusion

Governance

4.10 The *Australian Securities and Investments Commission Act 2001* (ASIC Act) provides that the FRC 'may determine its own procedural rules'[10] but otherwise makes no specific provision for the FRC's governance processes—the composition and location of its secretariat; its approach to consultation and the extent to which it should consult with the public on certain proposals; and the conduct of its meetings.

4.11 Evidence to the Committee reflected a great deal of dissatisfaction with the manner in which the FRC performed its functions. There was criticism that the FRC lacked transparency. Another concern was the FRC's failure to consult with interested stakeholders on matters which would affect them.

4.12 The location of the FRC's secretariat within the Department of the Treasury was seen by some as liable to produce governance failures and inconsistent with the priorities of the FRC.

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9 *Submission* 52, pp. [1-2].

10 Section 235C ASIC Act.

Transparency and the FRC's decision-making processes

4.13 For Professor Robert Walker, appearing on behalf of the Australian Council of Super Investors Inc (ACSI), the FRC's accountability for decisions made was somewhat lacking (or otherwise their communication skills were poor). He suggested that a broader membership might help to remedy this. He said in this regard that:

> There are some aspects of the Financial Reporting Council's activities which bemuse those who look at the world through the lenses of prospective investors in company securities. As one who has looked at the Financial Reporting Council's web site to try to comprehend the rationale for some of their decisions and directives to a standards board, I must say I have been bemused by the rationale or the lack of explanation of what they are doing. So it seems to me that any efforts made to widen representation and to make it more representative to the stakeholders it is intended to serve would be beneficial.[11]

4.14 Mr Keith Alfredson commented that the 'FRC makes important decisions' such as its strategy-setting role for the AASB but appeared not to consult with the public on the issues or to fully explore the implications of their decisions. He referred to the FRC's 'fundamental decisions' to adopt international accounting standards in 2005 and to harmonise government accounting between international standards and the GFS. These 'important decisions', he said, 'were made without any call for submissions from those who might have a public interest'. For 'the key body that has an important impact on standard setting', this was not 'good enough'.[12] He argued that 'there ought to be absolute openness about how those decisions were made' and a 'vast improvement in the way the FRC consults'.[13]

4.15 Mr Tom Ravlic was critical of what he considered was the FRC's failure to fully explore the implications of adopting international accounting standards. He commented that:

> …as far as I am aware, there has been no inventory done of the tax effects of adopting international financial reporting standards. Companies with whom I talk from time to time have indicated to me that they have had to discover the tax impacts as they go through their analysis of adopting international accounting standards. So, as part of the decision to adopt, we did not analyse the full-blown impact of moving to international financial reporting standards on other parts of our regulation. You rightly point out that tax is one of them. Prudential regulation is another one.[14]

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11 *Committee Hansard*, 16 March 2004, pp. CFS 84-5.

12 *Committee Hansard*, 14 April 2004, p. CFS 50.

13 *Committee Hansard*, 14 April, 2004, p. CFS 49.

14 *Committee Hansard*, 14 April, 2004, pp. CFS 14-15.

4.16 Mr Alfredson proposed that the FRC should be required to hold its meetings in public. He considered this would help to improve the FRC's transparency about how it arrived at 'fundamental decisions'.[15]

4.17 Professor Ian Ramsay thought there was a case for more openness in the FRC's proceedings but also thought that 'on certain matters of auditor independence, for example, while there would be a general principle of openness there may be some matters of such sensitivity that it would be appropriate to have closed proceedings'.[16]

4.18 Mr Tom Ravlic was 'puzzled by the fact the council still meets in private' given the public interest element in its role. Unless public meetings were mandated in legislation, he said, the FRC would 'continue to be subject to claims it is operating in a secretive, club-like environment'. He said further that:

> If transparency and openness are to be the key feature of the capital market then those overseeing the audit firms and others in the name of the community must meet in public. They must have that veneer of public accountability and face the community with the same degree of integrity expected of the auditors and companies striving to comply with a host of audit, accounting, conflict of interest and continuous disclosure rules imposed on them by legislators of governance rules.[17]

The Committee's views

4.19 The Explanatory Memorandum for the Corporate Law Economic Reform Bill 1998 said of the FRC that:

> In performing its functions and exercising its powers, it is expected that the FRC will operate in a manner that is open and consultative in nature.[18]

4.20 This had certainly been the expectation of the Committee when it conducted its inquiry into the legislation establishing the FRC and the standard-setting regime.[19]

4.21 Apart from this, the Committee is disturbed that the evidence reveals a clear loss of confidence in the integrity of the FRC's processes. The Committee's view is that, unless the FRC is more accountable for its decisions, the public interest will not be served.

4.22 The Committee takes this view notwithstanding Mr Macek's evidence that the FRC had recently decided against public meetings but had sought to compensate for

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15 *Committee Hansard*, 14 April, 2004, p. CFS 49.

16 *Committee Hansard*, 18 March 2004, p. CFS 8.

17 *Submission* 1A, p. 7.

18 Corporate Law Economic Reform Program Bill 1998, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 87.

19 Parliamentary Joint Committee on Corporations and Securities, *Report on the Corporate Law Economic Reform Program Bill 1998*, May 1999.

this by expediting the publication of its meeting bulletins. The Committee also notes Mr Macek's later comments that, given the more limited nature of the FRC's monitoring activities, 'the case for making the meetings open to the public is stronger than it otherwise would be'.[20]

4.23 The Committee accepts the evidence that the FRC's consultation on matters of some significance have left much to be desired. Again, the Committee believes the strong public interest element in the FRC's activities, requires that the FRC consults openly with stakeholders on proposals that could affect their interests.

Recommendation 9

4.24 The Committee recommends that the *Australian Securities and Investments Act 2001* should be amended to ensure that the Financial Reporting Council:

a) is required to conduct its meetings in public. This should not prevent meetings occasionally being held as closed proceedings where the matters are of such sensitivity that that is appropriate.

b) conducts public consultation on proposals within its functions and responsibilities that have a public interest element.

The secretariat

4.25 Mr Alfredson thought it inappropriate for the FRC to have to rely on a secretariat based in the Department of the Treasury because it involved a conflict of priorities. He characterised the FRC as 'resource starved' and added:

> …In particular I am not talking about money; I am talking about dedicated qualified staff—staff that understand the operations of the AASB, are dedicated and do not, like the secretary during my time, have other responsibilities, apparently including the writing of the CLERP 9 paper. It is hard to give the right priority to the FRC if that is the way the FRC secretariat is staffed.[21]

4.26 Mr Alfredson also thought that 'a stronger secretariat capable of implementing governance' may have ensured better consultation and consideration of pertinent issues in the FRC's decision making.[22]

4.27 Similarly, for Mr Greg Larsen, CPA Australia (CPAA), a Treasury-based secretariat was not acceptable mainly because FRC matters could not be its main priority:

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20 *Committee Hansard*, 29 April 2004, p. CFS 21.

21 *Committee Hansard*, 14 April, 2004, p. CFS 49.

22 *Committee Hansard*, 14 April 2004, pp. CFS 51-2.

> Under the previous regime of the Australian Accounting Research Foundation, we had an executive and secretariat that supported the standards boards and were focused on the outcomes of those standards boards. I think that, for all their goodwill and good people, Treasury's first call has to be the political requirements of the Treasurer and the government, and therefore it will always be a part-time job for them to be the secretariat to these people—or so it seems to me.[23]

4.28 Professor Ian Ramsay expressed a preference for the FRC (as the proposed oversight body for the AUASB) to have a separate secretariat so that it would get the priority it deserved, bearing in mind the 'many important demands' on Treasury's time. He was prepared to accept the status quo, however, if what he argued were shortcomings with the FRC's membership and resources were dealt with.[24] (Evidence on the FRC's membership and resources is discussed later in this report.)

The Committee's views

4.29 The Committee accepts the evidence that a Treasury-based secretariat is not working. Although board papers are being distributed on a more timely basis[25] and Treasury has made some changes, the Committee is not convinced that issues concerning priorities and conflicts can be fully resolved while present arrangements continue.

4.30 The Committee has taken into account the evidence from Mr Mike Rawstron, Department of the Treasury, that a Treasury-based secretariat provided certain benefits such as access to overseas posts, information about overseas developments and Treasury expertise.[26] However, the Committee defers to the almost unanimous agreement among the witnesses that, in the interests of good governance—which is one of the core objectives of CLERP 9—the FRC should have an independent secretariat. The Committee notes in this regard the following comments of Mr Charles Macek, Chairman, FRC:

> Again in line with good governance principles and particularly taking into account independence, we are of the view that the FRC would be best served by having an independent secretariat—that is, separate from the provision of support staff within the Treasury department in Canberra—and ideally, given the location of the two standards boards, that that independent secretariat should be co-located in Melbourne. We have some sympathy for the UK model, which has a Financial Reporting Council with an independent staff of only four, including an executive director, and the sorts

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23 *Committee Hansard*, 18 March 2004, p. CFS 27.

24 *Committee Hansard*, 18 March 2004, p. CFS 8.

25 Mr Charles Macek, *Committee Hansard*, 29 April 2004, p. CFS 24. Mr Macek advised that papers now generally reach members about a week before meetings as opposed to the one or two days that applied previously.

26 *Committee Hansard*, 29 April 2004, p. CFS 60.

> of responsibilities that we have in Australia with some additional responsibilities, including governance.[27]

Recommendation 10

4.31 The Committee recommends that urgent provision should be made for an adequately staffed and funded secretariat, independent of the Department of the Treasury and other Government departments, for the Financial Reporting Council.

Membership

4.32 The ASIC Act currently provides that the members of the FRC, including the Chairman, are to be appointed by the Minister. The Minister can appoint a member by specifying an organisation to appoint one of its representatives.

4.33 Membership is on the terms and conditions determined by the Minister.[28]

4.34 The Act does not specify how many members should make up the FRC or whether they should occupy their positions on a full- or part-time basis. There are also no requirements for members to have qualifications or experience that are relevant to the FRC's role.

4.35 The membership of the FRC attracted a great deal of comment. Many witnesses considered the FRC's additional responsibilities under CLERP 9 called for a review of the FRC's membership to ensure it was appropriately qualified and experienced, had a broader base of skills, and adequately represented the public interest.

4.36 The Group of 100 Inc, for example, thought the FRC's 'size, composition and qualities for membership' should be reviewed in light of its increased responsibilities. They proposed a dedicated secretariat and:

> …[a membership comprising] independent and eminent persons, appointed in their own right not having ties with professional organisations or lobby groups.[29]

4.37 They considered that a 'mix of business and professional people and those from broader disciplines concerned with the public interest would be appropriate'.[30]

4.38 Professor Ian Ramsay was another who thought the FRC's proposed new responsibilities called for a review of its resources and membership. On the latter point, he considered that the 'public interest' should be represented in the FRC's

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27 *Committee Hansard*, 29 April 2004, p. CFS 11.

28 Section 235A of the ASIC Act deals with the appointment of members, etc.

29 *Submission* 46, p. 2.

30 *Submission* 46, p. 2.

membership and thought it was 'unclear…who represents the public interest on the FRC'.[31]

4.39 When asked by the Committee for suggestions on who might make suitable members, Professor Ramsay responded that:

> The FRC as currently constituted largely has nominees from bodies. When I considered this issue of what independent body should best take carriage of auditor independence, I thought it quite appropriate that key stakeholders have representation. That would include the professional associations, ASIC and end users of financial statements.
>
> To a certain extent, the FRC currently has those nominees but, as I said, I do see an important role for the public interest and I am not quite sure where that is when I see the current FRC membership. In my report I also made an observation that, in terms of representatives of the public interest, one should give thought even to public advertisement. The relevant minister might want to think about advertising, and choose the best qualified people on the basis of public advertising. I know that is not the current process but, again, I think these sorts of initiatives may be worth thinking about to ensure that you do have the best possible pool of people to choose from.[32]

4.40 The Committee sought Mr Alfredson's comments on Professor Ramsay's suggestion that the FRC membership should be widened to reflect the public interest and that advertising might be a way to find suitable people in this regard. Mr Alfredson thought there was some lack of public representation but expressed a greater interest in having 'a group of people who are competent for the job'. On the value or otherwise of advertising, he commented that:

> Whether advertising actually brings in new names, I do not know. But it is interesting to note that when appointments were made to the AASB the FRC advertised, and I have to say that some names came out of the woodwork that I think would not have been identified if the FRC had not advertised.[33]

4.41 The Committee heard from several witnesses who thought the FRC's membership should reflect, as the Australian Chamber of Commerce and Industry (ACCI) proposed, 'a broad spectrum of business-related skills, not just those of an accounting or financial nature'.[34]

4.42 Pitcher Partners Accountants, Auditors & Advisors thought the FRC's proposed supervision of the AUASB should be subject to the requirement that it have 'sufficient expertise to understand the audit process and recognise “expectation gap”

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31 *Committee Hansard*, 18 March 2004, p. CFS 3.

32 *Committee Hansard*, 18 March 2004, p. CFS 9.

33 *Committee Hansard*, 14 April 2004, p. CFS 54.

34 *Submission* 60, p. 2.

issues'. Without this, Pitcher Partners was concerned that there was 'a risk that oversight by the FRC will exasperate unrealistic expectations of auditors'.[35]

4.43 The Australian Institute of Company Directors (AICD) similarly qualified its support of the FRC's expanded responsibilities with the provisos that:

> …this oversight body [should] be separate from Treasury and should concentrate on accounting and auditing issues alone, particularly given the importance of these new responsibilities. The skills and experience required for such new responsibilities are different in many respects from those required of existing FRC members. The proposals involve a significant increase in the workload for the FRC, together with the need for a separate secretariat.[36]

4.44 The main concerns of The Association of Superannuation Funds of Australia Limited (ASFA) in view of the FRC's new responsibilities for oversight of audit integrity and independence, were that 'for investors, the FRC must both be, and be seen, as a strong, effective and independent force'. According to ASFA:

> The current composition of the FRC raises concerns about its true independence from the producers of financial information, with stronger representation from the producers of financial information (such as the BCA, AICD, CPAA, ICAA), than the consumers of this information (AFSA, IFSA and SIA). [37]

4.45 ASFA noted that the newly-established Public Company Accounting Oversight Board (PCAOB) in the United States had a majority of non-accounting representatives and was chaired by a non-accountant. ASFA considered that 'users of financial information' including representatives of superannuation funds should be on the FRC.[38]

4.46 ACSI was another witness who considered FRC's membership was 'heavily weighted towards representation of preparers and auditors of financial statements, rather than those who rely on published financial information when making investments decisions'. While noting that the Government had proposed the establishment of a Shareholders and Investors Advisory Council, ACSI argued that 'the FRC, as the peak body, should include strong representation of investors'.[39]

4.47 The ANZ Banking Group suggested a membership review to ensure the FRC would have the expertise to perform its wider responsibilities effectively. In addition,

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35 *Submission* 13, p. 3.

36 *Submission* 35, p. 7.

37 *Submission* 19, p. [3].

38 *Submission* 19, p. [3].

39 *Submission* 5, pp. 4-5.

it proposed that FRC members should be appointed on the basis of merit rather than as representing particular sectional interests.[40]

4.48 Mr Brian Long, Ernst & Young, thought the FRC needed to be smaller. Taking into account the FRC's proposed expanded responsibilities, he advocated 'a group with complementary skills' with members from accounting and auditing backgrounds, the investment community and other areas needing representation.[41]

The Committee's view

4.49 On the evidence, the Committee has concluded that there is room for improvement in the membership mix of the FRC, particularly given its proposed new responsibilities. Certainly, Mr Charles Macek acknowledged that changes were needed in this area when he told the Committee:

> I think in a new board that would be by definition a smaller board, there would need to be a diversity of skills, an appropriate mix of skills. There would need to be a diversity of background, perspective and understanding. When one thinks of the different perspectives that ought to be reflected around such a board table they would include—I prefer to use these words—the user or investor perspective rather than public interest. They would certainly need to include the profession. They would need to include preparers and they would need to include the regulator.[42]

4.50 Mr Macek's comments about the need for a 'diversity of skills' and 'different perspectives' including the 'user or investor perspective' is consistent with most of the suggestions advanced by other witnesses to this inquiry.

4.51 The Committee believes that the FRC's membership must be appointed, at the very least, according to the type of criteria that apply to the AASB and that is proposed for the AUASB. This will ensure that the public interest is being served through the appointment of people who have the skills and experience to make a valuable contribution as members of the FRC.

Recommendation 11

4.52 The Committee recommends that the *Australian Securities and Investments Act 2001* should be amended so that members appointed to the Financial Reporting Council must have knowledge of, or experience in, business, accounting, auditing or law; or can demonstrate a sufficient involvement in the investment community or interest in corporate reporting to bring a user's perspective to the Council.

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40 *Submission* 14, p. 4.

41 *Committee Hansard*, 6 April 2004, p. CFS 35.

42 *Committee Hansard*, 29 April 2004, p. CFS 32.

Recommendation 12

4.53 The Committee recommends that the membership mix of the Financial Reporting Council should be evenly weighted between preparers of financial statements; accountants and auditors; and business and public interest representatives and users.

Funding

4.54 The FRC will have responsibility for approving and monitoring the AUASB's budgets, 'monitoring and periodically reviewing [its] level of funding and funding arrangements' and seeking contributions towards the costs of auditing standard setting.[43] These mirror arrangements in place for the AASB.

4.55 When the Part 12 arrangements were introduced on 1 July 2000, the Government intended that funding would be provided in equal measure by Commonwealth, State and Territory governments, the accounting bodies and the Australian business community.[44]

4.56 Submissions to this inquiry raised serious concerns about the funding arrangements and queried whether the FRC and other bodies would have sufficient funding to properly discharge their responsibilities.

4.57 By June 2003, it was clear that the tripartite arrangements were not working. The Australian Stock Exchange Ltd (ASX) had announced that after February 2004, it would be withdrawing the rent-free accommodation provided to the AASB. There had been a 'lower than expected level of voluntary financial contributions from the business sector' and the accounting bodies had advised that they were not prepared to commit to funding beyond December 2003 at which time they would reassess their contributions in light of CLERP 9.[45]

4.58 On 11 September 2003, the then Parliamentary Secretary to the Treasurer, Senator The Hon. Ian Campbell, when announcing the provision of an additional $2 million in funding for convergence and CLERP 9 activities, referred to the failure of the business sector to meet funding expectations and implied that the Government might resort to fundraising through mandatory levies.[46]

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43 Proposed subsection 225(2A) ASIC Act.

44 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 15. See also *Accounting Standards, Building international opportunities for Australian business,* Corporate Law Economic Reform Program, Proposals for Reform, Paper No. 1, Department of the Treasury, Canberra, September 1997, p. 41.

45 *Bulletin of the Financial Reporting Council*, 2003/2—26 June 2003, p. 2.

46 Press Release no. 047, *Government boosts funding for Financial Reporting Council*, 11 September 2003.

4.59 At that time, the FRC Chairman, Mr Charles Macek, had publicly expressed dissatisfaction with current arrangements and said there was a need for a 'robust [funding] framework':

> …where no one has to do again what my predecessor Jeff Lucy did, going cap-in-hand begging for corporates to contribute in order for us, as a statutory body, to do the job government has legislated for us to do. That's an absurdity.[47]

4.60 Echoing Mr Macek's sentiments, Mr Keith Alfredson told the Committee that it was a misuse of the FRC's time and 'totally wrong for the FRC to be given a job to go cap in hand to corporates and ask for donations'.[48] He proposed that funding should come from ASIC's revenue or through levies imposed on publicly-listed companies. He saw a danger in soliciting contributions from companies in that they 'could be interpreted as trying to gain influence through the making of donations'. He implied that funding should not be such an issue and said:

> We are just talking about petty cash. The budget of the Accounting Standards Board is only a few million bucks. Another million is only a drop in the ocean.[49]

4.61 The Group of 100 thought a new funding model was needed and expressed a preference for the levying of annual fees to be collected by ASIC. They added that their membership was 'comfortable' with this proposal.[50]

4.62 The Law Council of Australia (LCA) supported the establishment of the AUASB under the 'auspices' of the FRC and commented on 'the administrative convenience of a single oversight body for the financial reporting framework.' However, funding was a concern:

> The Committee is unclear how it is intended to fund the FRC and by proxy the AUASB. The Committee is aware of the recent need for the Government to inject an additional $2 million into the Financial Reporting Council. It would seem the existing funding arrangements—one-third each from the Commonwealth, State and Territory Governments, the accounting bodies and business—have not been successful, there would seem to be an urgent need to find a solution to longer-term funding of the FRC and therefore the AUASB.
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> …if the monitoring functions of the FRC are going to be meaningful they will need the capacity to engage personnel on a full, contract or part-time basis and this requires substantial funding.[51]

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47 *Australian Financial Review*, 'Companies to face audit levy', 15 September 2003, p. 6.

48 *Committee Hansard*, 14 April 2004, p. CFS 54.

49 *Committee Hansard*, 14 April 2004, p. CFS 54.

50 Mr John V Stanhope, *Committee Hansard*, 18 March 2004, p. CFS 107.

51 *Submission* 24, p. 3.

4.63 The ANZ Bank predicted that the FRC would need 'substantial additional resources' to fund its proposed new activities, and urged the resolution of funding difficulties as 'a matter of priority'.[52]

4.64 For the AICD, independence was an important aspect of the funding arrangements. The AICD expressed its support for the establishment of the AUASB but cautioned that its independence should be 'both real and perceived' and not 'compromised by the FRC having control over its funds'. The AICD proposed that the AUASB should be permitted to use funds for purposes agreed with donors, subject to the FRC's confirmation that the purposes were consistent with the AUASB's role.[53]

4.65 The Investment and Financial Services Association Ltd (IFSA) was strident in its criticism of the funding arrangements and submitted that:

> …it is inappropriate, and impractical, for a body that has a fundamental role to play in the Australian corporate regulatory structure to be made responsible for seeking contributions to the costs of overseeing the Australian accounting and auditing standards setting process.
>
> The oversight of the accounting and auditing standards setting process is fundamental to corporate regulation and should be funded by Government. Accounting and auditing standards, having the force of law, serve a public purpose and IFSA recommends should be funded from ASIC revenue collections.
>
> The regulatory nature of the intended role to be performed by the FRC in connection with accounting and auditing standards is underpinned by the responsibility for standards having the force of law in Australia under the Corporations Act 2001. Those standards are to be legislative instruments that are disallowable for the purposes of the *Acts Interpretation Act* 1901. Additionally, it is noted that a failure to comply with a notice issued by the FRC in the performance of its regulatory duties is an offence (section 225A(7) and (8)).[54]

4.66 It was IFSA's view that funding should be 'through normal government funding arrangements'.[55]

The Committee's views

4.67 It is obvious that the present funding model needs a complete overhaul. As Mr Charles Macek, FRC, told the Committee:

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52 *Submission* 14, p. 4.

53 *Submission* 35, p. 8.

54 *Submission* 44, pp. [1-2].

55 *Committee Hansard*, 16 March 2004, p. CFS 2.

> The resources question has been a perennial thorn in our side since the establishment of the council at the end of 1999. I have been on the council since its inception, and a large amount of council time has been spent on one of our requirements, which is to seek funding, which is not particularly productive.[56]

4.68 Mr Macek told the Committee that the Government had acknowledged the shortcomings with the present model and would be providing funding that was more commensurate with the FRC's requirements. The Committee notes Mr Macek's further comments that funding arrangements must 'stand up to any rigorous scrutiny by overseas regulators such as the PCAOB as to the soundness of our system in Australia'.[57]

4.69 While the Committee welcomes the additional $3.4 million provided by the Government for the FRC's activities in 2004-05,[58] the Committee has not seen confirmation that the FRC and the standard-setting bodies can look to the Government for their funding needs beyond 2004-05.

Recommendation 13

4.70 The Committee recommends that the Government should confirm that it will provide the funding for the Financial Reporting Council, the Australian Accounting Standards Board and the Auditing & Assurance Standards Board on a permanent basis beyond 2004-05.

4.71 Another issue for the Committee's consideration is whether the FRC should have control over the AASB's and the AUASB's funding. The Committee looks at the FRC's powers to approve the budgets and business plans of these bodies in the next section and concludes that this power is inconsistent with the preservation of the AASB's and AUASB's independence.

Powers

4.72 As already discussed, FRC members and its chair are appointed by the Minister on terms and conditions determined by the Minister.[59] The FRC has extensive powers in relation to the AASB. Notably, it appoints AASB members (except for the Chair) and approves and monitors the AASB's:

- priorities;

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56 *Committee Hansard*, 29 April 2004, p. CFS 16.

57 *Committee Hansard*, 29 April 2004, p. CFS 16.

58 The Commonwealth Treasurer, Press Release No. 039, 11 May 2004 – *Financial Reporting Council—improved accounting and auditing standards setting arrangements*.

59 Section 235A ASIC Act. The Minister may make an appointment by specifying an organisation or body to select the appointee.

- business plan;
- budget; and
- staffing arrangements (including level, structure and composition of staffing).[60]

4.73 The FRC determines the AASB's 'broad strategic direction'[61] and has power to direct, advise and give feedback on 'matters of general policy and the AASB's procedures'.[62] The AASB must comply with 'directions about its procedure' and consider 'the advice and feedback about its procedure' given by the FRC.[63]

4.74 Similar powers will apply to the FRC in relation to the AUASB.[64]

4.75 The FRC's power to set the 'broad strategic direction' of the AASB was the subject of some controversy when the standard-setting regime was first introduced. The argument raised was that the FRC's ability to exercise this power was in direct conflict with another provision expressly providing that the FRC could not 'direct the AASB in relation to the development, or making, of a particular standard' or 'veto a standard formulated and recommended by the AASB'.[65]

4.76 The application of the same powers to the FRC in relation to the AUASB rekindled the interest of some witnesses to the inquiry who were not satisfied that they were consistent with an independent standard-setting process.

4.77 Mr Tom Ravlic told the Committee that he was 'less than satisfied' that the powers of the FRC had not been clarified in relation to the standard-setting bodies.[66] His main concern was with the FRC's power to set the broad strategic direction of these bodies which he considered militated against their independence. He said in this regard that:

> Allowing the FRC the luxury of setting strategic directions places it too close to the task of the setting of the standards themselves. That is a fundamental breach of independence, real and perceived, because it an oversight body is then engaged by that very act in the setting of standards…While the council as an entity is prohibited from interfering with the drafting of a specific standard it is allowed to dabble in the standard setting sphere by setting a specific strategic direction…The council is an

60 Paragraph 225(2)(c) ASIC Act.

61 Paragraph 225(2)(d) ASIC Act.

62 Paragraph 225(2)(e) ASIC Act.

63 Subsection 236A(3) ASIC Act.

64 Proposed section 225 ASIC Act.

65 Subsections 225(5) and (6) ASIC Act.

66 *Submission* 1A, p. 6.

> oversight body. Decision making related to strategic directions takes it over the line…[67]

4.78 Mr Ravlic proposed that Australia should follow the example of the Financial Accounting Foundation in the United States which, in his understanding, did not have this power. He claimed that Sir David Tweedie, when Chairman of the International Auditing and Assurance Standards Board in the United Kingdom, had also opposed the FRC's having such a power.[68]

4.79 Mr Keith Alfredson was another who saw an inconsistency in this power and the independence of the standard-setting function:

> The FRC can set strategy but it cannot intervene in the technical content of standards. It is a bit of a strange one. You set up a strategy that says to adopt the international standards and in one fell swoop you have adopted the technical content of international standards.[69]

The Committee's views

Background—a previous inquiry

4.80 The Committee reviewed the Part 12 provisions, among others, during its inquiry into the Corporate Law Economic Reform Program Bill 1998.[70]

4.81 This legislation had reconstituted the AASB as a body corporate for the purposes of the *Commonwealth Authorities and Companies Act 1997* and gave it sole responsibility for the standard-setting functions of the former AASB and the Public Sector Accounting Standards Board (PSASB), namely, to 'make accounting standards under section 334 of the Corporations Act[71] for the purposes of the corporations legislation' and 'to formulate accounting standards for other purposes'.[72]

4.82 The new arrangements were intended as a response to the concerns of the business community that 'the standard setting process [was] captured by the accounting profession' and offered 'no real accountability to users'.[73]

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67 *Submission* 1A, p. 7.

68 *Committee Hansard*, 14 April 2004, pp. CFS 8-9.

69 *Committee Hansard*, 14 April 2004, p. CFS 51.

70 See the Parliamentary Joint Committee on Corporations and Securities, *Report on the Corporate Law Economic Reform Program Bill 1998*, May 1999.

71 An accounting standard made under section 334 has the force of law.

72 Section 227(1) ASIC Act.

73 Corporate Law Economic Reform Program Bill 1998, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 8-9.

4.83 The professional accounting bodies and the AASB raised concerns about the operational independence of the AASB, particularly in view of the FRC's powers to set policy directions for the AASB. The AASB said in this regard that:

> …if there are technical proposals being developed by the AASB that are a worry to the FRC, in the guise of setting priorities or allocating the funds the FRC will have the opportunity to have a greater technical influence than appears to be the intention.[74]

4.84 The majority report of the Committee supported the Government's policy objective of bringing Australian standards into line with international standards provided they enhanced the quality of financial reporting and opened up access to overseas capital markets. In response to concerns about the AASB's independence, the Committee was satisfied that there were sufficient checks and balances in the legislation to maintain its independence. Among other things, the Committee was assured that the disallowable instrument status of the accounting standards would help to safeguard their integrity by exposing them to Parliamentary review. In addition, the Committee noted that:

> The processes of the FRC should be transparent and accountable, and the Committee envisages the FRC holding its meetings in public session.[75]

4.85 The minority reports of the Australian Labor Party Members and the Australian Democrats both expressed concerns about the independence of standard-setting arrangements. The Labor Party members' report indicated that its members were:

> …somewhat concerned about the Financial Reporting Council's oversight of the standard setter the Australian Accounting Standards Board (AASB), particularly in setting the AASB's priorities, its business plan, budget and staffing arrangements.[76]

4.86 Senator Andrew Murray, Australian Democrats, thought the Minister's powers to appoint and set the terms and conditions of members of the FRC and the AASB chairman raised questions about the independence of these bodies. He distinguished these arrangements from those in the United Kingdom and commented that:

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74 Mr David Boymal, representing the ICAA and CPAA, *Committee Hansard*, 13 July 1998, pp. CS 22-23.

75 *Report on the Corporate Law Economic Reform Program Bill 1998*, Parliamentary Joint Committee on Corporations and Securities, May 1999, Chapter 5.

76 *Report on the Corporate Law Economic Reform Program Bill 1998*, Parliamentary Joint Committee on Corporations and Securities, May 1999, p. 66.

> We lack not only the external scrutiny mechanism in the form of the [UK] Commissioner for Public Appointments, but more fundamentally we do not have even basic procedural safeguards.[77]

4.87 Senator Murray proposed that these shortcomings 'should be addressed as a matter of public importance, with a far higher priority…than has hitherto been the case'.[78] In the Senate, the Australian Democrats proposed several changes to the standard-setting arrangements proposed in the Bill but these were defeated.

Findings of the current inquiry

4.88 It appears that the legislation setting out the respective powers and responsibilities of the FRC and the AASB had been intended to protect the independence of the standard-setting function. Although this might be debatable on a reading of the legislation itself, the following excerpt from the Explanatory Memorandum for the Corporate Law Economic Reform Program Bill 1998 discloses a clear intention to protect the independence of the AASB's standard-setting function:

> The provisions have been designed to ensure that the FRC is in a position to provide broad oversight over the standard setting process without being able to determine the content of particular standards. In particular, the FRC will not have any influence over the technical deliberations of the standard setter and will not be able to veto, either in whole or in part, any accounting standard made by the standard setter.[79]

4.89 The Committee is disturbed that its confidence in the transparency and accountability of the FRC as a safeguard against the erosion of the AASB's independence may have been misplaced. As this current inquiry indicates, the FRC has not conducted its meetings in open session as the Committee had envisaged and serious questions have been raised about its accountability.

4.90 The Committee therefore believes the legislation needs to be amended to ensure that the FRC is not empowered to set the 'broad strategic direction' of the AASB or the AUASB. It appears that, in practice, the FRC's exercise of this power can equate to setting the technical content of a standard.

4.91 The Committee considers that the FRC's powers to approve the priorities, business plans and budgets of the AASB and AUASB constitutes another threat to the independence of these bodies.

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77 *Report on the Corporate Law Economic Reform Program Bill 1998*, Parliamentary Joint Committee on Corporations and Securities, May 1999, p. 74.

78 *Report on the Corporate Law Economic Reform Program Bill 1998*, Parliamentary Joint Committee on Corporations and Securities, May 1999, p. 74, paragraph 3.9.

79 Corporate Law Economic Reform Program Bill 1998, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 87.

4.92 In this regard, the Committee notes the concerns expressed by the accounting bodies that the AASB might not be as independent as it should be, one reason being the FRC's power to approve and monitor the AASB's budget. The comment was made that:

> The one thing that does concern us about the FRC is that, although there are statements in the document indicating that the FRC is not to have a controlling influence on the Australian Accounting Standards Board, we feel that the influence has the potential of being greater than it may first appear. That is because the FRC appears to control the purse strings; the FRC appears to control the priorities. Quite frankly, if one does control the purse strings and the priorities, there can be a considerable amount of influence over the AASB which is supposed to be independent.[80]

Recommendation 14

4.93 The Committee recommends that the Bill should be amended so that the Financial Reporting Council will not have a function of 'determining the Auditing & Assurance Standards Board's (AUASB's) broad strategic direction'. Instead, the Financial Reporting Council should produce and make public its critique of the AUASB's strategic direction as part of the Financial Reporting Council's oversight function.

Recommendation 15

4.94 The Committee recommends that the Bill should be amended so that the Financial Reporting Council will not have a function of 'approving' the Auditing & Assurance Standards Board's (AUASB's) priorities, business plans and budgets. Instead the Financial Reporting Council should produce and make public its critique of the AUASB's priorities, business plans and budgets.

Recommendation 16

4.95 The Committee recommends that the *Australian Securities and Investments Act 2001* should be amended so that the Financial Reporting Council will no longer have a function of 'determining the Australian Accounting Standards Board's (AASB's) broad strategic direction'. Instead, the Financial Reporting Council should produce and make public its critique of the AASB's strategic direction as part of the Financial Reporting Council's oversight function.

Recommendation 17

4.96 The Committee recommends that the *Australian Securities and Investments Act 2001* should be amended so that the Financial Reporting Council will no longer have a function of 'approving' the Australian Accounting

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80 Mr David Boymal, *Committee Hansard*, 13 July 1998, p. CFS 24.

Standards Board's (AASB's) priorities, business plans and budgets. Instead the Financial Reporting Council should produce and make public its critique of the AASB's priorities, business plans and budgets.

The FRC's role regarding auditing standards and auditor independence

4.97 The Bill proposes, among other things, that the FRC will:

- provide broad oversight of the processes for setting auditing standards in Australia; and
- monitor the effectiveness of auditor independence requirements in Australia.[81]

4.98 A number of submissions were unsure what the FRC's role in monitoring auditor independence would involve.

4.99 The ASX argued that the FRC's oversight role in the auditing sphere was unclear and involved 'powers and duties which relate partly to auditing in general and partly to auditor independence'. The ASX proposed that the legislation should reflect that the FRC's 'relevant primary function' should be 'oversight of audit quality, of which auditor independence is an aspect'.[82]

4.100 The ASX's proposal found support with Mr Brian Long, Ernst & Young, who considered that audit quality and auditor independence were 'naturally linked and equally important'. He said he did not see how the FRC could oversee one and not the other. He agreed that the FRC's oversight should relate to audit quality of which auditor independence was one aspect.[83]

4.101 The focus of Mr Keith Alfredson's concerns was that the FRC's oversight functions for auditor independence would involve a compliance function. He said in this regard that:

> If overseeing auditing independence means going to accounting firms and seeing how they actually operate their independence, I consider that to be compliance and ASIC should do that.[84]

4.102 He did not think that the FRC's role should be 'one of monitoring or overseeing actual independence on specific audits'. Furthermore, it was his view that the FRC did not have the necessary surveillance or technical staff to do this. He

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81 Proposed paragraphs 225(1)(b) and (c) ASIC Act.

82 *Submission* 48, p. [1].

83 *Committee Hansard*, 6 April 2004, p. CFS 34.

84 *Committee Hansard*, 14 April 2004, p. CFS 53.

proposed ASIC as the more appropriate agency to take on this role and suggested it could be undertaken 'hand in hand with [ASIC's] accounts surveillance program'.[85]

The Committee's views

4.103 The first issue the Committee will deal with concerns the question of whether the FRC's function of monitoring auditor independence will take it into a compliance or enforcement area.

4.104 The Committee does not think the legislation supports this conclusion and notes that the emphasis in the Bill is on the FRC's 'monitoring' function.

4.105 Of the general functions listed, for example, the FRC is to '*monitor* the effectiveness of auditor independence requirements'.[86] The Bill provides further clarification in its provisions relating to the FRC's special functions which, in proposed subsection 225(2B), will include '*monitoring* and assessing' systems and processes used by auditors, etc; and '*monitoring* the overall compliance by companies…with the audit-related disclosure requirements of the Corporations Act'.

4.106 Should there still be room for doubt, the Committee notes the confirmation in the Explanatory Memorandum that the FRC's auditor independence function is 'purely one of monitoring activities and/or developments'. It goes on to say that:

> Enforcement of auditor independence requirements is the responsibility of either ASIC or the accounting bodies, depending on whether the independence requirement is contained in the Corporations Act or a code of professional conduct of one of the bodies.[87]

4.107 The other matter raised in the evidence concerns the nature of the FRC's monitoring role itself and whether the focus should be on audit quality with auditor independence being only one aspect of this.

4.108 The Committee notes the evidence of Mr Charles Macek, FRC, supporting the view that the FRC's monitoring role should be on audit quality and aspects of this including auditor independence and auditor competence, the latter which he referred to as 'probably…by far the most important'.[88]

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85 *Committee Hansard*, 14 April 2004, p. CFS 50.

86 Proposed paragraph 225(1)(c) ASIC Act.

87 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 86.

88 *Committee Hansard*, 29 April 2004, p. CFS 10.

4.109 Mr Macek explained that part of the rationale for wanting a broader remit was 'that in the minds of the public the FRC would be held responsible for any failures in the area of audit, which may not necessarily be duly a function of independence'.[89]

4.110 The Committee is concerned that conferring a broader monitoring role on the FRC could result in a conflict with ASIC's operations. The Committee would need more evidence than was presented at this inquiry to persuade it to recommend a course contrary to that adopted in the Bill.

FRC—other functions and powers

4.111 To assist in its monitoring and assessment of auditor independence, the Bill provides for ASIC and the Companies Auditors and Liquidators Disciplinary Board (CALDB) to disclose information to the FRC; and the FRC and AASB to disclose information to the CALDB and the professional accounting bodies.[90] Under the proposed amendments, the FRC will have powers to issue a notice (a FRC notice) to a professional accounting body requiring it to provide the FRC with:

- a copy of the body's professional code;
- information about the body's planning or quality assurance reviews; or
- details of the body's investigation or disciplinary procedures,

but only to the extent that the information relates to audit work done by Australian auditors.[91]

4.112 Professional accounting bodies and those acting on their behalf will have qualified privilege regarding disclosures made in response to a FRC notice.

4.113 The FRC will also have power to require an auditor to give it information or documents:[92]

- relating to audits involving the auditor;
- measures used by the auditor to ensure the auditor's independence; or
- any other matters.

4.114 Again, qualified privilege will apply to the auditor's response.[93]

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89 *Committee Hansard*, 29 April 2004, p. CFS 10.

90 Proposed amendments to ASIC Act—sections 127 (disclosures ASIC to the FRC), 213 (disclosures the CALDB to the FRC) and 237 (the FRC and AASB to the CALDB and accounting bodies).

91 Proposed subections 225A(1) and (2) ASIC Act.

92 The proposed legislation allows for the production of copies of documents.

93 Proposed subsections 225A(5) and (6) ASIC Act.

4.115 An auditor's non-compliance with a FRC notice to produce information or a document, will constitute a strict liability offence. A defence will be available to the member of an audit firm if the member did not know when the non-compliance occurred that the notice had been given to the firm, and the member took all reasonable steps to ensure compliance as soon as possible after the member became aware of the notice.[94]

4.116 Changes to the exposure draft of the Bill now incorporated into the Bill's provisions accommodate several of the proposals put forward by the ICAA and CPAA. However, their suggestion that a penalty should only be imposed for a failure to supply existing documents and not a failure to provide information that must be generated into a document has not been adopted.

4.117 The ICAA/CPAA submission expresses concerns that the FRC's annual report to the Minister regarding its auditor independence functions[95] might impugn the reputation of an auditor or unnecessarily publicise auditor or client information. Endorsing the approach taken by the Sarbanes-Oxley Act in the United States, the submission proposes that:

- auditors to be named in a report be given an opportunity to respond;
- the FRC give consideration to incorporating the response in the report; and
- publication of auditor or client names or confidential information only be permitted if the FRC considers it is necessary to properly discharge its functions.[96]

4.118 Mr Tom Ravlic thought the FRC's information-gathering powers should be more widely framed to apply directly to companies as well:

> Information gathering powers Section 225A are inconsistent. There should be a provision that gives the FRC powers to demand information from Australian or overseas companies that have Australian subsidiaries in relation to their decision making processes in awarding contracts to audit firms and others to examine whether they are living up to their audit committee charters or board charters. The other side of the transaction, if you like, also needs to be examined by the FRC. I don't buy the argument that the ASX corporate governance guidelines deal with some of these types of disclosures. The law empowering the FRC should be able to capture companies as well as their advisers/auditors. This is another example of where the legislation reflects some inequities between the way the accounting profession is being treated when compared with others.[97]

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94 Proposed subsection 225A(13) ASIC Act.

95 Proposed section 235BA ASIC Act.

96 *Submission*s 31 (CPAA) and 36 (ICAA), pp. 13-14 of attachment.

97 *Submission* 1A, Attachment, p. 5.

4.119 The ASX suggested that the FRC should be able to test information about a professional accounting body's operations and procedures which it gathered using its powers under proposed subsections 225A(1) and (2) of the ASIC Act.[98] In this regard, the ASX said:

> ASX is concerned that this limitation may adversely affect the FRC's discharge of its statutory functions.[99]

4.120 The ASX noted that the FRC had powers to require individual auditors to provide information about audits conducted by the auditor and argued that:

> It is not clear what use the FRC would make of information obtained from the individual auditor. For example, can the FRC refer onwards any evidence of substandard audit quality; say to ASIC or the CALDB or the professional bodies?[100]

4.121 The ASX also raised concerns that auditors breaching professional confidence obligations to clients when complying with FRC notices to produce would not be adequately protected and proposed that specific statutory protection be provided.[101]

4.122 The Explanatory Memorandum goes some way to answering the ASX's questions—at least regarding the options available to the FRC when following up instances of substandard auditing:

> The purpose of [the information gathering powers] is to enable the FRC to obtain information about the systems and processes that have been put in place by auditors and to assess, by reference to material about individual audits, whether those systems and processes are being followed by the auditor when it conducts an audit…
>
> To facilitate the FRC's function of monitoring auditor independence, amendments are proposed…to allow ASIC and the CALDB to provide information to the FRC and for the FRC to provide information to the CALDB and the professional accounting bodies. Paragraph 237(2)(d) already enables the FRC to provide information to ASIC.[102]

4.123 Chartered Secretaries Australia (CSA) had this to say about the FRC's information-gathering powers:

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98 The FRC has powers to require obtain information from a professional accounting body about the body's code, quality assurance reviews, and its investigation or disciplinary procedures.

99 *Submission* 48, p. 1.

100 *Submission* 48, p. 2.

101 *Submission* 48, p. 2.

102 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 87.

> …CSA cannot understand why the papers of an individual company's audit must be released if requested, yet the information gathered by an accounting body in relation to that audit, stemming from a review of the auditors' activities, are not available, notwithstanding that the accounting body does have the right to refer its concerns to ASIC. Both pieces of information should be available.[103]

The Committee's views

4.124 The Committee supports the joint submission of the ICAA and CPAA that the principles of natural justice should apply to auditors who are to be named in the FRC's report to the Minister.

4.125 Due to time constraints, the Committee was unable to fully explore the issues raised about the FRC's information-gathering powers. However, given that the FRC is not intended to carry out compliance or enforcement functions, it appears that calls to extend the FRC's powers in the enforcement arena are inconsistent with that limitation.

4.126 The Committee notes that the FRC will have powers to require a professional accounting body to provide it with details of the body's investigation or disciplinary procedures. Its role will also extend to giving the Minister and professional accounting bodies reports and advice on the investigation and disciplinary procedures of the professional accounting bodies. However, the FRC will not have powers to require the professional accounting bodies to meet specific complaints-handling standards.[104]

4.127 Although evidence to the Committee did not directly concern the FRC's powers regarding the professional bodies' disciplinary procedures, the Committee is disturbed to note allegations made in an article recently published by the *Business Review Weekly*. This article raises questions about the reliability of the co-regulatory model adopted by CLERP 9 for audit reform.

4.128 The main thrust of the argument is that, for the co-regulatory model to work, it is essential that the professional bodies' disciplinary arrangements are effective in identifying and appropriately disciplining members who do not comply with professional requirements. The article suggests that effective discipline depends to an extent on effective complaints handling. This is certainly the view of the Commonwealth Ombudsman, Professor John McMillan, who is quoted in the article as commenting generally about complaints and discipline that:

> The two are independent in a sense, but complaints handling systems alert you to discipline issues. In a professional services regulatory body, the

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103 *Submission* 8, p. 5.

104 Proposed subsection 225(2B) ASIC Act.

> major purpose of a complaints system is to identify disciplinary issues that are then taken up. One feeds into the other.[105]

4.129 The article listed a series of what it claimed were flaws in the complaints-handling procedures of the professional bodies. Among the allegations were that the professional bodies:

- did not publicise the availability of complaints handling systems to consumers nor did they require their members to do so;
- kept no statistics about the numbers and types of complaints received; response time or outcomes; and
- did not seek feedback from consumers on how their complaints handling systems might be improved.

4.130 These clearly fell short of the benchmarks set by the Commonwealth Ombudsman for effective alternative dispute resolution.[106]

4.131 The Explanatory Memorandum makes it clear that the Bill's auditing reforms adopt the co-regulatory model preferred in the Ramsay Report. The Ramsay Report said this about such a model:

> The current regulatory environment for the independence of auditors in Australia can be described as co-regulatory…
>
> …the recommendations contained in this report have, as one of their key objectives, continuing this co-regulatory environment. We recommend strengthening and updating section 324 of the Corporations Act in relation to the independence of auditors…At the same time, we see a strengthened role for the professional accounting bodies in updating their professional requirements and codes of ethics and providing leadership to the profession in terms of auditor independence. We believe the professional accounting bodies are well placed to play a central role in ensuring their auditors remain independent of their clients. It is appropriate to look to these bodies to fulfil this task…[107]

4.132 Professor Ramsay is reported in the *Business Review Weekly* article as indicating that his mandate for the Ramsay Report did not include an investigation of auditors' complaints and disciplinary procedures. He is quoted as saying that:

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105 Kath Walters, 'CLERP 9 and a flawed trio', *Business Review Weekly*, 3 June 2004, p. 46.

106 These benchmarks are quoted in the article from the Commonwealth Ombudsman's web site and are grouped under the headings: commitment, fairness, access, responsiveness, effectiveness and accountability.

107 Professor Ian Ramsay, *Independence of Australian Company Auditors, Review of the Current Australian Requirements and Proposals for Reform—Report to the Minister for Financial Services and Regulation*, Canberra, October 2001, p. 22.

> If those [systems] are lacking, then there would be cause for concern.[108]

4.133 According to the CEOs of the professional bodies interviewed for the article, they were adequately equipped to meet their co-regulatory responsibilities, and their complaints and disciplinary procedures were satisfactory.

4.134 While these issues were not raised in evidence to the CLERP 9 inquiry, the Committee nonetheless believes they deserve consideration at this stage.

4.135 The Committee said earlier that the FRC does not have power to require the professional accounting bodies to comply with specified complaints-handling procedures. It is the Committee's view that the FRC should not have such powers as they are inconsistent with the intended role of the FRC.

4.136 However, the Committee believes ASIC could work with the professional accounting bodies to ensure their complaints-handling systems meet benchmarks considered necessary for effective complaints handling.

Recommendation 18

4.137 The Committee recommends that the professional accounting bodies should liaise with the Australian Securities and Investments Commission (ASIC) to ensure that their complaints-handling procedures meet benchmarks which ASIC considers are necessary for effective complaints handling.

Conclusion

4.138 The Committee is disappointed that in the four years since the establishment of the FRC and the AASB under the ASIC Act, there has been controversy about the funding and performance of the standard-setting regime. In the Committee's view, these go beyond mere 'teething' problems and point to fundamental flaws in the design of the legislation. As this chapter illustrates, the Committee heard evidence which consistently reflected significant dissatisfaction—largely with the performance of the Financial Reporting Council.

4.139 The Committee believes the Government must move quickly to remedy the shortcomings which the Committee has identified. Certainly, the Committee does not agree to the Financial Reporting Council's taking on any new responsibilities until it has an independent, adequately staffed and funded secretariat, and is government-funded in accordance with the Committee's recommendations.

Recommendation 19

4.140 The Committee recommends that the Bill should be amended to ensure that the new responsibilities for the Financial Reporting Council should not come into force until:

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108 Kath Walters, 'CLERP 9 and a flawed trio', *Business Review Weekly*, 3 June 2004, p. 48.

- **the Financial Reporting Council has an adequately staffed and funded secretariat that is independent of the Department of the Treasury and other Government departments; and**
- **the Government confirms that the Financial Reporting Council will be government-funded beyond 2004-05.**

4.141 Furthermore, the Committee strongly urges the Australian National Auditor's Office to consider conducting a performance audit of the Financial Reporting Council's activities since its inception. The Committee believes this would be an important step towards restoring public confidence in the Financial Reporting Council and notes Mr Macek's comments that such a review would be worthwhile:

> Given that the FRC was established only at the end of 1999 and we are about to go into a changed role or an increased role for the FRC—and with any new organisation there is bound to be some learning that can be obtained by monitoring one's performance—I think it would be quite appropriate for there to be a comprehensive review of the FRC. It would include matters which I have already touched on, such as the composition of the board, the secretarial support and the location of that, amongst other matters.[109]

109 *Committee Hansard*, 29 April 2004, p. CFS 18.

CHAPTER 5

AUDIT REFORM—GENERAL AUDITOR INDEPENDENCE PROVISIONS

Introduction

5.1 One objective of the Bill is 'to establish best practice requirements on auditor independence in Australia'.[1]

5.2 To achieve this objective, the Bill adopts the approach envisaged in the Ramsay Report[2] which provides for a 'comprehensive legislative framework of auditor independence requirements in the Corporations Act…supplemented by the auditor independence rules of professional codes of conduct'.[3]

5.3 Before starting this review, the Committee looked to the Explanatory Memorandum for guidance on what, in seeking to strengthen 'auditor independence', the Bill intended to achieve. What qualities for example were encapsulated in the words, 'auditor independence'?

5.4 The Committee believes the following commentary from the Explanatory Memorandum provides useful benchmarks against which the Bill's 'auditor independence' proposals can be assessed:

> The sound operation of Australia's financial markets is dependent upon parties such as auditors providing information or services to investors free from any bias, undue influence or conflict of interest. Auditor independence is concerned with the auditor's capacity, including the perception of that capacity, to exercise objective and impartial judgement in relation to the conduct of an audit.[4]

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1 Corporate Law Economic Reform Program Bill (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 10-11.

2 Professor Ian Ramsay, *Independence of Australian Company Auditors, Review of the Current Australian Requirements and Proposals for Reform—Report to the Minister for Financial Services and Regulation*, October 2001, Canberra.

3 Corporate Law Economic Reform Program Bill (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 10.

4 Corporate Law Economic Reform Program Bill (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 9.

5.5 This commentary is consistent with the comprehensive definition provided in the ICAA and CPAA *Professional Statement F.1—Professional Independence* which says:

> *Independence* is:
>
> (a) *Independence* of mind—the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; and
>
> (b) *Independence* in appearance—the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a *firm's*, or a member of the *firm's* integrity, objectivity or professional scepticism had been compromised.[5]

5.6 The Bill seeks to safeguard auditor independence by minimising opportunities for conflicts of interest to arise, increasing auditors' accountability and requiring auditors to place a greater emphasis on risk management in the execution of their professional duties.

5.7 In this chapter, the Committee will review the following auditor independence requirements which are intended to focus auditors' minds on the necessity for their independence and increase their accountability:

- the auditor's general requirement of independence;
- the auditor's annual declaration of compliance with independence provisions of the Corporations Act and applicable professional codes; and
- the auditor's obligation to attend the AGMs of listed companies to answer reasonable questions about the audit report.

Auditor's general requirement of independence

5.8 The Bill imposes a general requirement for auditor independence by prohibiting an auditor from engaging in audit activity at a time when a conflict of interest situation exists in relation to the audited body. An auditor commits an offence if the auditor is aware of the conflict of interest situation but fails to act, or is not aware of the conflict of interest situation because there is not a proper quality control system in place that would identify such a conflict.

5.9 The test for independence is embodied in the definition of 'a conflict of interest situation'. Such a situation exists if because of circumstances at a particular time and in relation to the conduct of the audit of the audited body:

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5 Paragraph 14, Definitions.

- the auditor is not capable of exercising objective and impartial judgement; or
- a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgement.

5.10 This test is generally consistent with that proposed in the CLERP 9 discussion paper[6] and has met with wide acceptance.[7]

5.11 The Committee notes that the exposure draft of the Bill applied a more stringent test based on the HIH Royal Commissioner's recommendation that:

> …all standards of independence of auditors in Australia, including those contained in legislation and professional standards…[should] be consistent with the standard of independence defined as follows:
>
> An auditor is not independent with respect to an audit client if the auditor might be impaired—or a reasonable person with full knowledge of all relevant facts and circumstances might apprehend that the auditor might be impaired—in the auditor's exercise of objective and impartial judgment on all matters arising out of the auditor's engagement.[8]

5.12 Submissions to this inquiry overwhelmingly opposed the HIH test as being too broadly framed and out of step with commercial realities.

5.13 According to The Institute of Chartered Accountants in Australia (ICAA) and CPA Australia (CPAA), for example, the test was not objective or 'capable of clear application' and, given the potential criminal sanctions applicable for contravention, was unacceptable. The submission said further that the test was more restrictive than standards imposed by 'equivalent overseas regulatory regimes including the US

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6 *Corporate Disclosure, Strengthening the financial reporting framework—Corporate Law Economic Reform Program, Proposals for Reform: Paper No 9*, September 2002, Canberra.

7 Corporate Law Economic Reform Program Bill (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 46. Note that the Bill provides that the conflict of interest obligations are in addition to and do not derogate from any obligation imposed by the Act or a code of professional conduct.

8 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 171. However, the proposed definition of 'conflict of interest situation' adopts the Royal Commissioner's recommendation that references to an auditor should include an individual auditor and an audit firm and that all relevant circumstances such as relationships between the auditor (as an individual, audit firm or audit company) and the audit client should be considered when assessing the auditor's independence.

Sarbanes-Oxley Act[9] and section 8 of the International Federation of Accountants Code of Ethics which are reflected in Professional Standard F.1'. The ICAA and CPAA were concerned that regulation framed in such restrictive terms would damage the auditing profession and 'severely restrict the ability of Australian business to access essential skills and resources and…add significantly to the cost of compliance'.[10]

5.14 The UTS Centre for Corporate Governance was critical of what it called the 'High Court Judge test' and argued that:

- such a test was inappropriate and, in fact not achievable, in a commercial environment where 'the process of selection and payment [of auditors] is likely to be sufficient to create a perception that auditors *might* reasonably be unable to bring an impartial and unprejudiced mind (at the standard of a High Court Judge) to reporting discovered errors, irregularities and fraud' and

- the utility of the test in an HIH situation was questionable given that Andersens would have failed the lower threshold test—namely, that a reasonable person *would* assume impairment of their independence. This was despite the HIHRC's findings that Andersen's independence in fact had not been compromised.[11]

5.15 The Centre noted the Royal Commissioner's concerns about Andersen's reliance on information provided by HIH's actuary and contended that the auditor's independence would have been irrelevant if he or she did not have the competence to uncover problems with a client's accounting systems.[12]

5.16 The Centre thought that the 'reasonable man' test was more appropriate and recommended 'that this be dealt with as part of the auditing standards regulations and not by way of statutory law'.[13]

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9 As cited in the ICAA/CPAA joint submission, the standard set by the Sarbanes-Oxley Act in Rule 2-01(b) of SEC Regulation S-X provides that: *The Commission will not recognise an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.*

10 *Submission*s 31 (CPAA) and 36 (ICAA), pp. 41-4 of attachment.

11 *Submission* 21, p. 9.

12 *Submission* 21, p. 9.

13 *Submission* 21, p. 10.

5.17 The Committee agrees that the Bill's revised test, drawing on the Ramsay Report's recommendation, provides a more workable and commercially realistic basis on which auditor independence should be assessed.

Auditors' declaration of independence

5.18 The auditor's declaration of independence is intended to supplement the general requirement for auditor independence and again follows the recommendation of the Ramsay Report.

5.19 Proposed section 307C will require an individual auditor or lead auditor, as the case may be, to make a declaration regarding an audit of a financial year or half-year financial report that 'to the best of the [individual auditor's/lead auditor's] knowledge and belief':

- there have been no contraventions of auditor independence requirements and applicable codes of professional conduct in relation to the audit; or
- the only contraventions of the independence requirements and codes are those contraventions set out in the declaration.[14]

5.20 The declaration must be signed by the person making the declaration and given with the audit report to the directors of the relevant company, registered scheme or disclosing entity.

5.21 Failure to provide a declaration is a strict liability offence.[15] Furthermore, an individual may not claim exemption from the offence provisions on the basis that giving a declaration might tend to incriminate the individual or lead to a penalty.[16]

5.22 Direct or derivative use of information in the declaration may not be admissible in evidence against the individual in any criminal proceedings or proceedings exposing the person to a penalty except for an offence in relation to the declaration.[17]

5.23 The Committee received only minimal comment on this requirement.

5.24 Corporate Governance International Pty Ltd thought 'auditors self-certifying their independence' was 'ludicrous' and more a job for the audit committee.[18]

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14 Proposed subsection 307C(1) Corporations Act.

15 Proposed subsections 307C(2) and (4) Corporations Act.

16 Proposed subsection 307C(6) Corporations Act.

17 Sections 1308 and 1309 Corporations Act and an offence against 137.1 or 137.2 of the *Criminal Code* regarding false or misleading information or documents.

18 Mr Sandy Easterbrook, *Committee Hansard*, 9 March 2004, p. CFS 5.

5.25 The Committee asked Professor Ramsay how he thought this provision would affect auditors' independence in a practical sense. He responded that:

> One would hope that this sort of statement by the external auditor will not be a mere ticking of the box. If it works properly it will require the auditor to ensure that proper processes have been conducted within the audit firm and in the relationship between the audit firm and the client in order to make that statement. Of course there is a sting: for the first time it will be in the Corporations Act. If there are no proper compliance procedures in place, no proper monitoring and no proper reflection upon what is an appropriate relationship, there is quite a sting.[19]

5.26 The Committee does not oppose this requirement.

Auditors and AGMs

5.27 In line with CLERP 9's push to widen the opportunities for shareholder participation at annual general meetings (AGMs) and improve auditors' accountability, the Bill proposes to:

- make it mandatory for an auditor to attend the AGM of a listed company;[20]
- allow shareholders who will not be attending or asking questions at the AGM to submit, 'no later than the fifth business day' before the AGM, written questions about the content of the auditor's report or the conduct of the audit of the annual financial report to be considered at the AGM;[21]
- require the company to submit the questions to the company's auditor for preparation and return of a question list 'as soon as practicable after the time for submitting questions';[22]
- require the company 'at or before the start of the AGM' to make copies of the question list 'reasonably available to the members attending the AGM'.[23]

5.28 Proposed subsection 250T(1) requires the chair of an AGM to allow a 'reasonable opportunity':

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19 *Committee Hansard*, 18 March 2004, p. CFS 7.

20 Proposed section 250RA Corporations Act. An auditor who fails to attend or be represented at a company's AGM, commits a strict liability offence.

21 Proposed subsection 250PA(1) Corporations Act.

22 Proposed subsections 250PA(3)-(8) Corporations Act. Contravention by an individual auditor or lead auditor of an audit firm or audit company of the requirement to prepare and return to the listed company a question list is a strict liability offence.

23 Proposed subsection 250PA(9) Corporations Act.

- for members at the meeting to ask the auditor questions about the conduct of the audit and the auditor's report; and
- for the auditor to answer written questions submitted to the auditor under section 250PA.[24]

5.29 A chairman who contravenes this requirement commits a strict liability offence.[25]

5.30 These provisions received widespread support—albeit qualified in some instances.[26]

5.31 The Australian Council of Super Investors Inc (ACSI) was concerned that the Bill might not be wide enough to require auditors to answer reasonable questions about 'the basis upon which the financial statements had been prepared'.[27] Professor Robert Walker, appearing on behalf of ACSI, commented at the hearing that the legislation should clearly allow for 'qualitative discussion about whether [the auditor] agreed with [the selected] accounting choices or not'. This would ensure that shareholders' questions could not be dismissed by chairmen or auditors as dealing with issues outside the provision.[28]

5.32 The responses of several witnesses, when asked for their views about ACSI's concerns, agreed that it was reasonable to expect auditors to answer shareholders' specific questions about the accounting policies adopted by the company or the basis on which the accounts had been prepared.[29]

5.33 Professor Ian Ramsay commented in this regard that 'if there is an issue concerning a particular critical accounting policy and, if you like, good faith different interpretations, that is something that shareholders can quite legitimately ask a question in relation to and expect a meaningful answer'. Similarly, he thought shareholders' questions about the basis on which reports were prepared should be

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24 The proposed repeal of section 1289 with the substitution of new provisions will extend qualified privilege protections to auditors in relation to their answers to questions raised at the AGM or submitted to the auditor under section 250PA.

25 Proposed subsection 250T(2) Corporations Act.

26 See, for example, *Submission* 48 (ASX), p. 4; *Submission* 35 (AICD), p. 13; *Submission* 8 (Chartered Secretaries Australia), p. 5; *Submission* 19 (ASFA), p. [5] and Mr Keith Alfredson, *Committee Hansard*, 14 April 2004, p. CFS 60.

27 *Submission* 5, p. 8. See also Mr Phillip Spathis, *Committee Hansard*, 16 March 2004, p. CFS 70.

28 *Committee Hansard*, 16 March 2004, p. CFS 77.

29 See, for example, BDO Chartered Accountants and Advisers, *Committee Hansard*, 14 April 2004, p. CFS 79 and Mr Keith Alfredson, *Committee Hansard*, 14 April 2004, p. CFS 60.

permitted—'without necessarily wanting to have AGMs bogged down in minute detail, if there is something that is significant in terms of its outcome for the report'. [30]

5.34 Mr Douglas Gration, Chartered Secretaries Australia, thought it was 'completely appropriate' that shareholders should be allowed to ask auditors questions about the accounting policies adopted by management.[31]

5.35 The proposed provisions do not *require* auditors to answer written questions either at or after the meeting. The Explanatory Memorandum states in this regard that:

> Such a requirement would raise the issue as to whether the extra burden on auditors would lead to more useful information being disclosed. In addition, to require written questions to be answered would effectively elevate their status above questions asked orally at the AGM.[32]

5.36 The Committee received only one objection—from The Association of Superannuation Funds of Australia Limited (ASFA)—regarding the limitation on auditors' obligations to answer questions. While acknowledging the additional work involved and the 'potential for irrelevant or vexatious questions', ASFA proposed that auditors be required to answer 'reasonable shareholder questions within a reasonable period of time'.[33]

The Committee's views

5.37 The Committee welcomes the extended obligations placed on auditors and chairmen but believes the provisions should be amended to require auditors to answer shareholders' reasonable questions about:

- critical accounting policies adopted by management; and
- the basis upon which the financial statements were prepared.

5.38 The Committee believes shareholders' reasonable questions about the auditor's independence should be permitted given the purpose for external auditing of financial reports.

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30 *Committee Hansard*, 18 March 2004, p. CFS 6.

31 *Committee Hansard*, 18 March 2004, p. CFS 53.

32 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 131.

33 *Submission* 19, p. [5].

Recommendation 20

5.39 The Committee recommends that an auditor attending the annual general meeting of an entity should be required to answer shareholders' reasonable questions about:

- **critical accounting policies adopted by management and the basis upon which the financial statements were prepared; and**
- **the auditor's independence.**

Recommendation 21

5.40 The Committee recommends that the chairman of an entity should allow shareholders a reasonable opportunity to ask the auditor reasonable questions about:

- **critical accounting policies adopted by management and the basis upon which the financial statements were prepared; and**
- **the auditor's independence.**

5.41 The Committee does not support proposals to *require* auditors to respond to all questions asked given the potential extra costs involved. Having said this, the Committee would support a mandatory requirement if it appears that shareholders' reasonable written questions are not receiving sufficient attention at AGMs. Furthermore, the Committee does not object to an auditor, at a company's annual general meeting, tabling written answers to shareholders' questions lodged under proposed section 250PA of the Bill should the auditor wish to do so.

Recommendation 22

5.42 The Committee recommends that an auditor attending an annual general meeting should be permitted to table written answers to shareholders' questions which have been lodged in accordance with proposed section 250PA of the Bill if the auditor has prepared answers in this form.

CHAPTER 6

AUDIT REFORM—MINIMISING CONFLICTS OF INTEREST—EMPLOYMENT RESTRICTIONS

Introduction

6.1 In 2001, the Australian Securities and Investments Commission (ASIC) conducted a survey to gauge the extent to which external auditors and their clients were involved in relationships and practices generally considered to pose threats to auditor independence. Although, as ASIC cautioned, the survey was small—67 of Australia's 100 largest companies participated—the results were considered to be a 'useful addition' to available data on the issues covered.

6.2 ASIC's main findings were as follows:

- the provision of non-audit services by audit firms was widespread at least for major corporates;
- on average, non-audit fees represented about half of the total fees paid;
- processes within audited companies for dealing with potential conflicts of interest were generally lacking;
- there was minimal and inconsistent rotation of audit partners and no rotation of audit firms;
- few companies monitored investments in their securities by their auditors' superannuation funds;
- 'only a few companies' had former audit partners on their boards or employed former audit staff as senior executives; and
- the 'vast majority' had audit committees with 'appropriate operating guidelines'.[1]

6.3 The Bill seeks to regulate the types of employment and financial auditor/client relationships identified in ASIC's survey. Auditor rotation and the provision of non-audit services are also covered. According to the Explanatory Memorandum, the Bill applies restrictions to the employment and financial relationships referred to in

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1 ASIC media and information release 02/13, *ASIC announces findings of auditor independence survey*, 16 January 2002.

the Ramsay Report[2] as 'core circumstances which, if they exist, necessarily mean that the auditor is not independent'.[3]

Minimising threats to auditor independence—employment and financial relationships between auditor and audit client

6.4 Although the HIH Royal Commission (HIHRC) was unable to find evidence to conclude that Andersen's actual independence had been compromised, the perception was that it had been. One of the sources of this perception, according to the Royal Commissioner, was the employment relationships between former Andersen partners and HIH. In particular, he noted that three former partners of Andersen were on HIH's board—one having been appointed within 17 months of retirement, another the day following his resignation and the third, about five months after retiring from a 'significant' 25-year association with the HIH audit.[4]

6.5 Section 324 of the *Corporations Act 2001* (Corporations Act) places restrictions on the ability of an individual registered company auditor or a firm to undertake an auditing engagement for a company[5] with which the individual auditor or a member of the firm has an association. This association can be through employment or through personal or employment relationships with an officer of the company audited. A registered company auditor cannot be employed as an officer of the company. A registered company auditor cannot be a partner, employer or employee of an officer of the company nor can the auditor be a partner or employee of an employee of an officer of the company audited. A member of the firm likewise cannot have any association in any such capacity. In both cases, the individual registered company auditor or a member of the firm supplying audit services cannot be a debtor owing more than $5000 to the client company. A firm cannot act as a company's auditor if the firm pays an officer of the company for consultancy services on accounting or auditing matters.

6.6 As a further safeguard of auditor independence and in accordance with recommendations in the Ramsay Report and the HIH Royal Commission report, the Bill proposes to expand on existing prohibited auditor/client employment and financial relationships.

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2 Professor Ian Ramsay, *Independence of Australian Company Auditors, Review of the Current Australian Requirements and Proposals for Reform—Report to the Minister for Financial Services and Regulation*, Canberra, October 2001.

3 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 14.

4 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 176.

5 CLERP 9 will not apply to small proprietary companies defined in section 45A.

6.7 The Bill applies a range of specific restrictions on the employment and financial relationships between an audited entity and its auditors. Restrictions are also placed on certain relationships between former auditors and audited bodies.

6.8 Under the Bill, an auditor commits an offence if the auditor engages in audit activity at a particular time knowing that a prohibited relationship exists and the auditor fails to take 'all reasonable steps' to remedy this.

6.9 The Bill provides a defence if the defendant had reasonable grounds to believe a quality control system was in place providing reasonable assurance (taking into account the nature and size of the relevant audit practice) that there was compliance with independence requirements. Furthermore, for a prosecution to succeed where the prohibited relationship concerns a former professional employee or a former owner, former member of a firm or former member of a company, it must be proved that that person did not satisfy the independence test set out in the legislation.

6.10 The independence test is satisfied if the relevant person :

- does not influence the operations or financial policies of the audit practice;
- does not participate, or appear to participate, in the business or professional activities of the audit practice;
- does not have any rights against the audit practice regarding termination of the person's former employment as an auditor;
- has no financial arrangements with the auditor other than for regular payments of a fixed, pre-determined dollar amount which is not dependent on the revenues, profits or earnings of the auditor; and
- is not paid commission by the auditor for generating business to the auditor.[6]

6.11 Included among the categories of auditor on whom the Bill imposes additional employment prohibitions, are professional members of the audit team (professional team members) conducting the relevant audit and their immediate family members.[7] The definition of 'professional members of the audit team' applies not only to persons who play a direct professional role as registered company auditors in the conduct of an audit but also to 'any other person who is in a position to directly influence the outcome of the audit because of the role they play in the design, planning, management, supervision or oversight of the audit'.[8] As the Explanatory

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6 Proposed subsections 324CE(7), 324CF(7) and 324CG(11) Corporations Act.

7 An 'immediate family member' means 'a person's spouse or de facto spouse or a person who is wholly or partly dependent on the person for financial support'—proposed addition to section 9.

8 Proposed section 324AE Corporations Act.

Memorandum states, this definition 'is designed to cover the people in an audit firm or audit company who are most directly in a position to influence the audit'.[9]

6.12 In addition to extending prohibitions on the audit side, the Bill extends the types of positions in which an auditor cannot be employed by a former client (the audited body). These include:

- audit-critical employees[10] of the audited body; and
- partners, employers or employees of audit-critical employees of the audited body.

6.13 The existing prohibition on the payment of remuneration to a company officer by an audit firm for accounting or auditing consultancy services has been extended to cover:

- remuneration paid by an individual auditor, audit firm or firm member, audit company or company director or senior manager, or an acting entity;
- to an officer or an audit-critical employee of the audited body;
- 'for acting as a consultant'.

6.14 Note that this restriction applies to consultancy services generally and not merely those relating to accounting or auditing.

6.15 In accordance with recommendations in the Ramsay Report, restrictions on employment relationships between auditor and audited body expressly do not apply to small proprietary companies as defined in section 45A.

6.16 In addition to employment restrictions on auditors, the Bill places restrictions on financial relationships between auditor and audited body which implement the Ramsay Report's recommendations and are in line with IFAC and SEC rules.[11]

6.17 The Committee will now review the following three employment restrictions in the Bill which attracted significant debate:

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9 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 111.

10 An 'audit-critical' employee 'in relation to a company, or the responsible entity for a registered scheme, that is the audited body for an audit' is a person who 'is able, because of the position in which the person is employed, to exercise significant influence over a material aspect of the contents of the financial report being audited or the conduct or efficacy of the audit'—proposed addition to section 9.

11 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 117. (IFAC: International Federation of Accountants)

- the mandatory cooling-off period which auditors must observe before taking up employment with former clients;
- the 'multiple-officer restraint' applying to retiring auditors taking up senior positions with former clients; and
- audit partner rotation.

Cooling-off periods

6.18 Noting the extent of the employment relationships between former Andersen auditors and HIH, the HIH Royal Commissioner recommended the application of cooling-off periods as follows:

- for audit firm partners or key senior audit personnel directly involved in the audit of a client, there should be a four-year waiting period.
- for audit firm partners not directly involved in the audit of a client, there should be a two-year waiting period.

6.19 The Royal Commissioner opposed a two-year cooling-off period on the grounds that it 'might not be sufficient to arrest a reasonable apprehension that former partners retain an influence over members of the audit team'. He considered that the four-year period should apply to key senior personnel in the audit team as well as to audit firm partners so as not to 'lead to the compromise of the independence of the audit firm, or at least the perception of such a compromise'. He thought that the 'close relationships' key personnel were 'likely to have forged with other members of the audit team' would 'increase the possibility of management being able to exert influence over the auditor'.[12]

6.20 The four-year cooling-off period, adopted in the exposure draft of the Bill, received little support. Many submissions to this inquiry thought the proposal went further than was required and characterised it as excessive and onerous. The joint submission from The Institute of Chartered Accountants in Australia (ICAA) and CPA Australia (CPAA) articulated the following additional objections to the proposal:

- It was excessive compared with international requirements—two years in Europe and one year in the United States.
- Its application should be to partners who participated in the audit of the relevant audit client as in European and United States law.

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12 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol I, Canberra, April 2003, pp. 176-7.

- It would severely limit the availability of eligible people to sit on audit committees.[13]

6.21 Perhaps in response to the weight of opposition to the exposure draft proposal, the Bill has adopted a mandatory two-year cooling-off period. This prohibits a person from becoming an officer[14] of an audited body for two years if the person:

- ceases to be a member of an audit firm or director of an audit company and was a professional member of the audit team[15] engaged in an audit of the audited body.[16]

- ceases to be a professional employee[17] of the auditor if the person was a lead auditor or review auditor for an audit of the audited body.[18]

6.22 Under the Bill, a 'lead auditor' is the registered company auditor who is primarily responsible to the audit firm or audit company that is conducting the audit. A 'review auditor' is the registered company auditor (if any) who is primarily responsible to the individual auditor, the audit firm or audit company for reviewing the conduct of the audit.[19]

6.23 The amended provision in the Bill has been widely supported although the Law Council of Australia (LCA) argued that the provision was unnecessary. The LCA thought directors and boards should be the ones to assess any threats to independence posed by the employment of the entity's former auditor. Failing this and assuming a cooling-off period is mandated, the LCA proposed that the restriction should only apply to former partners. The LCA also proposed amendments to section 340 to give ASIC powers to grant relief, where considered appropriate, to persons affected.[20]

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13 *Submission*s 31 (CPAA) and 36 (ICAA), pp. 63-6 of attachment.

14 Proposed section 324CL Corporations Act specifies who is to be regarded as 'officers' of a company for the purposes of Division 3—Auditor independence.

15 Proposed section 324AE Corporations Act provides that the 'professional members of the audit team' are any registered company auditor who participates in the conduct of the audit, any other person who in the course of doing so, exercises professional judgment regarding the application of or compliance with accounting or auditing standards and legal requirements, and any other person who is in a position to directly influence the audit outcome.

16 Proposed section 324CI Corporations Act.

17 Proposed section 9 Corporations Act provides that a 'professional employee' of an auditor participates in the conduct of audits and in the course of doing so, exercises professional judgment regarding the application or compliance with accounting or auditing standards or legal requirements.

18 Proposed section 324CJ Corporations Act.

19 Proposed section 324AF Corporations Act.

20 *Submission* 24, p. 4. The LCA expanded on this argument at the hearing on 16 March 2004, *Committee Hansard*, p. CFS 49.

The Committee's views

6.24 The Committee notes the widespread support for this provision and cannot identify any compelling reasons to object to its introduction. It appears to the Committee to strike a reasonable balance between the level of the restriction applied and the benefit anticipated.

Multiple former audit firm partners

6.25 The Bill provides that a person who has been a member of an audit firm or director of an audit company cannot become an officer of an audited body if another person who is or was a member or director of the auditor at a time when the auditor undertook an audit of the audited body is also an officer of the audited body.[21]

6.26 The Explanatory Memorandum says this provision 'implements a recommendation of the HIHRC that the Corporations Act contain a prohibition on any more than one former partner of an audit firm, at any time, being a director of or taking a senior management position with the audited body'.[22]

6.27 The provision is complemented by a requirement for disclosure in the directors' report of each company officer who was a member of the audit firm or director of the audit company that audited the company and whether the company officer was a member or director of the auditor at the time of the audit.[23]

6.28 Contrary to the Royal Commissioner's recommendation that the restrictions should be enforceable not only against the relevant former partner or senior audit team member but also the relevant audit firm, the Bill's restrictions will apply only to the relevant former partner or senior audit team member.

6.29 This provision attracted a great deal of opposition. The main contentions were that it was unnecessary and too widely drafted, and would restrict the availability of appropriately qualified people to take up senior positions in the corporate world.

6.30 For the ANZ Banking Group, the multiple-officer restraint went further than was necessary to secure auditor independence.[24]

6.31 Similarly, in their joint submission, the ICAA and CPAA argued that the restraint was 'unnecessary given the cooling-off period requirements'. They also noted the absence of time limits on the provision's operation which they considered would

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21 Proposed section 324CK Corporations Act.

22 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 120.

23 Proposed paragraph 300(1)(ca) Corporations Act.

24 *Submission* 14, p. 5.

have undesirable practical consequences. In this regard, they gave the following example to illustrate their point:

> …if a partner retired from an audit firm in his early thirties and became an officer of the client, no one other former partner from that firm would be able to become an officer of the client until the first former partner ceased to hold office. In some cases, this may not occur for 20-30 years. This restriction is excessive and will adversely impact the availability of accounting and finance talent.
>
> Furthermore, it is difficult to see why a person who was once a partner in an audit firm should be 'tainted' for the remainder of their lives for the purposes of [the provision].[25]

6.32 The LCA thought it was inappropriate for the Corporations Act to 'deal in this level of specificity with issues like former members of audit firms'. It proposed that directors should be allowed to make the decisions regarding these matters.[26]

6.33 The Association of Chartered Certified Accountants (ACCA), while supporting the two-year cooling-off period for retiring auditors, said the multiple-officer restraint seemed 'particularly onerous in the case of multi-national companies'.[27]

6.34 The same concern was raised by KPMG which elaborated on the wider practical implications of this restraint when multi-national companies were involved. It said with regard to this issue that:

> …as the provision covers the company and its subsidiaries, the restriction would extend worldwide. This would force resignations if there were, for example, a former partner from the audit firm on the board of an Australian multinational company and a former partner in an officer role in one of a multitude of overseas subsidiaries.[28]

6.35 Mr Tom Ravlic queried why after 'that one curious governance catastrophe', the Royal Commissioner thought it necessary to introduce the multiple-officer restraint. Apart from being unconvinced of the need for such a restraint, Mr Ravlic thought the concentration of the auditing market with the Big 4 would limit choices for companies with former auditors on their boards or in senior management.[29]

6.36 Some submissions queried why auditors—and not other professionals—had been the target of additional regulation. According to the National Institute of

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25 *Submission*s 31 (CPAA) and 36 (ICAA), p. 66 of attachment.

26 *Submission* 24, p. 5.

27 *Submission* 42, p. [2].

28 *Submission* 33, p. 4 (Executive Summary).

29 *Submission* 1A, p. 9.

Accountants (NIA), auditors already had to comply with strict ethical, professional and legal requirements, and the extent to which an individual auditor could influence the auditing process was 'quite small'. In the NIA's view:

> …There are opportunities for lawyers, engineers and a myriad of other 'consultants' to provide 'favourable' advice in the hope of influencing future employment prospects. However, they are not being singled out in the same way as auditors are. The NIA does not believe the 'future employment' risk of auditors is any greater than these other professionals and advice providers. [30]

6.37 The NIA strongly opposed the multiple-officer restraint as an unnecessary and unjustifiable interference and submitted that:

> …If a company requires certain people to fill senior positions it is the role of the company to do so as they please and it is no role of Government to be governing the employment practices of companies. These people have not been proven to have done any wrong, yet the law assumes that because they work for an audit firm they are not to be trusted. Again is this restriction to apply to other professionals providing services to companies? If not, the Government must show the proof that auditors are not to be trusted, especially where there is more than one of them.[31]

6.38 The NIA was concerned that the employment restrictions would make auditing a less attractive career path 'to the detriment of the profession, the profession's clients and the quality of the audit process'. It was unable to see any benefit in imposing restrictions on auditors' employment prospects with former clients given their knowledge and understanding of a client's affairs and their 'level of professionalism and ethics…not always present in other potential sources of company officers'.[32]

6.39 By far the majority of submissions shared the NIA's concerns about the future of the accounting profession and those businesses reliant on practitioners' expertise.

6.40 Baker & McKenzie, for example, thought the proposal would 'significantly reduce the availability of retired Big 4 accountants to serve on boards' and reduce 'employment options for young auditors'.[33]

6.41 Mr Martin Alciaturi was particularly concerned that an indirect effect of the restriction would be to give investment banks a competitive advantage in the delivery of non-audit services. In this regard, he said:

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30 *Submission* 25, p. 17.

31 *Submission* 25, pp. 19-20.

32 *Submission* 25, p. 17.

33 *Submission* 37, p. 5.

> …Whilst a significant focus of recent legislative change has, understandably, been on financial advice provided to retail 'unsophisticated' investors, it is also in the overall national economic interest that independent financial advice be available to Australia's larger enterprises. The scale of operations of such organisations is such that 'boutique' advisers cannot always provide an adequate level of service and the Big 4 'audit firms' fulfil an important role in balancing the advice of investment banks who may be more interested in funding transactions than providing truly independent advice.[34]

6.42 For Ernst & Young, Australian business would suffer:

> …many skilled members of the audit profession progress from the professional accounting firms into commerce, many at a relatively early stage in their career, and provide a skilled workforce that is essential for Australian business to develop and to meet its governance obligations.[35]

6.43 KPMG expressed a similar view:

> There appears to be a general concern about a large number of former audit firm partners at one company. The provision as currently drafted would cause serious issues for Australian business which understandably, use audit firms as a pool to recruit deeply knowledgeable, financially experienced staff. If a company wishes to recruit such a person, it would have to change auditor (which might be difficult if it recruits staff from a range of audit firms), or require the incumbent director or employee to resign. In addition, as the provision covers the company and its subsidiaries, the restriction would extend worldwide. This would force resignations if there were, for example, a former partner from the audit firm on the board of an Australian multinational company and a former partner in an officer role in one of a multitude of overseas subsidiaries.[36]

6.44 Mr Tony Harrington, PricewaterhouseCoopers, drew on his recent experience to illustrate his contention that the restraint would make accountancy a less attractive profession for high-calibre individuals who should be working in the industry. He told the Committee:

> I can relate a particular story of one of our candidates who is just about to become a partner. With all these rules now, and the interest that we have in a particular industry and our involvement in that industry, he said, 'I'm not sure I want to be a partner, because if I become a partner then I lose my ability to go out from the firm.' In this day and age, lifetime careers in professional services firms are not the norm. The challenge is much more significant than it was when Rob and I started. So people look to multiple

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34 *Submission* 9, p. [1].

35 *Submission* 34, p. 3.

36 *Submission* 33, p. 4 (Executive Summary).

> careers and, in that context, this is impacting the decisions that young professionals are making about their desire to stay in the profession. Being a partner can actually put a restraint on their ability to operate in the marketplace, should they decide to leave.[37]

6.45 Professor Ian Ramsay, noting that the multiple-officer restraint was not among the recommendations made in his report on auditor independence, told the Committee about his concerns with this provision:

> There is a new provision in the bill that was not in my report: clause 324CK, which relates to multiple former audit partners. This is a recommendation that is based upon the report of Justice Owen, resulting from the HIH royal commission. In brief, it limits the number of partners or former partners of an audit firm that can join a client. I have some concerns about that particular provision. It appears to have no time limits, so that a person who retired from an audit firm many years previously, and may in fact have expertise and skills that would be of significant benefit to the client, would be prohibited from offering those skills and expertise to the client if indeed there is one other former partner from the audit firm already on that company.
>
> In an age when we only have four large audit firms and they have a lock on the largest listed companies in this country, and we have large companies that are trans-national in operation, there are some important issues to do with whether this particular clause, which I think is clearly well intentioned and arises out of an appalling situation involving our second biggest general insurer, may be over-inclusive and have an undue impact upon the market—if you like, the financial expertise—at a time when, for very good reason, companies need financial expertise on their audit committees and in critical accounting positions. In sum, then, might this catch—and I suggest it would—situations where there would in fact be no conflict; where the independence of the auditor would not be jeopardised by someone who might have stepped down from the audit firm 20 years previously? I suggest, with respect, that this might be a provision worth considering.[38]

The Committee's views

6.46 According to the Regulation Impact Statement in the Explanatory Memorandum for the Bill, the employment restrictions—of which the multiple-officer restraint is one—struck 'an appropriate balance between promoting auditor independence and not unduly impeding audit professionals joining companies and bringing with them valuable financial expertise'.[39]

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37 *Committee Hansard*, 6 April 2004, pp. CFS 55-6.

38 *Committee Hansard*, 18 March 2004, p. CFS 4.

39 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 15-16.

6.47 On the evidence before it, the Committee disputes that the multiple-officer restraint does strike an appropriate balance.

6.48 Certainly, the Committee wonders how the presumed benefit from the application of this restraint can possibly outweigh the likely deleterious impact on the profession and wider business sector.

6.49 The Committee accepts the evidence that the restraint:

- is too broadly framed—there are no time limits for its application and its reach could be quite extensive, particularly in the context of former multi-national clients; and
- would be likely to limit career opportunities for accountants and thus make it harder for firms to attract high-calibre individuals into the profession. Audit quality could suffer as a result. Similarly the 'pool of talent' produced by accounting practices to the benefit of the business sector would be diminished.

6.50 The provision also appears to apply whether or not a particular audit firm or audit company is still providing services to the audited body. This means, for example, that former partners of an audit firm that, since their departure from the audit firm, no longer audits the audited body, are still subject to the restriction.

6.51 In view of these factors and without convincing evidence that this restraint will make a positive difference to audit quality, the Committee recommends its deletion from the Bill.

Recommendation 23

6.52 The Committee recommends the deletion of the provision in the Bill (proposed section 324CK) prohibiting more than one former audit firm partner or audit company director from becoming an officer of a body audited by the audit firm or audit company.

Auditor rotation

6.53 The HIH Royal Commissioner said with regard to audit firm rotation that '[i]f nothing else, the long-standing appointment of an audit firm might adversely affect the perception of the audit firm's independence, since the public will not be informed about, or may be sceptical of, the efficacy of internal rotation of personnel'. Although attracted to the potential benefits of audit firm rotation, he was mindful that it could have an adverse effect on the availability of audit services 'in what is currently a limited market of professional services firms'.[40]

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40 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 179.

6.54 He supported the proposal outlined in the CLERP 9 discussion paper[41] for mandatory five-year rotation of lead engagement and review partners but thought that rotation should also apply to key senior audit personnel on the basis that:

> There is a risk that such key senior audit personnel may become too sympathetic to a client's interests, particularly if their long-term career aspirations become linked to their continued material role in the conduct of the audit. Those relationships increase the possibility of management being able to exert undue influence over the auditor.[42]

6.55 He referred to Professional Statement F1 as recognising the 'familiarity threat' posed to auditor independence in such circumstances.

6.56 When considering whether audit firm or audit partner rotation would enhance auditor independence, the Bill adopted the preference of the Audit Review Working Party and the Ramsay Report for mandatory audit partner—but not audit firm—rotation after five years.[43]

6.57 The Bill will place rotation obligations on auditors of listed entities who have 'played a significant role' in an audit. Under proposed section 9, a person plays a significant role in an audit if:

- the person is appointed as an individual auditor by a company or registered scheme for a financial year and:
  - acts as an auditor for the company or registered scheme in a financial year; or
  - prepares an audit report in relation to the audit client's annual or half-year financial report.
- in relation to the appointment of a firm or company by an audit client, the person:
  - is a registered company auditor; and

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41 *Corporate Disclosure, Strengthening the financial reporting framework—Corporate Law Economic Reform Program, Proposals for Reform: Paper No 9*, Canberra, September 2002, pp. 50-3.

42 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 178. See Recommendation 12, p. 180.

43 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 122.

- acts on behalf of the firm or company as a lead auditor[44] or review auditor[45] in relation to an annual or half-year audit for an audit client.

6.58 The rotation requirements provide that an auditor who plays a significant role in the audit of a listed entity for five successive financial years is not eligible to play a significant role in the audit of that entity for at least two successive financial years. An auditor is also not eligible to play a significant role in the audit of an entity for more than five out of any seven successive financial years.[46] The Explanatory Memorandum states in relation to the five out of seven-year time limit:

> This approach recognises that auditors may not necessarily audit a body in consecutive years however the relationship between the auditor and audited body can still give rise to a threat to independence…this approach prevents an auditor from avoiding the rotation obligation…for example, in circumstances where an auditor plays a significant role for four successive years, resigns from the audit for only one year and then resumes a significant role for another four successive years.[47]

6.59 An auditor who plays a significant role in the audit of a listed entity but is not eligible to do so contravenes the Act.

6.60 The member of an audit firm on whose behalf an individual who is ineligible to, but plays a significant role as the lead or review auditor of an audited body, contravenes the Act if the member is aware of the individual's ineligibility but fails to ensure that the individual ceases to Act.[48] A member who is not aware of the individual's ineligibility to act also contravenes the Act. This contravention is one of strict liability but a defence is available where a person had reasonable grounds to believe that the audit firm had a quality control system in place at the relevant time that provided reasonable assurance that the audit firm and its employees complied with the Act.

6.61 Similar provisions apply to audit companies and their directors.[49]

6.62 ASIC has been given a power to extend:

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44 Proposed subsection 324AF(1): a lead auditor is the registered company auditor who is 'primarily responsible to the audit firm or the audit company for the conduct' of an audit.

45 Proposed subsection 324AF(2): a review auditor is the registered company auditor who is 'primarily responsible to the individual auditor, the audit firm or the audit company for reviewing the conduct of the audit'.

46 Proposed section 324DA Corporations Act.

47 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 122.

48 Proposed section 324DC Corporations Act.

49 Proposed section 324DD Corporations Act.

- the five-year rotation trigger to six or seven years;
- the five out of seven successive years test to six out of seven years.[50]

6.63 In granting such relief, ASIC must be satisfied that the rotation requirements would impose an unreasonable burden on the auditor or the audited body having regard to the nature of the audited body and the activities in which it engages; the availability of other registered company auditors capable of auditing the body and any other matters which ASIC considers relevant.[51]

6.64 Under proposed section 342B, an auditor who continues to play a significant role in the audit of a company or registered scheme in reliance on an ASIC declaration, must notify the company or responsible entity in writing of the declaration promptly.

6.65 In a departure from the HIH Royal Commission's recommendation, the rotation requirements do not apply to key audit personnel. The Government has stated its reasons thus:

> CLERP 9 requires rotation of lead engagement and review partners after 5 years. It is these audit partners who are responsible for forming the final opinion on the financial statements of the client. In these circumstances, the Government does not consider that extending the rotation requirement to parties subordinate to the lead engagement and review partners will enhance auditor independence.[52]

Comments

6.66 Although there was widespread in-principle support for the rotation requirements, a great many witnesses voiced concerns that the requirements would have serious implications for the viability of small- to middle-tier accountancy practices.

6.67 Of the more enthusiastic supporters of the rotation requirements, The Association of Superannuation Funds of Australia Limited (ASFA) thought they struck an appropriate balance between the benefits of rotating and the costs involved. ASFA suggested that audit firm rotation might be worth further investigation if partner rotation proved successful.[53]

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50 Proposed section 342A Corporations Act. See also proposed subsection 324DA(2).

51 Proposed section 342A Corporations Act.

52 The Commonwealth Treasurer, Press Release No. 082, *Government's response to the recommendations of the HIH Royal Commission,* 12 September 2003, Attachment A, Recommendation 12.

53 *Submission* 19, pp. [4-5].

6.68 The Australia Stock Exchange Ltd (ASX) was another supporter of the rotation requirements as preventing 'an unhealthy degree of alignment developing between the auditor and the company while having regard to the relatively limited number of audit firms able to perform the required functions'. Although the ASX thought that rotation of audit firms would be more likely to 'break an undesirable nexus between client and auditor', it saw audit partner rotation as an acceptable compromise.[54]

6.69 The UTS Centre for Corporate Governance considered that any supposed benefits of mandatory rotation would be outweighed by a deterioration in audit quality. The Centre argued that the pursuit of auditor independence through rotation failed to recognise variations in auditor competence and expertise. The Centre argued its case as follows:

> In the Centre's view, little attention has been given to the effects of enforced rotation on auditor competence. In fact, it has been simply assumed that auditor competence delivered to an audit (such as industry expertise) is the same regardless of the industry partner, audit team or firm conducting the audit.
>
> Research conducted by researchers from the University of Technology, Sydney, working with the Co-operative Research Centre for Technology-Enabled Capital Markets finds support for this view. The research suggests that the market differentiates between the competence of leading industry-expert partners in a city and the rest of the partners completing audits in that industry. In the context of the rotation debate, it suggests industry expertise is not uniformly distributed throughout the city office or national firm, and clients know this.
>
> If mandatory rotation forces rotations beyond the top two local industry experts, some clients will lose the industry expertise they have come to rely upon and are prepared to pay for, and others will be expected to pay more for competence they do not require given their circumstances.
>
> These results suggest that mandatory rotation may have unforseen negative consequences, one of which could be a reduction in audit quality for some client firms. It is therefore the Centre's view that there is little utility in forcing rotations to gain the benefit of auditor independence if auditor competence is lost in the process.[55]

6.70 It was the Centre's view that audit committees and company boards should be left to decide whether or not rotation was necessary.

6.71 Grant Thornton Accountants shared the UTS Centre's concerns. In particular, it saw difficulties arising where an auditor had specialist knowledge of an industry—

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54 *Submission* 48, p. 3.

55 *Submission* 21, pp. 6-7.

not widely held by the profession—but highly valuable to the auditor's client. Grant Thornton considered the loss to the client of this specialist knowledge or, on a lesser scale, the loss of greater experience, as a result of audit partner rotation was 'contrary to the policy underlying the…legislation'.[56]

6.72 A related argument, raised by the ICAA and CPAA, was that rotation would result in a diminishing pool of available expertise and involve additional learning-curve costs without delivering improved audit quality to shareholders.[57]

6.73 Another concern raised by the ICAA and CPAA was that the rotation requirements would drive small- to medium-sized firms out of business; reduce competition and force clients previously serviced by the smaller firms to obtain audit services from larger and possibly more expensive firms. In the following excerpt, the ICAA and CPAA explained why they held these views:

> …the rotation requirements in effect place a minimum size requirement on firms…to undertake listed company audits. Firms must have at least 4 appropriately experienced audit partners in order to meet the rotation requirements for both lead auditor and review auditor. Such size requirements are particularly onerous given Australia's geographic/commercial spread. This will have a substantial impact on smaller audit firms.
>
> Currently there are approximately 120 organisations (i.e. sole practitioners or firms) auditing approximately 1400 ASX-listed public companies. Many of these firms will struggle to meet the rotation requirements, including the regional centres (e.g. Perth and Adelaide) of the second tier firms. Even the 'Big 4' firms will have difficulties where particular offices do not have the required 4 appropriately experienced audit partners.
>
> We believe that the outcome of the current draft legislation will be that most small- and medium-sized firms will choose to exit the listed public company audit market and it is likely that less than 20 of the larger firms will be left doing this work. This will reduce competition and increase costs significantly, particularly for small- and medium-capital listed public companies. As well as affecting these clients, this could have a major detrimental effect on the viability of many of these smaller accounting practices.[58]

6.74 These concerns about the effect of the proposed rotation requirements on smaller firms were raised repeatedly in evidence to the Committee.

6.75 Ms Azoor Hughes, Pitcher Partners Accountants Auditors & Advisors, predicted that auditor rotation requirements would force small- to middle-tier firms to

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56 *Submission* 39, pp. 2-3.

57 *Submission*s 31 (CPAA) and 36 (ICAA), pp. 74-5 of attachment.

58 *Submission*s 31 (CPAA) and 36 (ICAA), p. 74 of attachment.

withdraw the delivery of audit services from the market and force their clients to obtain these services from larger practices. She argued that these smaller firms were specifically structured to cater to smaller listed entities below the top 200, many of which were still in their preliminary growth phase. The withdrawal of smaller accountancy practices from service delivery to these smaller entities would be to their detriment, she said, for the following reasons:

- larger audit firms were not 'primarily concerned with young, growing businesses' and might not be aware of the regulatory support needed; and
- the fee structures in larger audit firms did not allow for the same standard of detailed examination provided by smaller firms.[59]

6.76 Ms Azoor Hughes questioned why the rotation requirements should apply to smaller practices. She claimed that the rationale for auditor rotation—to overcome issues of familiarity and fee dependence—was irrelevant for small- to middle-tier firms:

> Middle-tier firms are specifically structured to serve a large number of smaller clients. Consider, for example, a middle-tier audit partner with $1 million of fees and 20 clients at around $50,000 each. How dependent is that partner on any individual client? How willing would that partner be to compromise firm reputation for the sake of one client? We put forward the view that the risks are non-existent or minimal…
>
> As part of our practice management, Pitcher Partners does not accept clients who require what equates to full-time audit presence. Individual partners do not have one or even a few dominant clients that provide a majority of their fees. However, these partners will be subject to the same rotation rules as a partner who is predominantly employed on the audit of one client. The risk of familiarity is overcome by the rotation of audit managers over a period of time…[60]

6.77 Mr Matthew Adam-Smith, Grant Thornton, was another witness who raised concerns about the impact of rotation on smaller firms. He told the Committee that, although his firm was the fifth largest in Adelaide and sixth largest in Perth, his firm would 'struggle to meet the rotation requirements'. He predicted that many smaller firms would be forced to withdraw their auditing services to listed public companies, competition would be reduced and costs for auditing services would rise.[61]

6.78 BDO Chartered Accountants and Advisers told the Committee of the practical difficulties that rotation would cause for smaller audit firms, smaller listed companies and listed companies not located in major centres. BDO said that the anti-competitive

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59 *Committee Hansard*, 18 March 2004, p. CFS 63.

60 *Committee Hansard*, 18 March 2004, p. CFS 63.

61 *Committee Hansard*, 18 March 2004, p. CFS 73.

effects of audit partner rotation would 'reduce the options for listed companies when seeking to appoint an auditor'.[62] Mr Geoff Brayshaw, BDO, elaborated on these concerns and suggested an alternative basis for rotation:

> In general terms, rotation of auditors is the right response to the threat of familiarity. However, capable listed company auditors in small firms may be unable to rotate, and for that reason will not only lose audits but also be uncompetitive for potential audit appointments. If this happens, there will be some reduction of competition in the marketplace. Therefore we continue to hold the view that rotation should be restricted to the ASX All Ordinaries Index or the top 500, although I might mention that in the latest Corporate Governance Council comments they had actually restricted it to the first 300—or their amendments had been made to the first 300.[63]

6.79 A submission from a Western Australian firm, Harding & Associates, Accountants and Auditors, referred to the plight of smaller firms in Western Australia and argued that the allowance for seven-year rotation would not 'address the issues in any way'. The submission said that a 'significant number' of smaller accounting practices had only one registered company auditor, and referred to a 1998 survey that identified only 11 registered company auditors (RCAs) in rural and remote Western Australia. According to this submitter:

> Where only one RCA is available in an accounting practice, rotation is meaningless. It requires the client to change accounting firms.
>
> …
>
> The consequences for entities in remoter WA is significant in this situation. Gradually they will be obligated to move their audit services to the large city-based practices at substantially increased cost. For Not-for-Profit entities with limited funds, this means a reduction in their core services.[64]

6.80 Mr Harley McHutchison, Deloitte Touche Tohmatsu (Deloittes), said his firm supported rotation of the leading engagement partner but thought rotation of the concurring review partner needed to be 'revisited' because of its likely adverse impact on smaller firms. He told the Committee that this was 'an unreasonable burden for smaller auditing firms that audit a number of smaller listed companies, such as in Western Australia, and may effectively put those auditors out of business'.[65]

6.81 The NIA proposed that small- to medium-sized firms outside the Sydney and Melbourne CBDs should be exempted from rotation requirements. The NIA thought that rotation should be restricted to ASX-listed companies, and a comprehensive study

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62 *Submission* 50, p. [2].

63 *Committee Hansard*, 14 April 2004, p. CFS 73.

64 *Submission* 61, pp. [1-2].

65 *Committee Hansard*, 11 March 2004, p. CFS 21.

conducted to determine the impact of rotation on firms and audit quality over its first five years of operation. The future direction of auditor rotation could then be determined using the findings of this study.[66]

6.82 Noting that Parmalat practised auditor rotation, Mr Reece Agland, NIA, told the Committee that there was a need to look at jurisdictions where auditor rotation was practised to determine its effectiveness before mandating it in Australia.[67]

6.83 The Bill's definition of 'review auditor' attracted widespread criticism that it did not reflect the varying functions of a review auditor. It was claimed that this shortcoming posed particular problems for smaller firms in meeting rotation requirements.

6.84 Mr Harley McHutchison, Deloittes, described the different roles of the lead auditor and the review auditor. He said the distinction between the two was that the review auditor was often 'not client facing' and performed more of a quality assurance role.[68]

6.85 Mr Matthew Adam-Smith, Grant Thornton, told the Committee that the role of a review auditor could vary greatly depending on the size of the entity being audited. In this regard, he said:

> The role of the review partner on the audit of small and medium-sized listed public companies is very different to that of the review partner of a large, say, top 100 ASX company—being really just an internal quality control process. Whilst the review partner on, say, the Telstra audit would be an integral part of the audit team, spending hundreds of hours a year involved with the audit and in face-to-face relationships with senior management and the board, a review partner on a typical audit client outside, say, the top 200 listed companies would generally spend between perhaps 10 and 20 hours a year on that client and would never even meet the client face to face. Indeed, the client probably would not even know the name of the review partner because they are an office-based quality control procedure.[69]

6.86 Pitcher Partners provided the Committee with a similar description of the review auditor's role, namely, that it could involve a very close association with an audit or relate merely to technical matters. For review auditors conducting a technical review, it was argued that 'there is no justification for [rotation]…as there is minimal contact with the client or audit issues'. [70]

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66 *Submission* 25, pp. 24-5.

67 *Committee Hansard*, 11 March 2004, p. CFS 46.

68 *Committee Hansard*, 11 March 2004, p. CFS 25.

69 *Committee Hansard*, 18 March 2004, p. 73.

70 *Submission* 13, p. 5.

6.87 Pitcher Partners suggested that rotation should only apply to the lead auditor on the basis that the lead auditor 'carries the audit risk and perhaps the incentive to compromise independence (although this has not been proven)'.[71]

6.88 Another argument raised by Pitcher Partners was that with the limited number of specialist auditors operating in more 'high risk' industries such as banking and insurance, ASIC's rotation concessions would be sought more often in these areas. They predicted the paradoxical result that the less high risk industries would be the most exposed to rotation requirements and its associated costs:

> This means that the target of this proposed change will be relatively unaffected by its implementation while other entities take the additional cost of rotation.[72]

The Committee's views

6.89 Although the evidence reflects almost unanimous support for audit partner rotation—albeit qualified in some instances—the alternative proposal for audit firm rotation proved decidedly unpopular. ASFA and the ASX suggested there might be benefits in this more stringent requirement but appeared satisfied with audit partner rotation as an acceptable compromise.

6.90 Professor Geoffrey George, Victorian Graduate School of Business, was a strong critic of the CLERP 9 proposals generally and did not support audit partner rotation. He favoured audit firm rotation as a way of helping new entrants to compete in a market dominated by the Big 4.[73]

6.91 The Committee agrees that the lack of competition in the accounting services market in Australia is cause for concern. However, the Committee is sceptical that audit firm rotation, without more, would necessarily stimulate competition in a market that operates increasingly on an international basis and where only a limited number of firms have the reach and resources to meet the needs of certain clients. The Committee refers to the comments of Grant Thornton in this regard that:

> In terms of [the suggestion that audit firm rotation would open up] current big-four audit clients to the non big-four firms, I think there is an acknowledgement that in the big end of town—the top 100 companies—really only the big four have adequate resources to deal with jobs of that size.[74]

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71 *Submission* 13, p. 5.

72 *Submission* 13, p. 5.

73 *Submission* 16, p. [1].

74 Mr Matthew Adam-Smith, *Committee Hansard*, 18 March 2004, p. CFS 78.

6.92 Of the various studies reviewed in the Ramsay Report, some indicated a correlation between tenure and audit quality but the evidence was not significant.[75]

6.93 Nonetheless, the Committee notes that audit partner rotation is already endorsed as best practice by the professional bodies[76] and accepts that, in principle, it represents a better alternative to audit firm rotation as a means of safeguarding audit quality.

6.94 Having said this, the Committee believes that wide reach of the proposed rotation requirements will be detrimental to the interests of the market in audit services provision and should therefore be restricted.

6.95 The application of the requirements to smaller firms will have adverse implications for competition in an already uncompetitive market. The Committee considers that, in the context of the objectives of audit reform, this development will be counterproductive. Furthermore, the Committee is not satisfied that the definition of 'lead auditor' and 'review auditor' are appropriate. Evidence indicates that the definition of 'review auditor' is particularly problematic.

6.96 The requirements will apply to small- to middle-tier firms whose client base almost exclusively comprises smaller listed entities. According to statistics supplied by the ICAA, only 3 per cent of the top 300 listed companies use smaller firms for their audit work. However, for companies outside the top 300, this figure increases to 18 per cent. For companies outside the top 500, the figure is 20 per cent.[77]

6.97 As already discussed, the Committee heard evidence that the fees generated by smaller listed entities—frequently 'substantially less than $100,000 and often…even below $20,000'—were too low to pose a fee dependence threat. The Committee also heard that fees of this size did not support a level of audit partner/client contact that would pose a familiarity threat. Grant Thornton told the Committee, for example, that:

> …the next tier of firms [below the Big 4] are set up very differently, where audit partners are not set up to have a single client, and our skills are in managing series of assignments across a wider client base.[78]

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75 Professor Ian Ramsay, *Independence of Australian Company Auditors, Review of the Current Australian Requirements and Proposals for Reform—Report to the Minister for Financial Services and Regulation*, Canberra, October 2001, pp. 133-4.

76 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 20.

77 Letter dated 13 May 2004 with attachments (received by the Committee as additional information).

78 Mr Matthew Adam-Smith, *Committee Hansard*, 18 March 2004, p. CFS 78.

6.98 The Committee agrees with the approach of the Bill in not applying rotation requirements to key senior audit personnel. However, the Committee considers that rotation requirements should only apply to the lead or review audit partner whose objectivity may be undermined by fee dependence or the familiarity threat. The definitions presently in the Bill do not clearly reflect this.

6.99 The Committee accepts that the role of review auditors in audits of smaller listed entities would generally not be such as to pose threats to audit quality. In addition to the evidence already cited in this regard, the Committee refers to the comments made by Mr Geoff Brayshaw, BDO, that:

> …Review partners do not play a major role in smaller listed company audits and should be allowed to replace the lead partner. Review partners for smaller listed companies act in a quality control role and have little, if any, face-to-face involvement with management and the board. Therefore the review partner role, by its nature, does not introduce a threat of familiarity.[79]

6.100 Similarly, the ICAA and CPAA submitted that:

> …in…smaller listed company engagements, the review partner's professional judgement is less likely to be impaired through over-familiarity and there is less of a need for review auditor rotation.[80]

6.101 The Committee accepts the evidence that rotation is likely to force the withdrawal of small- to middle-tier firms from audit services provision. Additional information provided with a letter dated 13 May 2004 from the ICAA lends further weight to this argument and says that:

> …our members have indicated that they would rarely be interested in the audit of a listed company if they were automatically forced to retire from that audit after a five-year period due to not having a minimum of three audit partners.[81]

6.102 The Committee considers that this outcome, in itself, would be undesirable. Furthermore, the following comments made by Grant Thornton suggest that the Big 4 firms will not necessarily be able to fill the void left by smaller firms in regional centres should they withdraw from the market:

> My understanding is that even the big four, in specialist areas such as insurance and financial services where it is a specific industry skill base, would struggle to do that in regional capital cities such as Adelaide and

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79 Mr Geoff Brayshaw, BDO, *Committee Hansard*, 14 April 2004, p. CFS 73.

80 *Submission*s 31 (CPAA) and 36 (ICAA), p. 74 of attachment.

81 Letter dated 13 May 2004 with attachments (received by the Committee as additional information).

> Perth. To be suggesting that only the big four are capable of auditing very small listed public companies is not something I agree with at all.[82]

6.103 As the submission from Harding & Associates made clear, audit partner rotation for many small firms, in practice, will amount to audit *firm* rotation.[83] Interestingly, the Regulation Impact Statement for the Bill rejected audit firm rotation as a regulatory option because the benefits were considered insufficient to justify 'the significant compliance costs, in terms of disruption and loss of expertise that it would entail'.[84] These comments are consistent with the evidence presented to this inquiry.

6.104 The market for auditing services in Australia is highly concentrated. According to statistics provided by the ICAA, the Big 4 firms audit 92 per cent of the top 300 listed companies by market capitalisation with national firms auditing 4 per cent and small firms the remaining 3 per cent. As discussed previously, smaller firms audit 18 per cent of listed entities outside the top 300.

6.105 The Committee is disturbed that the rotation requirements will encourage further market concentration by forcing smaller audit providers to withdraw from the market. Obviously, the interests of audit clients and, more generally, the public interest, will not be well served in a less competitive market. In addition to these factors, the Committee believes that a reduction in competition for the delivery of audit services may well lead to an erosion in audit quality which, paradoxically, the rotation requirements are intended to safeguard.

6.106 The Committee is not satisfied that the relief available through ASIC to extend the rotation period from five to seven years will resolve the likely adverse impacts of the rotation requirements.

6.107 The Committee believes that the problems identified in the rotation requirements can be overcome in two ways.[85]

6.108 The first involves the definitions of 'lead auditor' and 'review auditor' in the Bill.

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82 Mr Matthew Adam-Smith, *Committee Hansard*, 18 March 2004, p. CFS 77.

83 *Submission* 61, pp. [1-2].

84 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 20-21.

85 The Committee asked the Australian Competition and Consumer Commission by letter dated 22 April 2004 to comment on claims that auditor rotation requirements would have anti-competitive effects on the provision of audit services. The ACCC did not respond to the Committee's request.

Recommendation 24

6.109 The Committee recommends that purposive definitions for 'lead auditor' and 'review auditor' should be adopted to reflect the rationale underlying the rotation requirements. In particular, the Committee recommends that the definition of 'review auditor' should be amended to ensure that a rotation obligation will not apply to a review auditor in circumstances where:

- **the review auditor performs a merely technical role in the audit; and**
- **the review auditor's contact with the audit client could not be regarded as material to the day-to-day conduct of the audit as a whole.**

6.110 If these amendments are adopted, the Committee believes they will go some way towards ensuring that the rotation requirements do not apply in circumstances where auditor objectivity is not under threat.

6.111 Furthermore, the Committee believes amendments to the Bill are needed to prevent the withdrawal of smaller firms from the market which, for the many reasons cited by the Committee, would be highly undesirable.

Recommendation 25

6.112 The Committee recommends that the Bill should be amended so that the rotation requirements only apply to the top 300 listed entities by market capitalisation.[86] In arriving at this cut-off point, the Committee took into account the various suggestions made by witnesses and the statistics provided by The Institute of Chartered Accountants of Australia on the auditing market in Australia.

6.113 The Committee notes that the Bill provides relief if rotation requirements could impose an 'unreasonable burden' on the auditor or audited body. Where ASIC is satisfied that rotation would impose an 'unreasonable burden', having regard to the nature of the audited body, whether an auditor needs specialist knowledge to audit the body and the availability of other suitable auditors to audit the body, it can extend the period during which an auditor is not subject to rotation requirements from five years to a maximum of seven years.[87] However, the Committee believes greater flexibility is needed to cater for practical contingencies.

6.114 The Committee heard from BDO that the Bill should allow ASIC to grant relief in circumstances where, for example:

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86 The time for rotation would run from the auditors' appointment.

87 The relief provisions in section 342A also allow for ASIC's consideration of any other matters which ASIC considers are relevant.

> …the strict letter of the law rules out an auditor, but circumstances are such that rotation will be achieved in the short term; for example, an impending merger or appointment of a new partner. [88]

Recommendation 26

6.115 The Committee recommends that amendments should be made to the Bill accommodate short-term postponement of auditor rotation by the Australian Securities and Investments Commission if this is not already provided for elsewhere in the *Corporations Act 2001*.

6.116 For those who might point to rotation requirements under United States law as reason for Australia to follow suit without considering the special features of the Australian market, the Committee notes the following comments made by Grant Thornton:

> …the CLERP 9 legislation seeks to impose rules that are similar to the US rules under Sarbanes-Oxley across all Australian listed companies, without recognising the vast difference between our capital markets and those in the US. The rotation of audit and review partner is only applicable for SEC registrants in the US—companies which are far larger than the majority of Australian listed public companies. Unlike in the US or the UK, in Australia we do not have a secondary board where smaller businesses can have access to capital markets. In the UK or the US those much smaller entities on the secondary markets are not subject to these one size fits all type of rules.[89]

6.117 Because the benefits of audit partner rotation appear to be a matter of speculation only, the Committee agrees with the National Institute of Accountants that the rotation requirements should be assessed after five years to determine whether they are in fact improving audit quality.

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88 Mr Geoff Brayshaw, *Committee Hansard*, 14 April 2004, p. CFS 73.

89 Mr Matthew Adam-Smith, *Committee Hansard*, 18 March 2004, pp. 73-4.

CHAPTER 7

AUDIT REFORMS—MINIMISING CONFLICTS OF INTEREST—SERVICES RESTRICTIONS

Introduction

7.1 The Bill does not define non-audit services. The Explanatory Memorandum indicates that, consistent with the terms of the Ramsay Report,[1] non-audit services are intended to be any services provided by the auditor outside the audit engagement. This approach also endorses the views of the HIH Royal Commissioner that the obligation rests on directors to understand what is involved in all services provided by the auditor and to assess their impact on auditor independence.[2] In this regard, it should be noted that the statement regarding the provision of non-audit services must be made by the directors of the client company.[3]

7.2 The Royal Commissioner noted that HIH's auditor had assessed the performance of audit personnel on their success in cross-selling non-audit services to clients and commented that:

> Use of a performance evaluation process of this kind should amount to professional misconduct by the audit firm and be subject to the disciplinary regime of the professional accounting bodies.[4]

7.3 He concluded that an auditor's provision of audit and non-audit services to clients potentially threatened auditor independence by raising opportunities for self-review. The concern was also expressed that the drive to procure more non-audit business could weaken incentives to maintain audit integrity.

7.4 The Royal Commissioner was somewhat equivocal about the CLERP 9 proposal not to impose a blanket prohibition on the provision of non-audit services by an audit firm. However, in the absence of an examination of the market implications arising from a blanket prohibition, and in the interests of government policy which

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1 Professor Ian Ramsay, *Independence of Australian Company Auditors, Review of the Current Australian Requirements and Proposals for Reform—Report to the Minister for Financial Services and Regulation*, Canberra, October 2001.

2 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, p. 174.

3 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 125.

4 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol I, Canberra, April 2003, p. 175.

sought consistency with other capital markets, he decided against recommending a blanket prohibition.[5]

7.5 The Bill proposes amendments to implement the recommendations of the HIH Royal Commission (HIHRC) and will require the annual directors' report for listed companies under the heading, 'Non-audit services' to include:

- details of each non-audit service provided and the fee for each service;
- a statement whether the directors are satisfied that the provision of non-audit services by the auditor during the year is compatible with the general standard of independence for auditors required by the Act; and
- a statement of the directors' reasons for being satisfied that the provision of the non-audit services did not compromise auditor independence requirements under the Act.[6]

7.6 If a listed company is included in the All Ordinaries Index at the beginning of its financial year or, if not in the All Ordinaries, has an audit committee, the directors' independence statements above, must be made in accordance with advice provided by the company's audit committee.[7]

7.7 The Bill's treatment of non-audit services was one of the more hotly debated topics and saw a clear polarisation of views between the supporters of the proposed provisions and their critics.

7.8 Of the critics, some favoured a blanket ban while others thought a prohibition on the provision of certain non-audit services would be more appropriate.

7.9 A blanket ban was favoured by the Australian Shareholders' Association Ltd (ASA) for the same reasons given by the HIH Royal Commissioner, namely, that the provision of non-audit services to audit clients threatened auditor independence in two ways:

- non-audit services could involve self-review; and
- audit integrity could be sacrificed by auditors seeking non-audit work.

7.10 During his appearance before the Committee, Mr Stuart Wilson expanded on the ASA's reasons for supporting a blanket ban:

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5 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol I, Canberra, April 2003, p. 173.

6 Proposed subsections 300(11B) and (11C) Corporations Act. See also *The Failure of HIH Insurance*, The HIH Royal Commission, Vol I, Canberra, April 2003, Recommendation 10, p. 175.

7 Proposed subsections 300(11D) and (11E) Corporations Act.

> The issue of non-audit services, as I think I might have mentioned, is twofold. Firstly, in a financial sense, audit firms use the audit itself as bait for engaging in the non-audit services. A common argument that is thrown forward is that, because the auditor knows the business, they are better placed to provide the non-audit services and, 'Hey, we're giving you the audit for next to nothing, a few hundred thousand dollars,' and with that there is an expectation that they will be granted those more lucrative non-audit services. So, irrespective of what the audit service is, that financial incentive to get those non-audit services fundamentally compromises the independence of the audit.[8]

7.11 If a blanket ban was not adopted, the ASA proposed that at a minimum the Bill should prohibit auditors' provision of the same non-audit services as are specified in the Sarbanes-Oxley Act, namely:

- internal audit;
- actuarial services;
- bookkeeping;
- financial information system design;
- valuation services;
- management functions (including human resources);
- investment advice;
- legal services; and
- corporate financial and similar activities.

7.12 The ASA also thought strategic taxation advice should be added to the list for the following reason:

> …where a company seeks advice on minimising its taxation and then [has] the auditor come back and say, 'That advice is correct and the amount of tax that you paid is correct,' we feel is one of those fundamental conflicts.[9]

7.13 The Law Society of South Australia (LSSA) shared the ASA's preference for a blanket ban. The LSSA's view was that the approach taken in the Bill was fundamentally flawed in that it failed to deal with the conflicts of interest involved. The LSSA said in this regard that:

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8 *Committee Hansard*, 9 March 2004, p. CFS 21.

9 Mr Stuart Wilson, *Committee Hansard*, 9 March 2004, p. CFS 21.

> So long as an auditor may be called upon to comment on the accounting treatment given to a certain financial arrangement, the efficacy or lawfulness of a particular business or financial structure or any other aspect of a company's affairs that affect the capacity of the accounts to truly and fairly reflect the company's affairs, (where any one of those accounting treatments, business or financial structures may have been the result of advice from another member of the audit partner's firm), there will be a fundamental conflict of interest.
>
> How can a partner be expected to give an adverse audit report on a client's business where that structure was created, advised upon or assisted by another of his partners or his employees.[10]

7.14 The Finance Sector Union of Australia (FSU) thought it essential that auditors' provision of certain non-audit services be prohibited if only to ensure that the perception of independence would not be compromised. The FSU proposed a ban on the following services which, it said, were those specified in the Australian Council of Super Investors Guidelines:

- preparing accounting records and financial statements;
- internal audit services;
- IT system services;
- broker or dealer services;
- investment advice;
- investment banking services; and
- legal work.[11]

7.15 The accounting profession supported the principles-based approach taken by the Bill. Support was also forthcoming from the ASX,[12] Chartered Secretaries of Australia (CSA),[13] the Australian Chamber of Commerce and Industry (ACCI),[14] the ANZ Banking Group,[15] the Australian Institute of Company Directors (AICD)[16] and the Group of 100 Inc.[17]

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10 *Submission* 45, pp. 1-2.

11 *Submission* 38, p. [7] of attachment.

12 *Submission* 48, p. 3.

13 *Submission* 8, p. 5. Chartered Secretaries Australia proposed that non-audit services disclosure should apply to all disclosing entities—not just listed companies.

14 *Submission* 60, p. 5.

15 *Submission* 14, p. 7.

7.16 Professional Statement F.1 (FI)[18] was widely endorsed as a useful supplement to the legislation in providing guidance to auditors when deciding whether or not the provision of non-audit services would be permissible in a given circumstance.[19]

7.17 Mr Stephen Harrison, for example, told the Committee that The Institute of Chartered Accountants in Australia (ICAA) preferred the legislation to leave it to Professional Statement F1 to set out the principles and provide guidance in determining what services should not be provided and what disclosures should be made in relation to services that were provided.[20]

7.18 Mr Michael Coleman, KPMG, gave the Committee some insight into the practical application of F.1. When asked whether he considered there were any services that an auditor should not provide, Mr Coleman responded as follows:

> Provided you comply with the safeguards and threats approach that is included in the professional standard, no. But F1, which is the professional standard on auditor independence, says that there will be certain circumstances where it is hard to imagine that any safeguard could avoid that threat. So to a very large extent the use of the F1 standard leads you into an environment where you have to be satisfied before you do provide certain services that you are not causing an independence problem.
>
> …the standard—the professional statement…actually says that in some instances it is unlikely that the safeguards that you could put in place would ever obviate the threat to independence.[21]

7.19 In contrast to the endorsement of F1 provided by some witnesses, the Australian Council of Super Investors Inc (ACSI) was not altogether confident that F1 could be relied on as an 'authority' on the provision of non-audit services and the maintenance of auditor independence in this area. More particularly, ACSI said:

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16 *Submission* 35, p. 12.

17 *Submission* 46, p. 3. The Group of 100 had concerns about the specificity of disclosures required but otherwise supported the approach of the legislation.

18 *Professional Statement F.1—Professional Independence*. This statement is based on the internationally harmonised standard for professional auditor independence agreed by the 120 nations who are members of the International Federation of Accountants. The CPAA and ICAA have adapted this standard 'to reflect Australian community expectations'. See *New Australian standard for audit independence*, CPA news release 23 May 2002.

19 Mr Harley McHutchison, Deloitte Touche Tohmatsu, *Committee Hansard*, 11 March 2004, p. CFS 29; Mr Stephen Harrison, ICAA, *Committee Hansard*, 11 March 2004, p. CFS 38; and Mr Michael Coleman, KPMG, *Committee Hansard*, 16 March 2004, p. CFS 28.

20 *Committee Hansard*, 11 March 2004, p. CFS 38.

21 *Committee Hansard*, 16 March 2004, p. CFS 28.

> It is not widely recognised that Professional Statement F1…actually allows auditors to value assets or businesses on behalf of an audit client. Auditors may then incorporate those valuations in Statements of Financial Position.[22]

7.20 There were three services which the ACSI considered should not be provided by auditors to their audit clients—valuation, accounting and recruitment services. Mr Phillip Spathis, ACSI, told the Committee that:

> Our specific concerns relate to the continuing possibility for auditors to undertake valuation services for entities whose financial statements they are auditing. We are concerned about the provision of executive recruitment for audit clients where as auditors they will be required to assess the quality of the financial information produced by those same executives. We are also concerned about the provision of accounting services that could result in a situation where auditors are in effect auditing their own work.[23]

7.21 In relation to the last point, ACSI referred to the 'commercial reality that the auditors of many public companies actually compile the final annual financial statements—and then audit their own work'. It proposed that for reporting entities seeking to attract public investment, such a practice should be 'severely restricted to the drafting of entries to adjust account balances as a consequence of audit findings'.[24]

7.22 The Association of Chartered Certified Accountants (ACCA) considered that 'appropriate comparative information' should be provided 'so the users of financial statements can make an assessment as to how the balance of audit to non-audit fees has changed over the years'.[25]

7.23 Mr Sandy Easterbrook, Corporate Governance International Pty Ltd, said that the legislation should be expressed to close any loopholes that might result from inconsistent views of what constitutes an audit as opposed to a non-audit service. He said that there should be a requirement for disclosure of audit-related fees and services as well as non-audit fees and services. This would allow for 'reliable disclosure', however described, across all disclosing entities.[26]

7.24 The Group of 100 submitted that:

> …across large groups it is often difficult and judgmental to determine amounts for non-audit services. The detail and specificity of the disclosures in respect of non-audit services should be subject to materiality. The G100

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22 *Submission* 5, p. 6.

23 *Committee Hansard*, 16 March 2004, p. CFS 70.

24 *Submission* 5, p. 6.

25 *Submission* 42, p. [3].

26 Mr Sandy Easterbrook, *Committee Hansard*, 9 March 2004, p. CFS 5.

> believes that the total amount of fees paid for non-audit services and the material components should be disclosed.[27]

7.25 The National Institute of Accountants (NIA) said that it did not favour the 'wholesale banning' of non-audit work by auditors. However, it suggested modification of reporting requirements so that non-audit work could be identified according to 'type' or 'class'. In particular, the NIA proposed:

> ...Under each class there could be a basic rundown of the types of services provided in that class and the total amounts in each class. Identifying the information in this way will help shareholders and others to have a better understanding of the situation than a list of every item…If a shareholder desired a complete listing then this could be provided…Such disclosures should also be in line with the appropriate accounting standards and guidance notes (See AASB 1034 Financial Report Presentation and Disclosures).[28]

7.26 Mr Harley McHutchison, Deloitte Touche Tohmatsu (Deloittes), said that, in his experience, clients were 'very sensitive' about engaging their auditors to undertake extensive non-audit services so much so that he would be 'amazed' if any of Deloitte's audit clients paid more than five times the audit fee for non-audit services.[29] In response to suggestions that Australia should follow the Sarbanes-Oxley Act and apply a blanket ban on the provision of non-audit services, he added:

> They have banned certain services…
>
> I think services of that nature are actually better dealt with in F1. I could visualise where CLERP 9 has a principle based statement that then refers to F1. My understanding now in the US is that there is getting to be a fair bit of push back on some of those prohibited services.[30]

7.27 Mr McHutchison suggested that, in addition to the disclosure requirements for non-audit services, there should also be disclosure of 'audit-related services'.

7.28 Professor Robert Walker, appearing on behalf of ACSI, told the Committee that:

> In practice, many auditing firms actually do write up the books at the end of the year. It is often not a case of the directors making the choice of accounting methods; it is often a case of auditors actually being engaged in part to do the adjusting entries and finalise the accounts. Often, as we say in the submission, that is okay, if it is a small private company; but it is

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27 *Submission* 46, p. 3.

28 *Submission* 25, p. 26.

29 *Committee Hansard*, 11 March 2004, p. CFS 29.

30 *Committee Hansard*, 11 March 2004, p. CFS 29.

> something that you would not, I think, expect of the major listed companies.[31]

The Committee's views

Is regulation needed?

7.29 The Regulation Impact Statement for the Bill provides the rationale for the non-audit services provisions. It says:

> When an audit firm provides non-audit services to a client it is serving two different sets of clients: management in the case of non-audit services; and the audit committee, the shareholders and all those who rely on the audited financial statements in the case of the audit. In serving these different clients, the audit firm is subject to conflicts of interest.[32]

7.30 The initial question for the Committee when looking at these provisions was whether there was a need for them. Did reliable studies exist, for example, to establish a definite link between audit failure and the level of non-audit services provided by auditors? In other words, did auditors' provision of non-audit services compromise their professionalism and objectivity to the extent that audit reports could not be relied on?

7.31 No conclusive or compelling evidence of a link was forthcoming from witnesses who argued for a blanket or selective prohibition on non-audit services.

7.32 Similarly, those supporting the status quo produced no evidence to support their position. Mr Michael Coleman, KPMG, suggested there was no evidence and said in this regard:

> A very large number of academic studies have been done that have been unable to suggest any link between the provision of non-audit services and audit failure. It is one of those statements that are made by people, without having any empirical evidence to back it up.[33]

7.33 Consistent with Mr Coleman's assertions, the Regulation Impact Statement for the Bill referred to the absence of research establishing such a connection:

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31 *Committee Hansard*, 16 March 2004, p. CFS 79.

32 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 16.

33 *Committee Hansard*, 16 March 2004, p. CFS 35.

> …there is no solid evidence of any specific link between audit failures and the provision of non-audit services…[34]

7.34 Although this might be the case, it would have helped the Committee if the results of those studies had been produced.

7.35 Mr Stuart Wilson, ASA, told the Committee of research suggesting that audit services were being used as a loss leader to attract non-audit work. He commented in this regard that there seemed to be 'a tendency for audit firms to perhaps use more junior staff or perhaps not be so rigorous in testing' with the result that the quality of audit work suffered. The Committee notes Mr Wilson's caveat that he had 'no actual evidence' to support these observations which were 'just anecdotal'.[35]

7.36 Mr Brian Long, Ernst & Young, challenged the logic of the argument that auditors attempted to secure audit engagements through loss leading to generate opportunities for non-audit fees. In this regard he said:

> There is a lot said about auditors accepting audit engagements so that they can sell other services, but there is not much said about why, if they are concerned about the finances, they would not be concerned about the audit fee itself. If earning additional fees is likely to interfere with their behaviour as an audit partner, why wouldn't the fact that they get paid to do the audit interfere with their behaviour as well? There are plenty of audit clients where the fees are millions of dollars and there might be a million or two for other services. If this is going to interfere with their objectivity, why isn't the base fee going to? As soon as you start paying your auditor, you go immediately into a situation where someone might perceive that they are not being objective or they will not be independent, because they are trying to protect the audit fee. I think that argument runs just as effectively there as it does over here, and my point is that the firms, and the larger firms in particular, are not reliant on one client. We would never jeopardise our independence for the sake of a fee.[36]

7.37 Mr Michael Coleman, KPMG, also thought the risks involved in loss leading were too great. He told the Committee:

> …I am not aware of any situation where there has been an audit undertaken at a fee to try to lead into other work, simply because the risk of getting the audit wrong is too great…

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34 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 17.

35 Mr Stuart Wilson, *Committee Hansard*, 9 March 2004, p. CFS 19.

36 *Committee Hansard*, 6 April 2004, p. CFS 30.

> You also have to recognise that it is the cost to us of professional indemnity insurance and the cost to us of litigation if we get it wrong.[37]

7.38 The Committee asked representatives of the ICAA whether they were aware of 'minimalist' audits or poor quality audits being performed as a result of insufficient fees. Would an audit firm offering its services at the lowest price, for example, be able to carry out an effective audit? [38]

7.39 The ICAA submitted that it was not aware of any cases where price had been 'a factor resulting in work…that was less than what was in accordance with, or required under, the auditing standards'.[39] It was the Institute's view that, whatever the price, it was an auditor's role to form an opinion and there were specific standards in place to ensure that the auditor's opinion was fairly formed.[40] Mr Stephen Harrison referred to what he considered was another incentive for auditors to perform up to standard:

> …The auditor will…make sure that they apply the necessary resources. To skimp on an audit simply because of any particular circumstances is to put their whole future at risk. They cannot afford to take that risk. [41]

7.40 The Committee accepts the evidence from witnesses on both sides of the fence as indicative of their individual experiences. However, while representatives of the accounting profession who participated in the Committee's inquiry might not engage in practices that compromise their objectivity and independence when conducting audits, the possibility that loss leading might be practised by some members of the profession does not strike the Committee as far-fetched.

7.41 The Committee notes the views of the Trade and Industry Committee in the United Kingdom that there was scope for placing limits on the provision of non-audit services by auditors, among other things, because:

> …it seems to us that there is a danger of audit services being used as a loss leader, not least because the lack of competition for auditing big and especially multinational companies must make it very difficult for even the most conscientious audit committee to determine a true market rate for the job.[42]

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37 *Committee Hansard*, 16 March 2004, p. CFS 36.

38 It should be noted that the Committee did not ask these questions in the context of the ASA's assertions regarding the use of auditing services as a loss leader.

39 Mr Bill Palmer, *Committee Hansard*, 11 March 2004, p. CFS 43.

40 Mr Keith Reilly, *Committee Hansard*, 11 March 2004, p. CFS 43.

41 *Committee Hansard*, 11 March 2004, p. CFS 43.

42 House of Commons Trade and Industry Committee, *The White Paper on Modernising Company Law, Sixth Report of Session 2002-03*, London, 13 May 2003, p. 30.

7.42 As in the United Kingdom, the Australian accounting market is dominated by a few large players. It seems to the Committee that the mechanisms driving loss leading behaviour in the United Kingdom market could well be at work here.

7.43 The Committee consequently believes it cannot dismiss the possibility that loss leading of audit services exists in the Australian market. As in the United Kingdom market, it might be that this practice—assuming it exists—is restricted to the larger firms. In this regard, the following comments made by Ms Dianne Azoor Hughes, Pitcher Partners, strike the Committee as entirely feasible:

> Middle-tier firms cannot afford to carry loss leaders, as the scale of our operations and the market in which we operate are significantly different from non-audit services offered to the larger corporations.[43]

7.44 While this is a matter of speculation only, it creates sufficient uncertainty to suggest to the Committee that some regulation is necessary. This is all the more so given the substantial loss of confidence in audit integrity that followed the spate of recent corporate collapses. In this regard, the Committee is mindful of the Royal Commissioner's comments that perceptions of auditor independence are as important as the reality.[44]

7.45 As to the form regulation should take, the Committee considered the following options:

- to apply a blanket ban;
- to prohibit specific non-audit services;
- to adopt the principles-based approach to regulation in the Bill and rely on disclosure as the control mechanism.

What form should the regulation take?

7.46 The main arguments raised in proposals for a blanket ban were that auditors should not be auditing their own work and that loss leading practices in the industry were not conducive to the conduct of quality audits.

7.47 That auditors should not audit their own work is not disputed. However, without definite proof to indicate self-review is widespread and without definite proof

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43 *Committee Hansard*, 18 March 2004, p. CFS 64. ASIC's survey on auditor independence referred to on page 1 of chapter 6 of this report concluded that the provision of non-audit services by audit firms was widespread at least for major corporates. This tends to lend weight to Ms Azoor Hughes' comments although the limited size of ASIC's survey should be taken into account.

44 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol I, Canberra, April 2003, pp. 167-8.

to establish the existence of loss leading in the market, the Committee believes a blanket ban would be excessive.

7.48 In addition, the Committee believes that there could be very real problems involved in distinguishing in legislation between what constitutes an audit service, as opposed to a non-audit service. As the Committee demonstrates in its discussion of selective prohibition below, the meaning and scope of various non-audit services are capable of highly variable interpretations. Mr Harley McHutchison, Deloittes, referred to the difficulties involved as follows:

> I note discussion about the notion of prohibiting the auditor from providing any services whatsoever other than audit services. One valid interpretation of audit services is the audit of the statutory financial report. This would mean the auditor could not give accounting advice, could not provide reports to regulators, could not perform agreed upon procedures reports on a range of matters, could not provide reports on fraud, could not report on the quality of internal controls, could not conduct financial due diligence on potential acquisitions and could not prepare an investigating accountant's report on historical results and so on. We do not support this notion because in our view it is not in the best interests of the audit client, nor is it in the best interests of its shareholders.[45]

7.49 The Committee was interested to hear from the auditing profession whether or not they considered there were any services that auditors should not provide. Most of the evidence concerned internal auditing and valuation services.

7.50 A number of witnesses thought Australia should follow the United States example which prohibits the provision of certain non-audit services by auditors and also requires audit committees to pre-approve the provision of other non-audit services. The prohibitions apply to:

- valuation services,
- bookkeeping services;
- actuarial services;
- investment banking services;
- legal services not connected with the audit;
- human resources services; and
- financial information systems design.

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45 *Committee Hansard*, 11 March 2004, p. CFS 24.

7.51 While the Committee agrees that an auditor's performance of certain non-audit services, including those banned by United States legislation, could involve significant conflicts of interest, it preferred the principles-based approach in the Bill's existing provisions for several reasons discussed below.

7.52 Certainly, the evidence to date suggests that the extent of auditing failure in recent years has been significantly greater in the United States than in Australia or the United Kingdom. This circumstance alone might account for the more hard-line approach adopted in the United States.

There is a danger that selective prohibition could be 'over-inclusive' or under-inclusive

7.53 Several witnesses did not support selective prohibition because they saw it as providing scope for inadvertent exclusion or inclusion of services. Professor Ian Ramsay, for example, told the Committee:

> I do not support the idea of banning a range of services… because that might give false comfort. You cannot necessarily think that, because you have banned eight services, that is it in terms of auditor independence. Those sorts of rules have the real risk of being over-inclusive and under-inclusive—missing important issues that might threaten auditor independence and catching ones that may not be a threat to auditor independence.[46]

7.54 Mr Greg Larsen, CPAA, expressed similar concerns:

> …I think Professor Ramsay brought this up…If [certain non-audit services] are listed in legislation as being excluded, that might mean people interpret that other audit services which should be excluded in particular circumstances are not excluded. So it is important that, if we wanted to actually make some specifically excluded, that is not seen to be the total list and that the principle of independence is always maintained where non-audit services are provided, whether they are listed as excluded or not.[47]

Significant difficulties would be entailed in providing workable legislative definitions of some non-audit services

7.55 Internal auditing is a case in point. Although internal auditing was considered by many as a definite candidate for prohibition,[48] evidence to the Committee indicated

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46 *Committee Hansard*, 18 March 2004, p. CFS 17.

47 *Committee Hansard*, 18 March 2004, p. CFS 31.

48 The Institute of Internal Auditing, for example, told the Committee that 'there is never an instance where auditor independence will not be compromised, either perceived or real, if the same professional services firm provides internal audit and external audit services to the same client'. Mr Michael Parkinson, *Committee Hansard*, 7 May 2004, p. CFS 28.

that there are considerable grey areas surrounding the meaning of this term. As Mr Michael Coleman, KPMG, suggested:

> Internal audit is as broad or as narrow as you wish it to be.[49]

7.56 The following exchange taken from the Committee's hearing on 14 April 2004 ensued after the witnesses were asked to define a boundary for internal audit. It gives an indication of the uncertainties associated with, and the subjective nature of, the term.

> **Mr Geoff Brayshaw:** Talking from experience, most internal audits are not truly independent of management; therefore, you would not be able to do internal audits in those circumstances. True internal auditing only reports to the audit committee and is not involved as a supplement to internal control processes but is a true comment on internal control. I do not have a problem with external auditors carrying out that form of internal audit work. There is a lot of internal audit work that has nothing to do with financial statements, and I presume that we are not too worried about whether you do an internal audit of the triple bottom line reporting and that sort of thing.
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> **Chair:** From the sound of it, in reality that internal audit process is an external audit process.
>
> **Mr Geoff Brayshaw:** An internal audit which is truly independent is an extension of the external audit process.
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> **Mr Kevin Reid:** It is deeper than the external audits. The external audit requires you to look at the manner in which the systems operate, and you do have to walk through those systems, but I think what Geoff is talking about is where you get into a greater depth. I would agree with his view that, in those circumstances, provided you are reporting to the right level, which is the audit committee, then an auditor is not breaching his or her independence.
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> **Mr Jeff Knott:** As long as there is not a reliance upon the internal audit working as part of the internal control itself. What we are envisaging is an extended audit opinion that has reference to internal control reviews et cetera—something along those lines. It is not necessarily the internal audit work where people are perhaps doing—
>
> **Chair:** What is left for internal audit then? If you are doing a deeper external audit which is, in reality, a significant part of the internal focus, albeit independent as you have described, what is left other than bookwork internally within the firm?
>
> **Mr Jeff Knott:** They would be left with perhaps debtors' circularisation—certain steps which are part of the internal control, where management and

49 *Committee Hansard*, 16 March 2004, p. CFS 29.

> the board require assurance internally to ensure that internal controls are actually operating, and that is part of the control environment that is in place in that entity. There is probably a lot of work there for internal auditors. I think we are saying that there is limited work for external auditors. There are areas where there is a report on internal control overview, which some might call an internal audit. We are not so sure that is an internal audit. It is either an extended scope of the external auditor's role or where he is providing an opinion in an audit opinion not only on the truth and fairness of financial statements but also on adherence to controls within the organisation.[50]

7.57 The following definition of internal audit provided by the Institute of Internal Auditors (IIA) reflects the scope of the internal audit function and, in the Committee's view, illustrates the challenges involved in distinguishing some internal audit from external audit activities:

> …The definition developed and published by the IIA is that internal auditing is an independent, objective assurance and consulting activity designed to add value to and improve an organisation's operations. It helps an organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management control and governance processes.
>
> …internal auditing reviews the reliability and integrity of information, compliance with policies and regulations, the safeguarding of assets, the economical and efficient use of resources and the achievement of operational goals and objectives. Internal audits encompass financial activities and operations—including systems, production, engineering, marketing and human resources…[51]

There is a need to allow for flexibility in the legislation to cater for exceptions and grey areas

7.58 Valuations were often cited during the inquiry as a clear example of a service that auditors should not provide—'valuation is pretty black and white'[52] and 'Evaluations are an absolute given'.[53]

7.59 However, the following exchange between Mr Michael Coleman, KPMG, and the Committee suggests that even in this seemingly clear-cut area, there should be enough flexibility to accommodate exceptions:

> **Mr Coleman:** One circumstance would be where an audit firm is providing a valuation of an asset and that valuation is included in the financial

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50 *Committee Hansard*, 14 April 2004, p. CFS 83.

51 Mr Michael Parkinson, *Committee Hansard*, 7 May 2004, p. CFS 27.

52 Ms Dianne Azoor Hughes, Pitcher Partners, *Committee Hansard*, 18 March 2004, p. CFS 68.

53 Mr Brian Long, Ernst & Young, *Committee Hansard*, 6 April 2004, p. CFS 30.

> statements. It is very hard to imagine that a valuation that has been prepared by the auditor could be done with a sufficient degree of independence for the auditor to—
>
> **Senator Conroy**—It would be unlikely, if you have provided the number, that you would ever argue: 'Here's the number I provided. Now let me audit it. No, I agree with myself!'
>
> **Mr Coleman**—KPMG policy prevents us from undertaking that work. But it is possible, even with that circumstance, for the directors to have some sort of safeguard in place. For example, they may have a valuer on the board and that—
>
> **Senator Conroy**—Do many companies have valuers on their boards?
>
> **Mr Coleman**—Yes. I would have thought that real estate companies probably do. So there might be circumstances where the board, either through internal or other resources, might feel that they can get a second check on those sorts of numbers. That is the expectation of F1: that there will be circumstances.[54]

7.60 The Committee notes, however, that the notion of having an alternative valuer opinion would be more relevant if that second opinion was available to the shareholders rather than the board.

7.61 As discussed earlier in this section, ACSI was critical of the endorsement of F1 as a supplement to the Bill's principles-based approach. Its main concern was that F1 'actually allows auditors to value assets or businesses on behalf of an audit client [and] then incorporate those valuations in Statements of Financial Position'.[55]

7.62 The Committee does not share these concerns and notes that F1 allows an auditor to perform valuation services only where these services are 'neither separately, nor in the aggregate, material to the financial report, or…do not involve a significant degree of subjectivity'. Where these conditions are not present, paragraph 2.73 of Appendix 2 of F1 provides that:

> If the valuation service involves the valuation of matters material to the financial report and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the *audit engagement*.[56]

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54 *Committee Hansard*, 16 March 2004, p. CFS 29.

55 *Submission* 5, p. 6.

56 ICAA and CPAA, *Professional Statement F.1—Professional Independence*.

7.63 Another non-audit service raised in the evidence as one that auditors should not provide was tax advice. The Committee was interested to hear auditors' views on this proposal and asked Mr Tony Harrington, PricewaterhouseCoopers, whether auditors should be permitted to audit their own tax advice.

7.64 Mr Harrington told the Committee that in tax and other areas, 'you have to follow a principle as opposed to a specific prescriptive rule' which would require that 'you [do] not move into a zone where there is a concern about your auditing your own work'. Referring to tax specifically, Mr Harrington told the Committee:

> …I come from a tax background and I know the complexities of the tax field. If you take just one end of the spectrum such as the compliance piece of satisfying obligations under the tax act, the fact that the audit firm understands the detail of the issues is helpful for you in the conduct of an audit. Otherwise we can layer on a lot of process and cost.[57]

7.65 Mr Brian Long, Ernst & Young, similarly told the Committee when questioned about the propriety of an auditor providing tax advice:

> …I do not think it is black and white. There is an attractiveness about saying, 'If you just say you can't do it then you won't have a problem.' But I am not sure that is the right answer for many corporations that find there are benefits in using an audit firm because they have knowledge of the organisation. There are benefits because there might well be a lower cost in doing that exercise—if you are not in truth impairing the independence. I fully support highly transparent disclosures about what the auditor has done…If you see that they have done other services and you know exactly what they are, you can form a view about whether you have a problem with that.[58]

7.66 The Committee heard evidence of the need for flexibility in circumstances where the benefits of auditors performing non-audit services were considered to outweigh any possible negatives. An auditor's familiarity with a client's operations, for example, means that the auditor can provide non-audit services within tight time constraints if the client should require this. It might also make more commercial sense for an auditor to provide non-audit services.

7.67 Professor Robert Walker, on behalf of the ACSI, told the Committee of an instance where 'auditors [performed] certain work on internal controls and what might be described as internal audit work…' in the interests of expediency:

> I have had experience on boards where, because of some problems, we found it desirable to bring in auditors to do far more detailed internal reviews—looking at data integrity problems and the like—than would be necessary to do the audit. Why did we bring them in?—because they knew

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57 *Committee Hansard*, 6 April 2004, p. CFS 68.

58 *Committee Hansard*, 6 April 2004, p. CFS 30.

> the systems. They could walk in and do the job, and we wanted it done quickly, to sort out a problem. That kind of internal audit work I do not think should be prohibited. Indeed, I think auditors being asked to do far more detailed work than the bare statutory minimum should be encouraged. If it is a case of requiring shareholders to vote on it, so be it.[59]

7.68 Mr Robert Ward, PricewaterhouseCoopers, made a similar point. He argued that one advantage of principles-based regulation—as opposed to prescription—was that it allowed for auditors' exercise of judgement when determining what services were permissible and what were not. It was his view that clients would be better served by an approach that catered for individual circumstances.

7.69 To illustrate his point, Mr Ward told the Committee of an instance where duplication of work and extra costs resulted when a client of his firm engaged another firm to carry out due diligence:

> In this particular case, we had to re-perform all the work of the firm that carried out the due diligence to satisfy ourselves for the purposes of the financial statements. In fact, ironically, in this particular case that firm would not release their work to us—that is, their files and so on—so we had to do all the work again because we needed to do that work to be satisfied on the financials. It was somebody well-intentioned saying, 'Please don't do this due diligence work for us because you'll be auditing your own work.' In fact, we had to do that work anyway to do a good audit. They had taken a prescriptive approach and said, 'Don't do it in this case,' and F1 actually addresses that. The language in F1 is very well drafted to test that principle.[60]

7.70 The Committee acknowledges that the adoption by another jurisdiction of a particular regulatory approach is no reason for Australia to follow suit. Nonetheless, the Committee draws some comfort from the findings of the United Kingdom Trade and Industry Committee (UK Committee) following its recent inquiry into modernising company law. The UK Committee decided against a blanket ban and selective statutory prohibition of the provision by auditors of non-audit services in favour of self-regulation notwithstanding its acknowledgement that 'public confidence in self-regulation…is low'.[61]

7.71 According to the UK Committee, 'some tasks could be carried out by auditors without undermining their independence, and potentially more efficiently than by

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59 *Committee Hansard*, 16 March 2004, p. CFS 79.

60 *Committee Hansard*, 6 April 2004, p. CFS 69.

61 House of Commons Trade and Industry Committee, *The White Paper on Modernising Company Law, Sixth Report of Session 2002-03*, London, 13 May 2003, p. 31. Although self-regulation was recommended, the UK Committee proposed that the Government should re-consider whether statutory restrictions were needed if self-regulation seemed to be failing.

bodies without the inside knowledge of company operations gained by auditors'.[62] Of particular interest in the context of the current debate, are the following reasons given by the UK Committee for deciding against a blanket ban:

- not all non-audit services posed a risk to auditors' independence; and
- the more benign non-audit services could be carried out 'potentially more efficiently than by bodies without the inside knowledge of company operations gained by auditors'.[63]

7.72 The UK Committee also considered statutory regulation 'as a rather inflexible way of addressing the issue of banning or restricting certain types of non-audit work' and considered such an approach would militate against the interests of small companies. In this regard, it said:

> …in respect of smaller client companies the provision of non-audit services is less lucrative to auditors, so the small accountancy firms that deal with such companies are less likely to be in a position to make their auditing services a loss leader. At the same time, small companies do not have many options when it comes to obtaining advice on, for example, their tax affairs, and their auditors would be an obvious source of professional help. It would therefore be wrong to impose statutory requirements about auditors that would affect companies of all sizes; and, even if one excluded smaller companies who are subject to a lighter auditing regime under company law, this cut-off point would not necessarily coincide with the division between companies where problems of auditor independence may arise and companies where there are likely to be such problems.[64]

7.73 The Committee heard evidence to suggest that the problems for small business envisaged by the UK Committee as a by-product of statute-imposed restrictions, might also apply to Australian companies. For example, Ms Dianne Azoor Hughes, Pitcher Partners, told the Committee that:

> In contrast to large listed corporates, many of the smaller listed entities do not have dedicated resources for statutory financial reporting. They rely on their auditors to ensure that they comply with the regulatory regime in which they operate.[65]

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62 House of Commons Trade and Industry Committee, *The White Paper on Modernising Company Law, Sixth Report of Session 2002-03*, London, 13 May 2003, p. 30.

63 House of Commons Trade and Industry Committee, *The White Paper on Modernising Company Law, Sixth Report of Session 2002-03*, London, 13 May 2003, pp. 30-1.

64 House of Commons Trade and Industry Committee, *The White Paper on Modernising Company Law, Sixth Report of Session 2002-03*, London, 13 May 2003, pp. 30-1.

65 *Committee Hansard*, 18 March 2004, p. CFS 63.

7.74 The Committee is satisfied that the disclosure requirements in the Bill are a workable and cost-effective approach to the regulation of auditors' provision of non-audit services that will:

- protect the interests of shareholders;
- serve the needs of a wide range of consumers of the services involved; and
- protect the interests of smaller listed companies.

7.75 The Committee is also satisfied that the 'threats and safeguards' approach advocated in F1 will provide a useful supplement to the legislation.

CHAPTER 8

AUDIT REFORM—RISK ALLOCATION AND MANAGEMENT

8.1 In this chapter the Committee examines two measures of the proposed legislation that address the issue of the liability of auditors for professional default. One measure allows for the incorporation of audit firms, thus restricting liability solely to the auditor(s) responsible. The other measure introduces a scheme to apply proportionate liability to damages actions for economic loss or property damage arising from misleading and deceptive conduct.

8.2 The Committee will then review proposals made in several submissions that the Bill should contain a requirement for all companies to have an audit committee.

Business structures for auditors—authorised audit companies

8.3 Under the *Corporations Act 2001* (Corporations Act), only a natural person may be registered as an auditor: there is no provision for a company to be registered as an auditor.[1]

8.4 Partnerships are the usual business structure adopted when there is more than one proprietor providing auditing services. Under partnership law, audit partners of an audit firm are exposed to unlimited joint and several liability for professional default. Partnership structure means that all partners of a firm can be liable for losses caused by one partner despite the fact that they may have had no involvement in the conduct causing the loss.[2]

8.5 Auditors had sought legislative measures to cap their liability. The Government rejected this proposal and commented that it was unable to see why professionals should be placed in a privileged position compared with other defendants and why loss should be shifted to other defendants or to the plaintiff. Furthermore, it was noted that:

> [a] scheme capping professional liability would also adversely affect the operation of the Corporations Act, which relies heavily on civil liability to provide a system of compensation and deterrence for wrongful conduct,

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1 Section 1279 *Corporations Act 2001*.

2 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 34 and p. 126.

whether for claims based on the Corporations Act directly or on common law principles of negligence.[3]

8.6 The Bill proposes to allow audit firms to incorporate. This will give auditors another option when structuring their businesses while helping to 'address some of the concerns relating to [their] professional liability'. Liability of auditors within audit firms will be quarantined to the particular auditor(s) who have caused the loss.

8.7 To become registered as an 'authorised audit company':

- all directors must be registered company auditors and not disqualified from managing a corporation under the Act;
- each share in the company can only be held and beneficially owned by an individual or the legal representative of an individual;
- the majority of votes attaching to shares in the company must be held and beneficially owned by individuals who are registered company auditors;
- the Australian Securities and Investments Commission (ASIC) must be satisfied that adequate and appropriate professional indemnity insurance is in place; and
- the company cannot be under external administration.[4]

8.8 Applications for registration must be made in writing to ASIC.[5] Registration is expressly subject to, among other things, 'the conditions or restrictions specified in the regulations' and 'any other conditions or restrictions determined by ASIC'. Furthermore, ASIC may impose conditions or restrictions on an audit company's registration at the time of registration or subsequently.[6]

8.9 The Institute of Chartered Accountants in Australia (ICAA) and CPA Australia (CPAA) saw features in both proposals which were cause for concern, namely, that they:

- failed to accommodate multi-disciplinary practices by requiring beneficial ownership of the majority of voting shares to be in the hands of individuals who are registered company auditors.

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3 *Corporate Disclosure, Strengthening the financial reporting framework—Corporate Law Economic Reform Program, Proposals for Reform: Paper No 9*, Canberra, September 2002, p. 99.

4 Proposed section 1299B Corporations Act.

5 Proposed section 1299A Corporations Act.

6 Proposed section 1299D Corporations Act.

- ought to limit the scope of ASIC's powers to impose conditions on registration to those matters consistent with registration eligibility criteria such as the company's corporate structure and constitution.

- ought not to allow conditions to be imposed post registration as this 'creates great uncertainty' which was 'further increased by the unfettered scope of restrictions ASIC may impose'.[7]

8.10 Mr Tom Ravlic supported the proposal to allow incorporation as 'a reasonable idea' in that it gave audit firms the same protection as any other business.[8]

8.11 The Australian Council of Super Investors Inc (ACSI) was not altogether comfortable with the incorporation proposal for two reasons:

- it could limit the ability of investors to obtain compensation for economic loss for 'the dissemination of false or misleading financial information'; and

- there was nothing in the legislation to ensure that ASIC's view of what constituted 'adequate and appropriate' professional indemnity insurance when assessing applicants for incorporation would accord with the public interest.[9]

8.12 The ANZ Banking Group supported audit company registration but was concerned with the 'significant discretion' conferred on ASIC to determine and apply conditions or restrictions on registration. It suggested that the Bill should set the parameters of ASIC's discretion or, alternatively, that the Bill might 'encourage ASIC to develop policy guidelines as soon as possible after the enactment of the Bill setting out in further detail how it intends to exercise its powers under this section'.[10]

8.13 The ANZ Bank's submission also suggested that consideration could be given to allowing limited liability partnerships which it claimed could 'combine the best features of partnerships (e.g. partnership culture) and companies (limited liability)'.[11]

The Committee's views

8.14 The Committee notes the general acceptance of the proposal to allow incorporation of auditors. The Committee is wary of ASIC's power to impose restrictions and conditions retrospectively and equally wary of an unfettered discretion to impose 'any other conditions or restrictions determined by ASIC'.

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7 *Submission*s 31 (CPAA) and 36 (ICAA), pp. 77-8 of attachment.

8 *Submission* 1A, p. 7 of attachment.

9 *Submission* 5, p. 7.

10 *Submission* 14, p. 7.

11 *Submission* 14, p. 7.

Recommendation 27

8.15 The Committee recommends that the relevant provisions with respect to the registration of an authorised company auditor be amended to remove the Australian Securities and Investments Commission's power to impose restrictions and conditions retrospectively and to limit the exercise of its discretion in this regard by the prescription of appropriate criteria.

Proportionate liability

8.16 The Bill amends the provisions of the *Australian Securities and Investments Commission Act 2001*,[12] the *Trade Practices Act 1974*[13] and the Corporations Act[14] to apply proportionate liability to damages actions for economic loss or property damage arising from misleading and deceptive conduct. Proportionate liability will not apply to intentional torts or claims involving fraud.

8.17 The Explanatory Memorandum notes that the proposed provisions implement a model for proportionate liability with the following key features endorsed by Commonwealth, State and Territory Governments:[15]

- the Court may take into account the proportionate liability of a wrongdoer who is not a party to the proceedings;
- a defendant will be required to give the plaintiff written and timely notification of any other person who the defendant believes could be liable for the whole or part of the plaintiff's loss;
- the Court will have a discretion to order costs against a defendant, on an indemnity or other basis, if the defendant has failed to discharge the disclosure obligation; and
- intentional torts and actions involving fraud will not be included in the proportionate liability regime.[16]

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12 Proposed sections 12GF and 12GP-GW.

13 Proposed sections 82 and 87CB-CI.

14 Proposed sections 1041I and 1041L-2.

15 *Submission* 51 from the New South Wales government confirms its support for these reforms and 'urges the Commonwealth Parliament to enact them as quickly as possible' to ensure that similar reforms enacted in New South Wales are not circumvented by recourse to the *Trade Practices Act 1974*.

16 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 153-4.

8.18 The Explanatory Memorandum refers to the introduction of proportionate liability as one way to curb rising professional indemnity insurance premiums. The regime is intended to allow plaintiffs to recover from a defendant only the proportion of the loss for which that defendant was responsible. It says further that:

> One of the major criticisms of the current system of joint and several liability is that it leads to plaintiffs targeting 'deep pocket' defendants, such as professional service providers and public authorities. This leads to increased liability insurance premiums for these potential defendants. Proportionate liability ensures that professionals, such as auditors, who hold professional indemnity insurance do not bear a disproportionate burden of claims where their co-defendants are uninsured.[17]

8.19 The new provisions apply only to 'apportionable claims' which are claims for economic loss or property damage caused by conduct prohibited in section 12DA, namely, 'conduct in relation to financial services that is misleading or deceptive or is likely to mislead or deceive'. A plaintiff may only claim once for the same loss or damage even though the conduct may found more than one cause of action. A defendant is a 'concurrent wrongdoer' if one of two or more persons who jointly or independently caused the plaintiff's damage or loss. It is immaterial that a concurrent wrongdoer is insolvent, is being wound up or has ceased to exist or has died.[18]

8.20 The amendments do not seek to apply the apportionable claim provisions to a concurrent wrongdoer who intended to cause or fraudulently caused the plaintiff's loss or damage. Claims involving these wrongdoers will be subject to existing legal rules. Other concurrent wrongdoers' liability must be determined in accordance with the new provisions.

8.21 Under proposed section 12GR where there are concurrent wrongdoers and whether or not all are parties to the proceedings:

- the court may award damages against a defendant only as far as the amount reflects the 'proportion of the damage or loss claimed that the court considers just having regard to the extent of the defendant's responsibility for the damage or loss'; and
- the court must exclude any damages attributable to the plaintiff's contributory negligence.

8.22 As mentioned earlier, the proposed amendments require a defendant to proceedings involving an apportionable claim to notify the plaintiff if the defendant has reasonable grounds to believe another person may be a concurrent wrongdoer. The

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17 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 153.

18 Proposed section 12GP ASIC Act.

defendant in such a case must give the plaintiff, 'as soon as practicable', written details of the other person's identity and the circumstances which make that person a concurrent wrongdoer. A defendant who fails to give the plaintiff such notice may have to pay all or any of the costs 'unnecessarily' incurred by the plaintiff because the plaintiff was unaware that another person might be a concurrent wrongdoer.[19]

8.23 However, a concurrent wrongdoer cannot be required to contribute to an amount paid by another concurrent wrongdoer or provide an indemnity to such a wrongdoer in respect of an apportionable claim.[20]

8.24 The new provisions do not override the laws of vicarious liability and 'a partner can still be held severally liable with another partner for the proportion of an apportionable claim for which the other partner is liable'.[21]

8.25 These provisions attracted little comment although there was some passing reference to them at hearings. In its submission, the Australian Stock Exchange Ltd (ASX) expressed support for the proposal as one which would 'assist in the development of a proper awareness of corporate responsibilities'.[22]

8.26 The Investment and Financial Services Association Ltd was 'generally supportive' of the new proposals but thought there should be 'adequate safeguards to protect consumers from circumstances designed to avoid appropriate liability'.[23]

8.27 On the other hand, the Law Society of Western Australia was strongly opposed and stated that:

> If proportionate liability is to apply to economic loss claims, then a principles approach demands that this apply to any profession or occupational group.[24]

8.28 A detailed submission from Maurice Blackburn Cashman Lawyers (MBCL) argued against the limitation of defendants' liability. MBCL disputed that large injury payments awarded by the courts were the 'main culprit of the insurance crisis'. It considered that other factors, including sustained underpricing of premiums worldwide during the 1990s and inadequate reserving, had left the insurance market

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19 Proposed section 12GS ASIC Act.

20 Proposed section 12GT ASIC Act.

21 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 157 (regarding proposed section 12GW ASIC Act).

22 *Submission* 48, p. 6.

23 *Submission* 44, p. 4.

24 *Submission* 7, p. 2.

unprepared for the events of September 11 which 'blasted a hole in world reinsurance reserves estimated at up to $50 billion'.[25]

8.29 MBCL questioned the need for reforms that offered 'substantial financial relief to wrongdoers and commensurate harm to the victims of their conduct':

> Insured parties will be able to shift liability onto other parties and where these parties are uninsured this will reduce the exposure of the insurance industry. Such uninsured parties will frequently lack the resources to compensate the victims of misleading and deceptive conduct and may end up insolvent…[26]

8.30 MBCL argued that the Bill's proportionate liability provisions were untenable for the following reasons:

- The plaintiff would bear an unreasonable burden in relation to contribution and third-party proceedings because of their direct impact on the plaintiff's recovery prospects.
- They would give defendants an incentive to reduce their liability and join other defendants or third parties who may not have the resources to properly defend themselves.
- They unfairly shifted the burden from wrongdoers to the plaintiff who was innocent of any wrongdoing.
- Proportionate liability would reduce the incentive for organisations to monitor the behaviour of their consultants, etc, in relation to their dealings with third parties.
- Plaintiff's solicitors would have difficulties in establishing a contribution claim under present procedural and ethical rules governing litigation.
- They would encourage unwieldy and extended litigation and place the plaintiff in the position of having to join defendants whether or not they have the means to meet a claim made against them.[27]

8.31 MBCL argued that the Bill's introduction of proportionate liability should be abandoned, failing which, they should be amended in accordance with Queensland legislation:

- to exempt their application to consumer and small investor claims of up to $500,000; and

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25 *Submission* 28, pp. 4-6.

26 *Submission* 28, p. 4.

27 *Submission* 28, pp. 8-12.

- where damages are apportioned and a defendant's insolvency within 2 years of an order to pay damages prevents a plaintiff's full recovery of the amount awarded against that defendant, the plaintiff may seek an automatic order that any shortfall will be divided equally between the plaintiff and the remaining solvent defendants with the plaintiff able to seek a further order for apportionment on that basis.[28]

8.32 The Committee sought KPMG's views about MBCL's argument that proportionate liability would unfairly shift the burden to the plaintiff. Mr Michael Coleman, KPMG, disagreed and commented that:

> I think the corollary to the argument that is there that says that a guilty party is somehow saved from liability is fallacious. The alternative is joint and several liability, and joint and several liability has had the unfortunate response over the years of apportioning most blame for corporate failures, or certainly the cost of paying for corporate failures, to the auditing professions. That is simply because, when a company fails, often the only person left standing is the auditor, notwithstanding the fact that largely most people do admit that the failure of a company is not the failure of an auditor; the failure of a company is to do with things such as the strategic direction of the entity and the types of things they did and it is largely to do with management.[29]

The Committee's views

8.33 The Committee endorses the principle of proportionate liability and views the safeguards and limitations proposed in the legislation as appropriate. It is not convinced that proportionate liability unfairly brings harm to victims. It is not a question of offering substantial financial relief to wrongdoers but quite the opposite: of protecting non-wrongdoers from unfairly shouldering the blame.

Audit committees

8.34 In its *Review of Independent Auditing by Registered Company Auditors*, the Joint Committee of Public Accounts and Audit (JCPAA) had recommended amendments to the Corporations Act to require all publicly-listed companies to have an independent audit committee complying with prescribed specifications relating to the role, responsibilities and composition of the committee.[30]

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28 *Submission* 28, pp. 12-13.

29 *Committee Hansard*, 16 March 2004, p. CFS 40.

30 JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, Canberra, August 2002, Recommendation 2, p. 53.

8.35 This departed from the recommendation in the Ramsay Report[31] that the ASX's Listing Rules should be the vehicle of first choice for the imposition of mandatory audit committee requirements. The Report advocated amendment of the Corporations Act to make such provision only if the listing rules failed to do so.[32]

8.36 On 1 January 2003, ASX Listing Rule 12.7 introduced a mandatory requirement for the top 500 listed companies to have audit committees.[33] This Listing Rule was amended with effect from 3 May 2004, to require the top 300 listed companies to also comply with the requirements for audit committees in Recommendation 4.3 of the ASX Corporate Governance Best Practice Guidelines.

8.37 The Bill contains no provisions relating to audit committees. The omission from the legislation of any prescription of audit committees, their composition and functions drew mixed views including some criticism. Comments focussed on who should have audit committees, how they should be composed and what they should do.

Who should have audit committees?

8.38 The Association of Superannuation Funds of Australia Ltd (ASFA) and Corporate Governance International Pty Ltd (CGI) thought audit committees should be mandatory for all listed companies.[34]

8.39 CGI raised concerns that listed companies outside the top 500 would not necessarily have 'a proper mechanism for ensuring' reliable public reporting.[35] According to CGI, the fact that a company might only be small was not sufficient reason for not having an audit committee if it was listed and 'using public money'.[36]

8.40 A similar view had been expressed by the JCPAA which described the argument that audit committees imposed unreasonable costs on small to medium companies as 'increasingly tenuous'. The JCPAA considered that listing on a stock exchange brought considerable benefits and questioned why a company unable to

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31 Professor Ian Ramsay, *Independence of Australian Company Auditors, Review of the Current Australian Requirements and Proposals for Reform—Report to the Minister for Financial Services and Regulation*, Canberra, October 2001.

32 Professor Ian Ramsay, *Independence of Australian Company Auditors, Review of the Current Australian Requirements and Proposals for Reform—Report to the Minister for Financial Services and Regulation*, Canberra, October 2001, pp. 15-16.

33 The listing rule came into effect on 1 January 2003.

34 *Submission* 19, p. [5] and Mr Sandy Easterbrook, *Committee Hansard*, 9 March 2004, p. CFS 5.

35 Mr Sandy Easterbrook, *Committee Hansard*, 9 March 2004, p. CFS 5.

36 Mr Sandy Easterbrook, *Committee Hansard*, 9 March 2004, p. CFS 5.

afford an audit committee, with at least one independent director,[37] should be permitted to list.[38]

8.41 Mr Stuart Wilson, Australian Shareholders' Association Ltd (ASA), said the proposition that the Bill should make the ASX's audit committee requirements mandatory had the ASA's 'in principle' support but he suggested that the costs involved might not necessarily serve the interests of shareholders in smaller companies. He commented in this regard that:

> I would imagine that shareholders in companies outside of the top 200 would be concerned at the additional layer there, assuming of course that the board as a whole would take responsibility for the audit committee function in those instances.[39]

8.42 Mr Stephen Harrison, ICAA, told the Committee that the ICAA was satisfied with the ASX's provision for audit committees and did not see a need for legislative backing to make them mandatory.[40]

Audit committees —their composition and functions

8.43 Under the best practice recommendations of the ASX Corporate Governance Council, the audit committee must follow specific reporting guidelines,[41] have a formal charter[42] and comprise:

- only non-executive directors;
- a majority of independent directors;
- an independent chairperson, who is not chairperson of the board; and
- at least three members.[43]

8.44 In its submission to the current inquiry, the Institute of Internal Auditors proposed the following requirements for audit committees:

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37 This is one of the concessions for smaller companies proposed in the Ramsay Report. The JCPAA report refers to this on p. 51.

38 JCPAA, *Report 391, Review of Independent Auditing by Registered Company Auditors*, Canberra, August 2002, Recommendation 2, p. 51.

39 *Committee Hansard*, 9 March 2004, p. CFS 24.

40 *Committee Hansard*, 11 March 2004, p. CFS 39.

41 Recommendation 4.5. The Guide to reporting on Principle 4 requires information about audit committee members' names, qualifications, meetings held, attendances, the audit committee charter and procedures for selection and rotation of the external auditor.

42 Recommendation 4.4.

43 Recommendation 4.3.

- only independent directors should sit on audit committees;
- the CEO and CFO should not sit on an audit committee as members but would could attend by invitation of the audit committee chair;
- the audit committee should be responsible for appointing and terminating the appointment of the head of internal audit;
- the head of internal audit should report directly to the audit committee chair; and
- the 'Chief Audit Executive (Internal Auditor)' should sign off on all internal audits conducted on behalf of the audit committee and this should be reported in the Annual Report.[44]

8.45 The Committee refers to the strong support in the CLERP 9 discussion paper for the recommendations of the Audit Review Working Party and the Ramsay Report that the audit committee of a company:

- should appoint the auditor; and
- should make recommendations concerning the remuneration of a company auditor.[45]

8.46 There appear to be no definite requirements in ASX Listing Rule 12.7 or the best practice recommendations that put these recommendations into effect.

8.47 The Committee also notes the comments of the HIH Royal Commissioner on the ASX's requirements for audit committees. While professing a limited familiarity with the relevant best practice requirements, he suggested they might need clarification to ensure that:

- audit committee membership would be independent not only of management, but also the external auditors; and
- the system of reporting to the board would allow sufficient time for the audit committee to consider the financial reports of the company before their public release.[46]

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44 *Submission* 26, p. 3.

45 *Corporate Disclosure, Strengthening the financial reporting framework—Corporate Law Economic Reform Program, Proposals for Reform: Paper No 9*, Canberra, September 2002, p. 77.

46 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, pp. 180-1. Box 2.1 of Principle 2 of the ASX *Principles of Good Corporate Governance and Best Practice Recommendations*, sets out indicators of a director's independence. As noted by the Royal Commissioner, these do not expressly require audit committee members to be independent of external auditors.

The Committee's views

8.48 In general, evidence to the Committee about audit committees suggested that they were performing a useful and valued role. The following comments of Mr Kevin Reid, BDO, were fairly representative of the views expressed:

> …The advent of audit committees over the last decade or so has been an enormous step forward. Audit committees have been adopted in a voluntary sense by many listed companies. The existence of those audit committees provides us with an avenue to deal with key issues which come out of the audit process and allow those issues to be dealt with. The changes that the ASX have made are further steps in the right direction.[47]

8.49 The Committee believes that the ASX Listing Rules and best practice requirements, in combination with the Bill's additional safeguards for auditor independence, provide satisfactory arrangements for audit committees at this stage.

8.50 However, the Committee suggests that the ASX's best practice requirements should adopt the recommendations of the Audit Review Working Party and the Ramsay Report that audit committees should be responsible for appointing a company's registered external auditor and setting the remuneration of that auditor. The HIH Royal Commissioner's comments that the best practice recommendations need to ensure the timeliness of reporting requirements and clarify independence requirements for audit committee membership should also be adopted.

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47 *Committee Hansard*, 14 April 2004, p. CFS 78.

CHAPTER 9

AUDIT REFORM—ENFORCEMENT—DISCIPLINARY MEASURES

Companies Auditors and Liquidators Disciplinary Board (CALDB)

Introduction

9.1 Enforcement of standards that govern the conduct of the audit industry is essential. To be effective, an enforcement regime requires resources, the credibility that stems from independence and not only the power to wield the big stick but also the ability to offer alternatives to resolve disputes about compliance in a timely and less formal fashion.

9.2 The Companies Auditors and Liquidators Disciplinary Board (CALDB), as the disciplinary arm of the enforcement regime, has powers to cancel or suspend an auditor's registration and to reprimand or require certain undertakings from an auditor who no longer satisfies competency or integrity standards or has failed to comply with statutory requirements.[1]

9.3 Under the present legislation, accountants form a majority of the three-member Board and those three members must hear and determine all matters within the remit of the Board.

9.4 In this chapter the Committee examines the proposals in the Bill to improve the Board's credibility and operational efficiency.

9.5 In the following chapters, the Committee will review other proposals designed to strengthen enforcement of financial reporting requirements. These include the proposed establishment of an alternative dispute resolution body—the Financial Reporting Panel; the conferral of legal backing on auditing standards, and the expansion of auditors' reporting obligations.

Proposed changes to the structure of the CALDB

9.6 At present the CALDB comprises three part-time members appointed by the Minister for a minimum three-year term which can be renewed. Of these members, the chairperson must be a lawyer who has been enrolled for at least five years. The other two members are appointed—one from a panel of five nominated by The Institute of Chartered Accountants in Australia (ICAA) and the other from a panel nominated by CPA Australia (CPAA).

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1 Section 1292 Corporations Act.

9.7 The Bill proposes to change the Board's membership and operating arrangements to counter 'concerns about [the CALDB's] operational capacity and its perceived independence from the accounting profession'.[2]

9.8 CALDB membership will increase from 3 to 14 and will comprise:

- a chairperson and deputy chairperson (both having legal qualifications) appointed by the Minister;
- 3 members appointed by the Minister from a panel of 7 nominated by the ICAA (accounting members);
- 3 members appointed by the Minister from a panel of 7 nominated by the CPAA (accounting members); and
- 6 members appointed by the Minister from the business community (business members).[3]

9.9 In addition to these membership changes, the present functions of the Board will be split. The Board itself will retain responsibility for procedural issues and general business but disciplinary matters will be managed by panels nominated by the chairperson from the CALDB membership. A panel will comprise—in addition to the chairperson or deputy chairperson—either:

- 2 accounting members (1 each from the ICAA and CPAA) and 2 business members (a 5-member panel); or
- 1 accounting member and 1 business member (a 3-member panel).[4]

9.10 With the chairperson or deputy chairperson able to chair a panel, two panels may sit at one time and 'thereby hear and determine matters more expeditiously'. The proposed amendments will also allow for greater representation by non-accountants on the CALDB and its panels. This, the Explanatory Memorandum indicates, will 'enhance the perceived independence of the Board' while recognising the 'importance of retaining accounting expertise'.[5]

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2 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 134.

3 Proposed subsections 203(1), (1A), (1B) and (2A) *Australian Securities and Investments Commission Act 2001* (ASIC Act). A person from the business community must have qualifications in, or knowledge of or experience in one or more of business or commerce, company administration, financial markets, financial products and services, economics or law—proposed subsection 203(2A).

4 Proposed section 210A deals with the membership and functions, etc. of CALDB panels.

5 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 135.

9.11 Proposed subsection 210A(5) directs the chairperson to constitute a 5-member panel where the chairperson is satisfied that it is practicable and appropriate. According to the Explanatory Memorandum, a 5-member panel is to be preferred 'wherever possible' although a 3-member panel would be appropriate 'in the case of more routine matters such as where a respondent has failed to lodge an annual statement, or in the case of similar matters of an administrative nature.[6]

Comments

9.12 The Committee received only limited comment on these proposals.

9.13 The Association of Superannuation Funds of Australia Limited (ASFA) thought the change would enhance the independence of the Board and refuted 'suggestions that non-accountants are somehow incapable of assessing whether accountants have failed in their duty as auditors'. ASFA proposed that users of financial reports should be represented on the panels as appointees from the business community.[7]

9.14 The Law Council of Australia recommended that at least one auditor and/or insolvency practitioner should sit on the Board.[8]

9.15 The National Institute of Accountants (NIA) supported a greater mix of expertise on the Board and 'the idea of separating the Board from the hearing of complaints'. In contrast to ASFA's views, the NIA questioned whether having a majority of non-accountants to hear complaints would be 'helpful' given the 'very technical issues that will be before the CALDB'.[9]

9.16 The NIA proposed the following changes to the membership of the Board and panels:

- Only the chair and deputy chair should hold positions on the Board and the panels;
- The Board should comprise:
    - the chair and deputy chair drawn from the legal profession;
    - the president or nominee from each of the three professional accounting bodies;
    - three representatives from the business community; and

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6 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 137-8.

7 *Submission* 19, p. [6].

8 *Submission* 24A, p. 1.

9 *Submission* 25, p. 30.

- a representative of the Minister.

- The Board should appoint members of the panels from a list comprising:
  - 10 representatives from the accounting and auditing profession to 'be nominated personally, and not by reference to their membership of any particular professional accounting body' with each nomination supported by two other members of the profession; and
  - 10 representatives from 'other professions' such as lawyers, engineers, doctors etc and the 'business community'.[10]

9.17 As for the composition of the hearings panels to be nominated by the Board, the NIA suggested:

> A panel could be made up of either three or five persons…having reference to availability, proximity, specialist knowledge and independence issues. Either the Chairperson or the Deputy Chairperson would head the panel, with an appropriate mix of other according to the charges being heard. For example, if the issue relates to the appropriate determination of an accounting or auditing standard, then it may be appropriate to include more members of the accounting and audit profession, due to the technical knowledge that would be required.[11]

The Committee's views

9.18 The Committee welcomes the proposals to improve the efficiency of the CALDB and its perceived independence from the accounting profession. The Committee notes the issues raised in submissions and believes improvements could be made to the proposal for CALDB membership to enhance its expertise and provide for some representation by users of financial reports.

Recommendation 28

9.19 The Committee recommends that, in relation to the membership of the Companies Auditors and Liquidators Disciplinary Board, some of the members from the accounting profession should be appointed on an individual basis rather than as representatives of a professional association; auditors and/or liquidators should be included in the selections from the accounting profession; and consideration should be given to including users of financial reports appointed from the public, private and not-for-profit sectors.

Sharing of information with other disciplinary bodies

9.20 To assist the professional accounting bodies in their disciplinary function, the draft Bill makes provision for information sharing between the CALDB and these

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10 *Submission* 25, pp. 30-32.

11 *Submission* 25, p. 32.

bodies.[12] The Committee has no objection to these arrangements and sees them as another step towards improved enforcement within the auditing profession.

Identifying the firm or audit company

9.21 Proposed subsection 1296(1A) of the *Corporations Act 2001* (Corporations Act) provides that the notice of the CALDB's decision to cancel or suspend an individual auditor's registration may identify the firm or audit company of the individual involved. Under the existing provisions, CALDB notices must be lodged with the Australian Securities and Investments Commission (ASIC) and published in the Gazette.[13]

9.22 The Association of Chartered Certified Accountants commented on the question of whether the firm name or the individual's name should be publicised :

> The experience of the Andersen demise must imply that there are potential reputational risks associated with expanding this disclosure requirement when it is the individual rather than the firm who is subject to the disciplinary action. ACCA does not, however, feel that it will be possible in practice to isolate a member from association with his/her firm name.[14]

9.23 The NIA did not support publication of a firm's name if disciplinary action had been taken against an employee of the firm unless 'there has either been a failure of the firm itself or some action of the firm, that has contributed to the cause of the disciplinary process'.[15]

The Committee's views

9.24 The Committee believes that this proposal merely imposes accountability on auditors' employers which is consistent with other requirements in the Bill. The Committee therefore does not oppose this provision.

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12 Proposed section 213 ASIC Act. The section will provide for information sharing with bodies prescribed by the regulations as well.

13 Note that under section 1274 of the Corporations Act, documents lodged under section 1296 may be inspected.

14 *Submission* 42, p. 2 of annexure.

15 *Submission* 25, p. 33.

CHAPTER 10

AUDIT REFORM—ENFORCEMENT—THE FINANCIAL REPORTING PANEL

Introduction

10.1 The *Corporations Act 2001* (Corporations Act), *Australian Securities and Investments Act 2001* (ASIC Act) and the rules of professional bodies set out mandatory requirements for financial reporting. It is important that these requirements can be enforced and that the mechanisms available allow for timely and cost-effective enforcement.

10.2 In this chapter, the Committee will examine the proposal in the Bill to establish a Financial Reporting Panel (Panel). The Panel is intended as an alternative to court action in instances where a company and the Australian Securities and Investments Commission (ASIC) cannot reach agreement over whether the company's financial report meets the mandatory requirements.

10.3 In the next chapter, the Committee will discuss two other changes proposed in the Bill to improve enforcement. One proposal is to give auditing standards legislative force and the other is to extend auditors' reporting obligations to ASIC.

Financial Reporting Panel (the Panel)

Background

10.4 In its submission to the Government's CLERP 9 discussion paper,[1] ASIC proposed the establishment of a Financial Reporting Panel to resolve disputes between ASIC and reporting entities about their compliance with financial reporting requirements.

10.5 ASIC proposed the Panel as a timely and cost-effective alternative to slower and more expensive court proceedings which it considered were 'disadvantageous for the market, the company and ASIC'. Another benefit was that the Panel would have the expertise needed to make determinations about the matters under review.[2]

10.6 At the Committee's oversight hearing with ASIC in December 2002, the then Chairman of ASIC, Mr David Knott, offered his views on how the Panel would operate:

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1 *Corporate Disclosure, Strengthening the financial reporting framework—Corporate Law Economic Reform Program, Proposals for Reform: Paper No 9*, Canberra, September 2002.

2 ASIC Submission on CLERP 9, November 2002, pp. 6-7.

> The type of procedure that we have in mind is a panel concept, as in the United Kingdom. How exactly that would work remains to be seen. We think it could, for example, operate under the umbrella of the Financial Reporting Council. It would be a place where, if we were uncomfortable with the interpretation in a set of accounts, we could go to present a case and seek a ruling in relation to the issue for that company. Inevitably, I think it would then be a matter of whether the company accepted that position or rejected it. We would hope that in those circumstances the issue would be transparent and public. If we thought the issue was such that it could then be litigated, we could always pursue litigation. My understanding is that in the UK that practice has been a successful one and that, by and large, companies accept the verdict.[3]

10.7 In contrast to the Urgent Issues Group (UIG) which dealt with systemic issues, ASIC proposed that the Panel's jurisdiction would be limited to the subject matter of disputes between ASIC and individual companies. Another point of difference was that rulings would be non-binding.[4]

10.8 Most of ASIC's proposals for the functions, powers and membership of the Panel are reflected in the Bill. Although ASIC had suggested that the Panel should 'sit under the umbrella of the FRC'[5], it is uncertain whether this will be the case.

10.9 The machinery provisions for the Panel are contained in a new Part 13 to be inserted into the ASIC Act. These deal with the establishment of the Panel, specify membership requirements, the terms on which members hold office, reporting requirements and the processes applicable to the Panel's conduct of its business and proceedings. Proposed Division 9 of Part 2M.3 of the Corporations Act specifies the circumstances in which ASIC or a lodging entity may refer disputes to the Panel and how the Panel is required to deal with a referral.

Overview of comments

10.10 The proposal for a Financial Reporting Panel received fairly wide—albeit qualified—support and its share of critics.

10.11 Of the critics, the Commercial Law Association of Australia Limited (CLAAL) considered the proposal was 'flawed to such a degree' that it should not proceed. Among the CLAAL's concerns was that Panel members would not have the competency to deal with issues going 'beyond the bounds of the accountancy standards'. Another concern was that no appropriate mechanisms were in place to ensure the 'depth and detail' of scrutiny that applies to judges to manage conflicts of

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3 *Committee Hansard*, 2 December 2002, p. CFS 45.

4 *Committee Hansard*, 2 December 2002, p. CFS 45.

5 Financial Reporting Council.

interest. The CLAAL saw this as opening up the potential for Panel decisions to be corrupted by members' personal interests.[6]

10.12 The Australian Institute of Company Directors (AICD) asked whether the quality of listed company accounts was a matter of such concern as to justify the creation of a new bureaucratic body. In common with many other witnesses, the AICD questioned the value of an 'after-the-event' and non-binding ruling. In this regard, it suggested that:

> It would be preferable if there could be a binding ruling on a dispute with a right of appeal.[7]

10.13 The Australian Stock Exchange Ltd (ASX) shared the AICD's doubts that the Panel would perform a really useful function. It noted that the Panel's rulings would not be binding on either party, 'either by statute or election' and argued that there was nothing in the legislation to discourage a party against which the Panel had made a ruling from taking the dispute to court. The ASX thought the funds and personnel for the Panel could be put to better use and advocated:

> …a system of comprehensive review of financial reports (and preferably, prospectuses) operated by a statutory body with powers to require an entity to re-issue a report, such as that operated by the Financial Reporting Review Panel in the UK and equivalent bodies in other jurisdictions in this Region.[8]

10.14 For several witnesses, the Panel proposal was a good idea or at least an idea worth developing.

10.15 Among those who supported the Panel's introduction,[9] Chartered Secretaries Australia saw particular advantages in the speed, informality and lower cost associated with alternative dispute resolution. Another benefit was that matters would be heard by 'persons with particular experience'.[10]

10.16 For Baker & McKenzie, the Panel would ease 'the pressure on ASIC to take difficult accounting issues to court' and contribute to the more timely dissemination of information to the market.[11]

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6 *Submission* 49, p. [2].

7 *Submission* 35, p. 15.

8 *Submission* 48, p. 5.

9 See, for example, *Submission* 29 (PricewaterhouseCoopers), p. 3; *Submission* 30 (Deloitte Touche Tohmatsu), p. 2; *Submission* 31 (CPAA), p. 2; *Submission* 36 (ICAA), p. 3; *Submission* 41 (Telstra Corporation Limited), p. 3; *Submission* 42 (ACCA Australia & New Zealand), p. 1; *Submission* 46 (Group of 100 Inc), p. 2; and *Submission* 60 (Australian Chamber of Commerce and Industry), p. 11.

10 *Submission* 8, p. 6.

11 *Submission* 37, p. 3.

10.17 A large number of witnesses who supported the proposal for a Financial Reporting Panel had reservations about its jurisdiction, membership and procedures. Another issue concerned the Panel's status and whether another body such as the Financial Reporting Council (FRC) should oversee its activities.

10.18 Some preferred greater autonomy for the Panel and advocated a model similar to the Takeovers Panel.[12] It appears that this may have been the Government's intention. Certainly, the Department of the Treasury indicated that they had envisaged a structure for the Panel based on the Takeovers Panel.[13]

10.19 The Committee will review these and other issues raised in submissions within the following framework:

- the Panel's jurisdiction and rights of referral;
- the status of the Panel's determinations;
- membership;
- procedural matters and conduct of hearings; and
- oversight.

The Panel's jurisdiction and rights of referral

10.20 ASIC has a right to refer a matter to the Panel where a lodging entity's financial report does not comply with accounting standards or reflect a true and fair view.[14] Where ASIC has informed an entity that its financial report is non-compliant, the entity may refer a matter to the Panel but only with ASIC's consent.[15]

10.21 Comments on these provisions focused on two issues:

- the jurisdiction of the Panel—should it include pre-reporting disputes as well?
- rights of referral to the Panel—should the lodging entity be able to refer matters to the Panel without ASIC's consent and should auditors also have referral rights?

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12 *Submission* 1C (Mr Tom Ravlic), p. [5]; *Submission* 11 (Securities Institute), p. [1] of attachment and *Submission* 24 (Law Council of Australia), p. 7.

13 Ms Kerstin Wijeyewardene, *Committee Hansard*, 29 April 2004, p. 61.

14 Proposed section 323EC Corporations Act.

15 Proposed section 323EG Corporations Act.

Jurisdiction

10.22 Several witnesses argued that the Panel should be able to adjudicate disputes before, as well as after, the completion and publication of financial statements. Of these witnesses, some envisaged an extensive pre-publication role for the Panel.

10.23 The Securities Institute of Australia, for example, endorsed the HIH Royal Commissioner's recommendation and advocated a jurisdiction for the Panel which would embody the functions of the Urgent Issues Group.[16]

10.24 Similarly, the Group of 100 Inc and Telstra Corporation Limited envisaged that the Panel could provide guidance on 'company-specific' and controversial issues for companies' use when selecting an appropriate accounting policy.[17]

10.25 On the other hand, The Institute of Chartered Accountants in Australia (ICAA) thought a pre-publication jurisdiction should only be invoked 'in pretty rare circumstances…where the client and the auditor had reached quite different conclusions that could not be reconciled' and where the implications were serious:

> [The ICAA] would like to think the panel in those circumstances could be used beforehand to resolve such differences rather than after the gate has been shut, where it is a punitive issue rather than something to be resolved with an appropriate accounting treatment in the interests of the shareholders.[18]

10.26 The National Institute of Accountants (NIA) saw advantages in pre-publication dispute resolution in limited circumstances but did not favour the Panel as the appropriate mechanism for this. It proposed that an alternative model should be developed by the Department of the Treasury, ASIC and the professional accounting bodies.[19]

10.27 Opponents of calls for the Panel to have a pre-publication jurisdiction saw a fundamental inconsistency in transferring an integral part of the auditor's role—namely, responsibility for making decisions and judgement calls about contentious issues—to a third party. The Association of Chartered Certified Accountants (ACCA), for example, argued that an extension of the Panel's jurisdiction to include pre-publication adjudication of disputes was 'potentially detrimental to the auditor's

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16 *Submission* 11, p. 1 of attachment.

17 *Submission* 46 (Group of 100 Inc), p. 2 and *Submission* 41 (Telstra Corporation Limited), p. [3] of attachment.

18 Mr Stephen Harrison, *Committee Hansard*, 11 March 2004, p. CFS 39.

19 *Submission* 25, p. 36.

duty to make professional judgements regarding the application of particular policies and treatments'.[20]

10.28 Similar views were expressed by Mr Keith Alfredson who submitted that pre-vetting would 'severely undermine the independence and professionalism of auditors and could become a process for allowing auditors not to have to make the "tough" decisions'.[21]

10.29 Another critic of suggestions for the Panel to have a pre-vetting function, Mr Tom Ravlic, was adamant that the Panel 'should not be treated as a nanny to which auditors and their company clients go when they want some advice'. Echoing the sentiments of the ACCA and Mr Alfredson, Mr Ravlic considered that a pre-publication jurisdiction for the Panel would relieve auditors of one of their core responsibilities. It was his view that:

> …The auditors are there to make a call on an issue. That is what they are paid to do—they are paid to do so in the public interest and they are paid to do so in a manner that does befit their knowledge and expertise.[22]

10.30 Mr Ravlic also queried what the Panel's role would be if matters on which the Panel had issued a pre-publication ruling were then disputed by ASIC after publication.[23]

10.31 The Committee sought CPA Australia's (CPAA's) views on the argument that a pre-vetting role for the Panel would undermine auditor independence and professionalism. Although acknowledging that there could be a threat to an auditor's independence, Mr Greg Larsen, CPAA, thought there was value in resolving issues before they became seriously contentious. Ms Catherine Mulcare, CPAA, also suggested that the mere existence of a pre-publication tribunal could enhance an auditor's powers of persuasion in relation to conflicts arising at the pre-reporting stage.[24]

Referral rights

10.32 The Committee heard a range of suggestions about who should have rights to refer matters to the Panel. For example, should ASIC be the only party having standing to make referrals? Should companies also have referral rights without having first to obtain ASIC's consent? Should auditors have standing?

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20 *Submission* 42, p. [3]. The ACCA thought there was an argument for naming the Panel the 'Financial Reporting Review Panel' to more accurately 'identify its mission'.

21 *Submission* 52, p. [3].

22 *Committee Hansard*, 14 April 2004, p. CFS 9.

23 *Committee Hansard*, 14 April 2004, p. CFS 9.

24 *Committee Hansard*, 18 March 2004, pp. CFS 30-1.

10.33 The Group of 100 said there should be no 'restriction on the parties who can make references to the FRC'—possibly because of the wider guidance role it envisaged for the Panel.[25] Others thought auditors[26] or lodging entities (presumably without ASIC's consent)[27] should have referral rights.

10.34 The Law Council of Australia (LCA) argued that the extension of a referral right to lodging entities would give them a means of avoiding situations where disputes might be prolonged because ASIC had deferred going to the Panel. Ms Kathleen Farrell, LCA, said in this regard that:

> We note that in the legislation, in the bill that went to parliament, there is a requirement for ASIC to consent before an issue can go to the panel. There are some times when I think that is not good enough. I have seen live examples of where an accounting issue has not been resolved between ASIC and a company. When that company wants to issue a prospectus or do some other public thing, suddenly the issue that has been festering for ages can become a trip-wire on whether it should be able to issue its prospectus or do its takeover or some other act like that. I think it is appropriate to have a body like the financial reporting panel that can get those sorts of issues cleared up…I think it should not wholly be up to ASIC as to whether or not that issue goes before the panel.[28]

The Committee's views

10.35 The Committee agrees with the Bill's proposal that the Panel's jurisdiction can only be invoked post-publication. The Committee believes that pre-publication referrals would create potential conflicts for the Panel if ASIC were to raise concerns about accounts on which the Panel had ruled pre-publication. Allowing other parties recourse to the Panel pre-publication could pose a threat to auditors' independence and professionalism. Similarly, giving auditors a pre-publication referral right is considered to be inconsistent with fundamental aspects of their role.

10.36 The Committee is aware of the concerns raised by the HIH Royal Commissioner that there appeared to be no satisfactory arrangements through which disputes between auditors and companies about the interpretation and application of accounting standards could be resolved. The Royal Commissioner commented that with HIH, 'such issues were always “resolved” by adopting the view of management which, on occasion, promoted an incorrect accounting treatment'. To deal with this problem, he recommended that professional accounting bodies should issue guidelines

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25 *Submission* 46 (Group of 100), p. 2 and *Submission* 41 (Telstra), p. [3] of attachment.

26 *Submission* 11 (Securities Institute), p. 2 of attachment.

27 *Submission* 1A (Mr Tom Ravlic), p. 9; *Submission* 35 (AICD), p. 15 and *Submission* 52 (Mr Keith Alfredson), p. [3]. Mr Alfredson's proposal to extend the right of referral only applied in relation to post-publication disputes.

28 *Committee Hansard*, 16 March 2004, pp. CFS 51-2.

encouraging their members to consult with independent third parties or the UIG to resolve disputes.[29]

10.37 The Committee agrees with the Royal Commissioner that the professional accounting bodies could play a role in dispute resolution in pre-publication financial reporting. However, the Committee notes that the willingness or otherwise of an auditor to defer to an inappropriate accounting treatment insisted on by management hinges strongly on the auditor's independence. The Committee is satisfied that the additional requirements in the Bill to safeguard auditor independence should be sufficient to deal with the type of situation to which the Commissioner has referred.

10.38 The Committee also notes that it is open to an auditor to provide a qualified opinion on a company's financial reports.

Recommendation 29

10.39 The Committee recommends that the role of the Financial Reporting Panel should be restricted to making determinations on financial reports after their publication. The Committee does not support proposals for the Panel to have a 'pre-publication' jurisdiction.

10.40 The Committee could see no reason to deny lodging entities recourse to the Panel at their own instigation rather than requiring them to obtain ASIC's prior consent. If ASIC and a lodging entity disagree on the entity's compliance with financial reporting requirements, it seems only logical that both should have access to alternative dispute resolution. Furthermore, the Committee does not consider this would be an inappropriate use of the Panel's resources as it appears to the Committee that only lodging entities with genuine concerns would be prepared to seek the determination of an independent third party.

Recommendation 30

10.41 The Committee recommends that lodging entities should be able to refer matters to the Financial Reporting Panel without having to obtain the consent of the Australian Securities and Investments Commission (ASIC). The notification and referral procedures presently in the Bill would have to be amended to accommodate a lodging entity referral and would include the requirement for a lodging entity to notify ASIC of a referral. In particular, the lodging entity should be subject to the same notification procedures (amended as appropriate) that presently apply when ASIC refers a matter to the Panel.

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29 *The Failure of HIH Insurance*, The HIH Royal Commission, Vol 1, Canberra, April 2003, Recommendation 7, p. 141.

The status of the Panel's determinations

10.42 One of the issues attracting considerable comment was whether or not the Panel's findings were intended to have precedent value. The Bill does not expressly state that the Panel's findings are or are not intended to have any precedent value. Even though the fact they are non-binding could suggest they are not intended to have precedent value, there is the possibility that they might unofficially assume this status.

10.43 One view taken was that their precedent value would be minimal, among other things, because not all of the circumstances taken into account by the Panel could be known.

10.44 Factors relevant to questions about the precedent value of the Panel's decisions are that its hearings will generally be conducted in private; confidential information must not be publicised[30] and there is no requirement for the Panel to give reasons for its decisions in its reports. On this last point, the Bill proposes that the Panel, upon making a decision about a dispute before it, must prepare a report that states whether there has been compliance with financial reporting requirements. If there has not been compliance, the Panel need only refer to the changes needed to achieve compliance.[31]

10.45 The ANZ Banking Group did not think the Panel's rulings should or could have precedent value given their potential for conflict with rulings or other guidance issued by the UIG and other bodies.[32] Another reason was that the Panel's obligations to protect the confidentiality of confidential commercial information disclosed during its proceedings meant that the rationale for the Panel's decisions could not be assessed within the context in which they were made.[33]

10.46 Even if the Panel's findings were to have no precedent value, the ANZ Bank saw further problems with the confidentiality provisions. Noting that the Bill provides for a court to have regard to the Panel's findings, the ANZ Bank queried 'the extent to which a Court or tribunal of fact should have regard to a report of the FRC which does not include confidential information…important to the FRC's determination'.[34]

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30 Under proposed section 239BC of the ASIC Act, the confidentiality requirements in section 127 of the same Act will apply to the Panel.

31 Proposed 323EK Corporations Act.

32 *Submission* 14, p. 10. ASIC can only refer matters to the Panel if it considers there has not been compliance with 'financial reporting requirements' which, under proposed section 9 of the Corporations Act are accounting standards and true and fair view requirements.

33 *Submission* 14, p. 10.

34 *Submission* 14, p. 10. Under proposed section 239BC, the Panel will be bound by the confidentiality requirements in section 127 of the ASIC Act.

10.47 Several witnesses shared the ANZ Bank's concerns about the potential for conflict between the Panel's rulings and guidance material issued by the UIG.[35]

10.48 It appears to the Committee, in light of the following comments by Mr Tom Ravlic, that concerns about the Panel's rulings vis-à-vis the UIG's pronouncements may be misplaced:

> …Under the current proposals that we are facing with the adoption of international accounting standards, the urgent issues group abstracts will become a part of the standards that are set—that is, the abstracts, the consensus views, will effectively become the same as accounting standards.
>
> …
>
> It is presently intended by the Australian Accounting Standards Board that the UIG abstracts sit in a separate accounting standard that has been called AASB 1048.[36]

The Committee's views

10.49 The Committee agrees with the many submissions that argued against the Panel's decisions having any value as precedents. It also notes in this regard the submission from the National Institute of Accountants that the Panel's role should be narrowly construed so as to apply to dispute resolution only, with no precedent value attaching to its rulings.[37]

10.50 It appears to the Committee that the legislation did not intend the Panel's determinations to have precedent value. Furthermore, the Committee believes this would be inconsistent with Australia's adoption of international accounting standards. However, because there seemed to be some uncertainty about the status of Panel decisions, the Committee believes the legislation should state expressly that the decisions will have no precedent value.

Recommendation 31

10.51 The Committee recommends that the Bill should clarify that the determinations of the Financial Reporting Panel should not have a wider application as precedents for the interpretation of financial reporting requirements.

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35 *Submission* 11 (Securities Institute), attachment 1; *Submission* 52 (Mr Keith Alfredson), p. [3] and *Submission* 35 (AICD), p. 15.

36 *Committee Hansard*, 14 April 2004, p. CFS 10.

37 *Submission* 25, p. 36.

Membership

10.52 The Bill proposes that the Panel will have at least five members appointed by the Minister on a part-time or full-time basis. There will be no maximum number of part-time members. This is to provide a sufficient pool from which Panel members not having conflicts of interest in a particular matter can be drawn.[38] Members must be experienced or qualified in accounting, auditing, business, company administration or law. There is no requirement for weighting of membership according to the nature of their knowledge or experience.

10.53 The Panel's Chairperson is to be appointed by the Minister for a term not exceeding five years but can be re-appointed.

10.54 For the purposes of determining a particular matter the Chairperson must appoint a three-member Panel. If the Chairperson is not to sit on that Panel, the Chairperson must appoint one of the sitting members as Chairperson and another as Deputy Chairperson. Members must disclose any conflicts of interest to the Chairperson who may only consent to their participation in a particular matter if their interest is immaterial or will not preclude that member from acting impartially.

10.55 A concern raised by some witnesses was whether there would be sufficient numbers of suitably qualified people not having conflicts of interest who could sit on the Panel as part-time members.

10.56 For Pitcher Partners Accountants Auditors & Advisors, for example, the main challenge would be in finding suitably qualified 'financial reporting technical experts' who did not have conflicts of interest.[39]

10.57 Similarly, Ms Kathleen Farrell, LCA, raised concerns that the predominantly part-time membership of the Panel posed difficulties in finding enough people free from conflicts of interest. Drawing on her experience as a member of the Takeovers Panel, she noted that although its part-time membership varied between 38 and 46, finding three members without conflicts of interest to sit on any one day had proved difficult. It was her view that the Panel needed full-time members because it would be difficult to find part-time members who would not have conflicts of interest—'unless they are full-time members they will have conflicts'. Notwithstanding this, Ms Farrell considered that the Takeovers Panel worked well and saw value in its full-time secretariat and the 'secondees' who supported the Panel's work. She advocated the Takeovers Panel as a model for the Panel.[40]

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38 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 147.

39 *Submission* 13, p. 8.

40 *Committee Hansard*, 16 March 2004, pp. CFS 67-8.

10.58 Of the remaining submissions, most were concerned with the qualifications required of Panel members or the extent to which certain professions would be represented at any given hearing.

10.59 As discussed earlier, the Commercial Law Association of Australia Limited had serious reservations about the competency of Panel members and doubted that procedures to manage conflicts of interest were sufficient. The Association commented in this regard that:

> Panel members are not judicially trained and many, if not most, are unlikely to be legally trained. Nor are they seized of the jurisdiction, the power or the competence to effectively consider and decide upon matters beyond the bounds of accountancy standards. For example, underlying fraud, witness credibility, or other applicable State or Commonwealth laws will not be best appreciated and determined upon.
>
> It is also submitted that the degree of scrutiny of those who are appointed to Panel membership, and their existing relationships and continuing direct and indirect pecuniary and other interests, is not considered or monitored in the depth and detail as operates for Judicial appointments. Could Panel decisions be influenced in any way by a desire not to stray outside accounting standard competency? Or a willingness to maintain the Panel member's reputation or his or her firm's client base, corporate opportunities or investments in any way?[41]

10.60 For the Securities Institute, Panel membership needed to be widened to include preparers, users and corporate issuers. It said this would give the Panel a broad-based expertise and ensure that it was not 'highly skewed to any legalistic or technical accounting interpretation'.[42]

10.61 In contrast perhaps to the Securities Institute's views, the ICAA and CPAA placed greater store on expertise in more technical accounting matters and proposed that the Panel should sit with at least a majority of members having 'relevant expertise in financial reporting with specific accounting knowledge'. They also proposed that, if the FRC was to have oversight of the Panel, then it would be more appropriate for Panel members to be appointed by the FRC chair rather than by the Minister.[43]

The Committee's views

10.62 The Committee heard from the Department of the Treasury that the Panel was expected to have 'a full-time administrator with support staff and a part-time chair with 20 to 30 part-time members'.[44]

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41 *Submission* 49, p. [2].

42 Ms Julie Burke, *Committee Hansard*, 6 April 2004, p. CFS 13.

43 *Submission*s 31 (CPAA) and 36 (ICAA), pp. 6 and 96 of attachment.

44 Ms Kerstin Wijeyewardene, *Committee Hansard*, 29 April 2004, p. CFS 61.

10.63 The Committee understands the concerns raised by several witnesses about the difficulties in assembling a predominantly part-time membership that will not have conflicts of interest regarding many of the matters to be heard by the Panel. The Committee notes the LCA's evidence that the Takeovers Panel experiences the same difficulties but manages to overcome these. The Committee suggests that the Government should carefully monitor the Panel's activities over the next 12 to 18 months to determine whether the appointment of any full-time members could be justified.

10.64 The Committee is satisfied that the criteria for membership are satisfactory but suggests that, in the interests of assembling a well-qualified and experienced membership, recruitment with the aid of public advertising would be useful.

Procedural matters and conduct of hearings

10.65 The Bill's provisions relating to procedural matters attracted limited comment.

10.66 Mr Keith Alfredson took issue with the maximum 90 days from the date of the referral allowed to the Panel to provide the parties and the market operator with a copy of its decision.

10.67 Under the Bill, the Panel must provide a copy of its report regarding a dispute within 60 days of referral (although this time can be extended to 90 days with prior notification) to the following parties:

- the lodging entity;
- ASIC; and
- the relevant market operator in the case of a listed company or listed registered scheme.

10.68 Mr Alfredson argued that a 90-day delay for a Panel decision was inconsistent with the concept of a well-informed market and he queried why investors should have to wait this long to know the outcome of a dispute. He proposed that ordinarily a time limit of 30 days would be more appropriate.[45]

10.69 The ICAA and CPAA were concerned about the impact a Panel decision could have on an auditor's reputation and considered that auditors should be entitled to:

- attend all proceedings;
- receive ASIC's notification of its intention to refer a matter to the Panel;
- have its response included with ASIC's referral; and
- make submissions to the Panel.

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45 *Submission* 52, p. [3].

10.70 They also argued that qualified privilege should apply with regard to documents or information given to the Panel.[46]

10.71 The ICAA and CPAA advocated that any auditor identified in the Panel's annual report to the Minister should have a right of reply. On this point, the ICAA and CPAA told the Committee that:

> …if [the Panel] proposes to name an auditor in its annual report…it must refer the relevant passage, in context, to the auditor concerned for comment, and must give proper consideration to timely responses, having regard to protecting the confidentiality of audit clients, and the legitimate business interests of auditors.[47]

10.72 The Securities Institute also raised concerns that Panel procedures and processes might not provide the necessary safeguards to achieve fairness and consistency. The Institute's concerns appeared to arise from the wide discretion conferred on Panel members to determine the procedural rules for their hearings. Noting that the Panel's 'procedures and process for decision-making' lacked detail, the Institute saw a need for 'checks and balances' to ensure the Panel's proceedings would not be 'subject to the idiosyncrasies of the members who make up the FRC for any given matter'.[48]

The Committee's views

10.73 The Committee notes that the standard timeframe within which the Panel must deliver its decision is 60 days from the referral date. Although the Committee has some reservations about allowing the Panel to extend the time available for the issue of its determinations to 90 days, the Committee would prefer that experience should dictate whether modifications to timeframes are needed.

10.74 The Committee believes the Government should monitor the Panel's performance to this end.

10.75 The Committee agrees with the ICAA's and CPAA's concerns about the possible implications for an auditor's professional reputation and believes the Bill should incorporate amendments to provide for auditor participation in proceedings along the lines proposed by these bodies.

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46 See *Submission*s 31 (CPAA) and 36 (ICAA), p. 99 of attachment. Proposed section 323EK provides for publication of the report. Arguably, it is possible to identify the reasons from the Panel's report on each case it considers. Proposed subsection 323EK(1) requires the Panel to state in its report whether the financial report complies with requirements. Under proposed subsections 323EK(2) and (3), the changes the Panel considers should be made to achieve compliance must be stated.

47 See *Submission*s 31 (CPAA) and 36 (ICAA), p. 105 of attachment.

48 *Submission* 11, p. 1.

Recommendation 32

10.76 The Committee recommends that an auditor should be entitled to attend the proceedings of the Financial Reporting Panel if the financial reports audited by that auditor are in dispute. The Committee recommends that the auditor should have rights to be notified of a referral, to have its response included with the Australian Securities and Investments Commission's referral and to make submissions to the Panel.

Oversight of the Panel

10.77 The Bill does not provide for oversight of the Panel, nor does it give any indication of where the Panel will sit within the corporate regulatory framework.

10.78 The Committee received a great many submissions responding to the Government's request for comments on the FRC's proposed oversight of the Panel.[49]

10.79 Of these, the ICAA and CPAA[50] thought FRC oversight had definite advantages given its ultimate responsibility for accounting standards and interpretative guidelines. Furthermore, they proposed that the FRC's links with the AASB and UIG would enhance information flows between these bodies and the Panel, and act as a check against Panel decisions that departed from international accounting standard interpretations.[51]

10.80 More subdued support came from Mr Keith Alfredson who, while not opposing FRC oversight, made it clear that this should be conditional on improvements to the FRC's transparency. He proposed several measures—among them—that the FRC should be required to conduct its meetings in public 'in the interests of greater transparency and to conform with best practice (such as that followed by the Trustees of the International Accounting Standards Board)'.[52]

10.81 The Securities Institute was somewhat equivocal about FRC oversight. On one hand, it envisaged that FRC oversight could add to the Panel's 'status, power and

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49 Issue 2.1 of the Commentary on the Draft Provisions (released with the exposure draft of the Bill) indicated that '[s]ome stakeholders have suggested that the Financial Reporting Council should oversee the operation of the FRP' and invited comments on 'potential oversight arrangements'. See CLERP (Audit Reform & Corporate Disclosure) Bill, Commentary on the Draft Provisions, Corporate Law Economic Reform Program No 9, Canberra, October 2003, p. 85.

50 *Submission*s 31 (CPAA) and 36 (ICAA), attachment.

51 See *Submission*s 31 (CPAA) and 36 (ICAA), p. 96 of attachment.

The submission also suggests at p. 6 of the attachment that the monitoring role undertaken by the FRC in relation to accounting standards and that proposed in relation to auditing, duplicate ASIC's role. To ensure cooperation between these two bodies, the submission proposes that ASIC and the FRC clarify their respective roles in a Memorandum of Understanding.

52 *Submission* 52, p. [1].

authority'. On the other hand, it was concerned that the Panel's 'perceived impartiality and independence from regulatory restrictions or interference' would be open to question and the 'peer review concept' damaged.[53]

10.82 For the ACCA, there were 'benefits and drawbacks attached to almost all the possible oversight combinations'. It thought that oversight by ASIC, for example, could result in the Panel's becoming 'a policeman rather than…an arbitrator'. It noted that critics of oversight by the FRC thought this would limit the Panel's independence and its capacity to have 'any real teeth'. Despite this, the ACCA favoured oversight by the FRC as 'an easy-to-understand and easy-to-administrate model'.[54]

10.83 Of the opponents to FRC oversight, the Investment and Financial Services Association Limited (IFSA) was not convinced that establishing the Panel would be the 'best approach' but commented that it would need 'at least to be operationally independent of both ASIC and the Financial Reporting Council'.[55]

10.84 The NIA's first option regarding oversight of the Panel was that it should have its own oversight committee. Failing this, the NIA favoured oversight by the Companies Auditors and Liquidators Disciplinary Board (CALDB)[56] which it thought would be best equipped to handle this function.[57]

10.85 Mr Tom Ravlic had reservations about FRC oversight. He considered that the FRC's ultimate responsibility for accounting standard setting was inconsistent with its oversight of a body that was more of an 'alternative enforcement mechanism'. He saw the Panel as sitting 'quite comfortably next to the Takeovers Panel as a dispute resolution body' and proposed that a separate body altogether might be established to oversee both.[58]

The Committee's views

10.86 The Committee supports the establishment of an alternative dispute resolution body such as the Financial Reporting Panel. The Committee heard no evidence to convince it that oversight by ASIC, the CALDB or the FRC would be necessary or add value to the Panel's performance. It appears to the Committee that oversight by any of these bodies would present conflicts with their principal responsibilities.

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53 *Submission* 11, p. 2 of attachment.

54 *Submission* 31, p. 2 of annexure.

55 *Submission* 44, p. [3].

56 As constituted according to the NIA's proposals—i.e. with more accountants and professionally-qualified non-accountants rather than people from the business sector.

57 *Submission* 25, pp. 36-7.

58 *Committee Hansard*, 14 April 2004, p. CFS 9. See also Mr Ravlic's *Submission* 1C.

10.87 Having said this, the Committee agrees with the ICAA and CPAA that communication between the Panel and the FRC would be desirable to ensure consistency between Panel determinations and international accounting standards interpretations. However, the Committee envisages that communication between these bodies is possible without FRC oversight.

Conclusion

10.88 The Committee believes that the role of the Financial Reporting Panel in providing an alternative for resolving disputes will enhance the balance of the enforcement regime. The Committee supports the proposals advanced by several witnesses that the Panel should be modelled on the Takeovers Panel and notes in this regard that this appears to be the Government's intention.

10.89 Mr Keith Alfredson advocated an extended role for the Panel in reporting on and proposing solutions to deficiencies in accounting standards and formal interpretations that had prompted referral to the Panel. He said in this regard that:

> In all cases, the Panel should be required to report any considered deficiencies in the relevant accounting standards and formal interpretations of those standards that gave rise to the need for the referral to the Panel and suggestions for overcoming any alleged deficiencies for referral to the AASB, and if considered appropriate by the AASB to the IASB.[59]

10.90 The Committee agrees that the Panel could perform a useful role in alerting the AASB and IASB to issues of concern.

Recommendation 33

10.91 The Committee recommends that the Government should amend the Bill to require the Financial Reporting Panel to provide a copy of its determinations including reasons for these determinations to the Australian Accounting Standards Board.

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59 *Submission* 52, p. [3].

CHAPTER 11

AUDIT REFORM—ENFORCEMENT—AUDITING STANDARDS AND AUDITORS' REPORTING OBLIGATIONS

Introduction

11.1 The Bill proposes to give auditing standards legislative force as disallowable instruments[1] and to require auditors to conduct audits of financial reports according to those auditing standards.

11.2 The Explanatory Memorandum indicates that these proposals are intended to give the Australian Securities and Investments Commission (ASIC) wider enforcement powers, ensure greater consistency across the auditing profession and provide 'a mechanism by which appropriate sanctions and remedies can be imposed for a breach of the standards'.[2]

11.3 Another proposal in the Bill to strengthen the enforcement armoury expands auditors' reporting obligations.

11.4 Currently, auditors are required to notify ASIC if the auditor suspects on reasonable grounds that a contravention of the Act has occurred and believes that the contravention has not been or will not be adequately dealt with by comment in the auditor's report or by bringing it to the attention of the company's directors.[3]

11.5 The Bill proposes to extend auditors' reporting obligations to include a wider range of suspected or actual malfeasance.

11.6 In this chapter, the Committee will review the many submissions received on these proposals.

Auditing standards as disallowable instruments

11.7 The Bill provides that an auditing standard made by the proposed reconstituted Auditing & Assurance Standards Board (AUASB) will be a disallowable

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1 As with accounting standards, an auditing standard will be a disallowable instrument for the purposes of section 46A of the *Acts Interpretation Act 1901*—proposed subsection 336(2) Corporations Act. Proposed subsection 336(1) provides that the AUASB may make auditing standards for the purposes of the Act.

2 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 59-60.

3 Section 311 Corporations Act.

instrument for the purposes of section 46A of the *Acts Interpretation Act 1901*. The Bill provides further that auditors must comply with auditing standards.[4]

11.8 Submissions to the Committee were overwhelmingly opposed to the conferral of disallowable instrument status on auditing standards. The following excerpt from the joint submission of The Institute of Chartered Accountants in Australia (ICAA) and CPA Australia (CPAA) is fairly representative of the main objections raised:

> Unlike accounting standards, which are arguably able to prescribe clearly defined methods of preparing and presenting financial statements, auditing standards must address the parameters within which auditors must exercise their professional judgement in a large range of circumstances. Auditing standards therefore cannot readily be written in prescriptive terms.
>
> There is the risk that there will either be an impermissible degree of uncertainty in auditing standards drafted under the proposed regime (and corresponding difficulty of objective enforcement) or the auditing standards will become unduly prescriptive and mechanical to the detriment of the quality of audits. This could encourage a 'form over substance' approach which is contrary to both existing accounting and auditing standards, which require a 'substance over form' approach.
>
> A quality audit requires auditors to have the ability to plan and conduct their audit in accordance with established professional standards in audit methodologies (which are constantly developing) and pursuant to the exercise of their own professional judgement.
>
> To accord auditing standards the force of law will inevitably slow down the process of making and amending auditing standards and make them more prescriptive and less able to adapt to changing business conditions and international auditing standards.
>
> Auditing standards are adequately enforced by the application of existing common law remedies (i.e. for breach of contract or in tort).
>
> No auditor should be exposed to a claim for breach of statutory duty arising solely as a result of the exercise of that auditor of his or her professional judgement.[5]

11.9 The Committee will now examine these arguments and others raised in the submissions.

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4 Proposed sections 336 and 989CA Corporations Act.

5 *Submission*s 31 (CPAA) and 36 (ICAA), pp. 15-16 of attachment.

Auditing standards are not suited to legal prescription

11.10 The Committee heard from many witnesses that legislative backing for auditing standards was inconsistent with the intrinsically discretionary nature of these standards. The ICAA and CPAA said in this regard that:

> The language of current standards is discretionary or advisory and not sufficiently directive or appropriately prescriptive to give rise to legal liabilities. In our submission standards which address the manner of exercise of an auditor's professional judgement should not be given the force of law.[6]

11.11 One concern was that to give the standards legal force without changing their current form and language would create uncertainty and thus make it difficult for auditors to determine what conduct was permitted and what was not.

11.12 On the other hand, it was argued that attempts to resolve this uncertainty through modification of the language used in the standards could lead to a degree of prescription which left little room for the exercise of discretion. In this case, the law might be more certain but its utility as a mechanism to improve audit quality could be open to question.

11.13 Mr Robert Ward, PricewaterhouseCoopers, made this point when he contended that prescription could shift the focus of the legislation from what should be the primary objective of the auditing standards, namely, achieving audit quality to achieving compliance with myriad procedural requirements. He told the Committee that:

> There is also a risk for the firms and the profession. This comes of it all being just too hard. If a procedure is legislated—that is, I need to sign an engagement letter—do you want to have people who have effectively broken the law around a procedure in an audit, as opposed to finding that the audit opinion was appropriate? As we go through the next two years those challenges will be there. I think it could be harder than we expect.[7]

11.14 In a similar vein, the Australian Institute of Company Directors (AICD) speculated that the level of prescription likely to be entailed in legislation could promote 'box ticking' and lead to 'a lesser standard of audit'.[8]

11.15 For Mr Bill Edge, AuASB, the result would be 'a checklist mentality of complying with the letter of the law rather than the overarching principles'.[9]

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6 *Submission*s 31 (CPAA) and 36 (ICAA), p. 22 of attachment.

7 *Committee Hansard*, 6 April 2004, p. CFS 63.

8 *Submission* 35, p. 7.

9 *Committee Hansard*, 18 March 2004, p. CFS 39.

11.16 Apart from allegations that 'form over substance' shortcomings would be entailed in a more prescriptive, rules-based approach, questions were raised about how legislation could effectively prescribe 'the manner of exercise of an auditor's professional judgement'.[10]

11.17 Mr Jeff Knott, BDO Chartered Accountants and Advisers, was dubious that this could be done and commented that:

> Whilst recognising the likelihood of legislative backing to the standards, having legislative backing to what is judgement in the formation of an opinion is an interesting concept.[11]

11.18 Similarly, Mr Robert Ward, PricewaterhouseCoopers, thought that legislation was incapable of embodying the features productive of a quality audit and commented in this regard that:

> …good auditing is based on certain principles, dare I say it, of a qualified and independent state of mind—all of those things—and all the various procedures. Good auditing, though, is auditing not what is there but what is not there. I do not know how law can say, 'Audit what is not apparent,' so it becomes more of an art and a science as opposed to how to account for this particular set of circumstances…[12]

11.19 For Mr Greg Larsen, CPAA, it was in the public interest to have laws imposing obligations on professions. However, he opposed laws that sought to prescribe how those obligations should be met.[13]

11.20 Several witnesses rejected the argument that because *accounting* standards were legislative instruments, the same could and should apply to *auditing* standards.

11.21 Mr Bill Edge, AuASB, contended that this showed 'a lack of understanding of the two standards'. He said that accounting standards were 'relevant to measurement and disclosure in financial reports and…[were] far more easily definable'. He then described auditing standards as follows:

> Auditing standards include what we call basic principles and essential procedures. They can include a lot of guidance or other material that relates to judgement or behaviour. If you understand the difference, you will see the difficulty in enforcing that. As a point of principle no-one could say—and I sit here as the auditing standards board chairman—that we do not want more credibility given to those standards. Putting them in the law would certainly give them a greater force. The issue is that they were never drafted with the

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10 *Submission*s 31 (CPAA) and 36 (ICAA), p. 22 of attachment.

11 *Committee Hansard*, 14 April 2004, p. CFS 75.

12 *Committee Hansard*, 6 April 2004, p. CFS 63.

13 *Committee Hansard*, 18 March 2004, p. CFS 22.

> intention that they would be interpreted in law. The interpretations to date in law are whether an auditor has been negligent and breached the duty of care which is an overriding obligation.[14]

11.22 He stated that a major reason for giving accounting standards legislative backing had been to make them enforceable against non-members of the accounting profession, namely, directors. He suggested that the same rationale did not apply in the case of auditing standards.[15]

11.23 The AICD likewise saw no credence in the argument placing auditing standards on the same footing as accounting standards. The Institute characterised accounting standards as 'necessarily highly prescriptive' in contrast to auditing standards which reflected that 'the auditing function requires the exercise of judgement'. The Institute concluded:

> This means that the standards, legal framework and structures which work for accounting standards may not work well for auditing standards.[16]

Giving standards legislative backing is inconsistent with international convergence

11.24 Another argument raised by opponents of the proposal, was that it conflicted with Australia's program of convergence with international standards.

11.25 On this point, the AuASB submitted that the Board's program of harmonisation and convergence with International Standards on Auditing (ISAs), involved the adoption of standards that required 'minimal departure from the actual wording in ISAs'. Mr Bill Edge said that giving standards legislative backing would conflict with the convergence program and explained why he thought this was so:

> For many years since 1995 we have been harmonised. Everything in Australian standards is equal to or greater than the international standards but the words are different as we have taken the benefit of redrafting some words in Australia. We have now, while wanting to be a little bit more proactive on that, converged. 'Converged' means to adopt them word for word and add material in Australia to make them more stringent if we feel that is appropriate, but you can then hold both standards up and see clearly what is the international wording and what has been the additional requirement added in Australia. We would like to continue that. Again, the issue of the legal backing of standards there is exactly the same as we just said. We may be jumping at shadows but the fear is that we will be precluded from taking word for word from the international jurisdiction because something may be drafted internationally without the thought that this would be a legal instrument. We might find it too onerous or too

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14 *Committee Hansard*, 18 March 2004, p. CFS 39.

15 *Committee Hansard*, 18 March 2004, p. CFS 38.

16 *Submission* 35, p. 7.

> detailed or too prescriptive so we might want to change it here in Australia but that may cause convergence not to be successful.[17]

11.26 PricewaterhouseCoopers argued that auditing standards related 'mainly to behaviour and professional judgement' which were 'difficult to put into legislative language'. It contended that to make standards disallowable instruments would require substantial rewriting of the international standards. As a result, the AuASB's current policy of harmonisation with international standards would be 'unworkable' and 'Australia [would be] at a disadvantage to other countries and [less attractive as] as a destination for overseas accountants'.[18]

11.27 The CPAA expressed a similar view that converting auditing standards into disallowable instruments could frustrate Australia's program of convergence with international standards and impose limits on the ability of Australia's standards to adapt to changing international practices.[19]

11.28 The CPAA also contended that the effort and costs[20] entailed in redrafting the standards into disallowable instruments was 'a real waste of resources' and questioned 'where the funding for that is reflected in the impact statements'.[21]

Would legal backing improve audit quality?

11.29 A great deal of the evidence on this proposal questioned whether legal backing for auditing standards would lead to an improvement in audit quality. The general consensus was that it would not.

11.30 Mr Keith Alfredson reflected the views of many when he argued that the focus on auditing standards in the pursuit of audit quality was misplaced. He said in this regard that:

> The ultimate test is: will this whole process make any difference to the quality of audits? I have a bit of a jaundiced view. I do not think the quality of audits has got much to do with the auditing standards. When I was doing an audit, whether I did a good audit or a bad audit was a matter of (1) whether I could discover what I should discover—and probably no auditing standard would help me do that, other than in a very generic sense—and (2) if I did discover it, whether I was willing to have a strong enough backbone and make the right decision. That is what quality of auditing is all about.

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17 *Committee Hansard*, 18 March 2004, p. CFS 41.

18 *Submission* 27, p. [3].

19 Mr Greg Larsen and Ms Catherine Mulcare, *Committee Hansard*, 18 March 2004, pp. CFS 28-9.

20 Mr Bill Edge, AuASB, told the Committee that redrafting the auditing standards would require twice the current staff of the Board and would cost approximately $1.7 million a year for the two-year transition period. See *Committee Hansard*, 18 March 2004, p. CFS 39.

21 *Committee Hansard*, 18 March 2004, p. CFS 22.

> The argument seems to be that, if you make auditing standards regulations, it will give ASIC more teeth and auditors will do a better job. I actually do not think auditors would do a better job because ASIC might do something; they do a good job because they are dead scared of being sued these days. The stronger reason is that they are auditors because they believe in integrity and professionalism, and I think most auditors try to do the right thing.[22]

11.31 A submission from the Australian Council of Super Investors Inc (ACSI) was also not convinced that giving auditing standards legal backing would be a good thing but for quite different reasons. The ACSI was concerned that there were defects in the standards which, if given legal backing, might operate against investors' interests.

11.32 The ACSI suggested that advice 'independent of the accounting profession' should be sought to determine whether this would be the case and, if so, whether the offending standards should be 'carved out' from the legal regime.[23] The ACSI commented that some of the problems with the standards were that they:

- appeared to conflict with common law—for example 'in their narrow delineation of the responsibilities of auditors in relation to suspected fraud'.
- 'directed auditors to seek assurances from company management about matters that should properly be the subject of the audit (e.g. assessments of the extent to which uncorrected misstatements are material to the financial report in AUS 210, or requirements for highly detailed management representation letters in AUS 510)'.
- 'effectively authorised auditors to abandon audit engagements if they became too difficult to complete, for example, if auditors delayed the exchange of audit engagement letters, or failed to re-confirm the terms of an engagement previously recorded in writing for an earlier year.
- purported to make it the responsibility of auditors to draft initial or subsequent letters of engagement—when that role properly should rest with the audit committee of a Board'.[24]

The Committee's views

11.33 Initially, it had been the Committee's view, based on its experience with accounting standards, that redrafting of auditing standards would not be necessary or at least would be minimal.

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22 *Committee Hansard*, 14 April 2004, p. CFS 57.

23 *Submission* 5, p. 5.

24 *Submission* 5, pp. 4-5.

11.34 However, the Committee heard many claims that this would not be so, the main argument being that auditing standards were couched in language unsuited to their having legal force. It would have assisted the Committee if witnesses had provided actual examples of standards to illustrate their concerns.

11.35 Notwithstanding this, the Committee is willing to accept that redrafting of standards will in fact be necessary to draw a clearer line between conduct that ought to attract a penalty and conduct that ought not. The Committee accepts also that in redrafting the standards to give them more certainty, some prescription will be necessary.

11.36 This view is certainly consistent with the following comments made in the CLERP 9 discussion paper:

> …the structure and style of auditing standards are such that there would be practical difficulties in making them easily enforceable without significant redrafting.[25]

11.37 Even if the Committee were not to accept the argument that redrafting was necessary to provide greater certainty, there is the possibility that they will need some redrafting to make them more amenable to parliamentary scrutiny and disallowance motions.

11.38 On the evidence available, it is difficult for the Committee to judge whether the extent of prescription required would be such as to supplant the current principles-based approach adopted in the standards. The Committee agrees that such a development could promote a shift to a 'form-over-substance' approach and contribute to a decline in audit quality.

11.39 Another factor which should be taken into account, however, is the extent to which improved enforcement of the standards made possible by giving them legal backing, will correct any tendency towards a decline in audit quality. Again, without evidence showing that better enforcement will promote audit quality, the Committee can only speculate on the outcome.

11.40 One argument raised in some submissions was that bringing the standards within a legislative regime and thus subject to parliamentary scrutiny was inappropriate, the implication being that the Parliament was not qualified for such a role. Contrary to this argument, the Committee believes the Parliament has sufficient resources at its disposal to allay concerns that it is not competent to review legislation before it. The Committee therefore does not see parliamentary scrutiny as an acceptable basis to oppose giving the standards legal force.

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25 *Corporate Disclosure, Strengthening the financial reporting framework—Corporate Law Economic Reform Program, Proposals for Reform: Paper No 9*, Canberra, September 2002, p. 27.

11.41 Having said this, the Committee does accept the argument that putting auditing standards into legal 'form' will interfere with Australia's convergence with International Standards on Auditing.

11.42 The Bill provides for the AUASB to make or formulate auditing standards by issuing the text of an international auditing standard although modification is permitted 'to the extent necessary to take account of the Australian legal or institutional environment'.[26] The following excerpt from the Explanatory Memorandum reflects strong Government support for international convergence:

> The AUASB will be empowered to make an Australian auditing standard by issuing the text of an international standard with any minimum modification to ensure that the standard operates effectively having regard to the existing Australian legislative framework and institutional regulatory arrangements. The AUASB may make such a standard regardless of the fact that the international standard does not reflect the views of the AUASB when it provided comments on the exposure draft of the standard or when the AUASB participated in any deliberations during the standard's development. The rationale for this is that it may be considered in Australia's best interests to adopt an international standard with minimum modification because it represents the results of many deliberations and compromises necessary to achieve international acceptance.[27]

11.43 The Committee has looked at ways in which the standards might be given legal force without jeopardising the international convergence program.

11.44 Several witnesses indicated a preference for giving the standards legal backing 'by reference', the implication being that this would obviate some of the difficulties arising from their proposed status as disallowable instruments. Mr Tom Ravlic proposed in this regard that:

> We should consider adopting the Canadian model of legislating standards that effectively places the standards in the law as an entire package just by reference alone.[28]

11.45 The Canadian model referred to provides for regulations to prescribe the adoption of 'standards as they exist from time to time, of an accounting body named in the regulations'.[29]

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26 Proposed subsection227B(4) ASIC Act.

27 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 90. (The Commentary on the Draft Provisions sought comments on whether the AuASB should have the function of developing a conceptual framework within which to evaluate proposed Australian and international auditing standards. See p. 17.)

28 *Submission* 1B, p. [3].

29 Paragraph 261(1)(f) of the Canada Business Corporations Act.

11.46 Even if incorporation by reference were used, the standards would still have the same status as that proposed in the Bill.

11.47 The uncertainties stemming from the discretionary language used in the standards would not be cured and thus some redrafting and prescription would be necessary—at least to clarify what conduct would constitute a breach of the standards.

11.48 It appears to the Committee that the practical impact of the conversion of auditing standards into disallowable instruments needs to be thoroughly investigated to ensure that conversion:

- is possible without posing a threat to audit quality;
- will result in improvements to audit quality through improved enforcement; and
- will not frustrate Australia's program of convergence with International Standards of Auditing.

11.49 Until it can be established that conversion of auditing standards into disallowable instruments will or is likely to improve the status quo, the Committee cannot support the proposal in the Bill for conversion.

11.50 The Committee considers that, in the interests of certainty and consistency with Australia's program of convergence with international standards, the impact of conversion of auditing standards into disallowable instruments should be thoroughly investigated with a view to determining the best way to proceed.

Recommendation 34

11.51 The Committee recommends that the provisions in the Bill under which auditing standards will be disallowable instruments should not be proceeded with until a thorough review determines how legislative backing can be achieved without threatening international convergence and audit quality. Once these issues are resolved, the Committee would support the conferral of legislative backing on auditing standards.

Auditors' duty to disclose information to ASIC

11.52 Under section 311 of the Corporations Act, a registered company auditor is required, when auditing or reviewing financial reports, to give ASIC written notification as soon as possible if the auditor on reasonable grounds suspects that a contravention of the Act has occurred and has not been or will not be adequately dealt with by comment in the auditor's report or by bringing it to the attention of the company's directors. In the absence of malice, an auditor is protected from liability in defamation proceedings for any oral or written statement made in the course of the auditor's duties.

11.53 The Bill proposes to expand the duty of auditors to disclose information to ASIC.[30] The proposed section adds to the matters to be reported and provides how the obligation will apply to an audit company.[31] It also clarifies how an auditor may determine whether a contravention is significant.

11.54 The additional matters which auditors must report to ASIC within the 28-day time limit are circumstances amounting to an attempt, in relation to an audit, to 'unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit' or to interfere with the proper conduct of an audit.

11.55 The provision imposes the reporting obligation on an individual auditor,[32] the lead auditor of a company audit team and the lead auditor of a non-company audit team.

11.56 In determining whether a contravention is 'significant' for the purposes of the section, the Bill provides that consideration should be given to the penalty, the effect of the contravention on the overall financial position of the entity and the adequacy of available financial information about the entity as well as any other relevant matter.

11.57 Auditors who fail to report as required to ASIC will have contravened the Act.

11.58 The Explanatory Memorandum has commented in relation to the proposed amendments that:

> [They] balance the need to ensure the profession is able to conduct its business in a flexible way, but at the same time recognise the important role that auditors play as the principal external check on the veracity of companies' financial statements. As such, auditors are in a unique position to determine whether there has been a contravention of the law. The provisions harness the role of auditors by encouraging the timely disclosure of possible breaches of the law.[33]

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30 The amendments proposed to section 311 will also apply to auditors of financial services licensees under proposed amendments to section 990K Corporations Act, and to auditors of managed investment schemes under proposed amendments to section 601HG Corporations Act.

31 Proposed subsections 311(1)(individual auditors), 311(2)(audit company) and 311(3)(lead auditor) Corporations Act.

32 The Bill defines 'individual auditor' in section 9 of the Corporations Act as 'an individual who consents to be appointed, or is appointed, as auditor of a company or registered scheme'.

33 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 133.

Comments

11.59 The Committee received numerous submissions opposing the provisions contained in the exposure draft of the Bill. Of the more vigorously contested provisions, the Bill has made the following changes:

- the 7-day time limit for reporting to ASIC has been extended to 28 days;
- the reporting obligation imposed on more junior as well as senior auditors now applies only to 'individual auditors'[34] and lead auditors; and
- the broader requirement for auditors to report *any* suspected contravention of the Act now only applies to significant contraventions or unreported or unremedied contraventions.

11.60 Objections which the Bill has not accommodated in amended provisions are listed below:

- an auditor should be required to report to ASIC:
  - attempts to influence, coerce, manipulate or mislead a person conducting an audit only if they are fraudulent or dishonest; [35]
  - attempts to interfere with the proper conduct of an audit only if they are for the purpose of rendering the financial statements materially misleading';[36]
  - attempts to influence, coerce, manipulate or mislead a person conducting an audit only if the behaviour cannot be resolved by bringing the matter to the attention of management or the directors.[37]
  - actions 'not directly authorised by directors or…outside delegated authorities'. These might cover transactions entered into by directors or other company officers 'not directly authorised by the Board or audit committee' or beyond their delegated powers.[38]
- it should be an offence for a company officer to engage in conduct that is reportable under section 311 but not otherwise referred to in the Act; [39]

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34 See definition in note 33.

35 *Submission*s 31 (CPAA) and 36 (ICAA), p. 86 of attachment.

36 *Submissions* 31 (CPAA) and 36 (ICAA), p. 86 of attachment.

37 *Submission* 14, p. 8.

38 *Submission* 5, p. 9.

39 *Submissions* 31 (CPAA) and 36 (ICAA), p. 86 of attachment.

- the reference to 'unduly' in the clause starting with 'unduly influence' should be replaced by:
  - 'fraudulently' or 'improperly'[40];
  - 'improperly'.[41]

11.61 As mentioned earlier, the reporting obligation is triggered, among other things, when 'the auditor is aware of circumstances that amount to an attempt, in relation to the audit…to unduly influence…a person involved in the conduct of the audit'. The Investment and Financial Services Association Ltd (IFSA) thought the trigger for the reporting obligation should be conduct which the auditor considers is an attempt to undermine the probity of the audit and said in this regard that:

> IFSA appreciates the objective of the provisions but considers that the approach is flawed because it is based on a value judgement being made by an auditor and puts in issue the ability of an auditor to provide professional services, the assumption being that the audit will be in some way compromised.
>
> IFSA recommends that a better approach, given the problem that the provision seeks to address, is to give the auditor qualified privilege in relation to reports to ASIC in respect of persons whom the auditor considers are attempting to undermine the probity of the audit by influencing, coercing, manipulating or misleading the auditor in the performance of the audit. The requirement will in this way reflect the obligations and protections for compliance committee members under section 601JE of the Act.[42]

The Committee's views

11.62 The Committee is not convinced that there is a case for narrowing the scope of the reporting obligation and notes, in this regard, the comments in the Explanatory Memorandum that:

> …auditors are in a unique position to determine whether there has been a contravention of the law. The provisions harness the role of auditors by encouraging the timely disclosure of possible breaches of the law.[43]

11.63 However, the Committee does think there is scope for improvement with the time period within which auditors must report to ASIC. The Bill provides that

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40 *Submission* 35 (ACSI), p. 41 of annexure.

41 *Submission* 24, p. 6.

42 *Submission* 44, p. [3].

43 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, p. 133.

reporting must be as 'as soon as practicable, and in any case within 28 days after the auditor becomes aware of those circumstances'.

11.64 The Committee encourages changes to the Bill that would require auditors to report on an 'as soon as possible' basis if the conduct carries significant implications for market stability.

SENATOR GRANT CHAPMAN
CHAIRMAN

CLERP 9 REPORT (SECOND PART): SUPPLEMENTARY REMARKS

AUSTRALIAN DEMOCRATS
SENATOR ANDREW MURRAY

Executive summary

In these Supplementary Remarks I have briefly outlined Democrat views on some CLERP 9 areas we have concerns with, and areas in which we will be seeking to amend the CLERP 9 Bill.

Our amendments will include:

- all public appointments by Government under the Act should be governed by the overriding principle of appointment on merit;
- an audit committee is not independent, and an auditor is not independent, if either is subject to the patronage or direction of the dominant shareholder/s, and an auditor is not independent if they receive non-audit services of a kind prohibited in Australia, the European Union (EU), or the United States of America (USA).

Introduction

I support the Report of the Committee, but have a number of additional points that I think are important to make.

As I said in my Minority Report to the first of the Committee's two reports into the CLERP 9 bills, the Australian Democrats are and have been strongly supportive of the process and intent of the Corporate Law Economic Reform Programme (CLERP).

The Democrats recognise that the majority of changes proposed by the CLERP 9 legislation will improve corporate governance, accountability and good process.

CLERP 9's provisions will be supported by us and should be commended. These proposals will be assisted by further amendments, both arising from the Committee's Report, and some that will be moved in the Senate by the Democrats and Labor.

Nevertheless the Report does not get to the heart of the difficulties surrounding auditor independence.

We are particularly supportive of the recommendations to:

- clarify the functions of the Financial Reporting Council and require that its meetings are conducted in public;

- require an auditor to attend the annual general meeting of an entity to answer shareholders' questions; and
- allow the CEO and CFO sign-offs to take into account the practicalities of their reliance on the information provided by others.

Auditor Independence

A considerable part of the CLERP 9 changes relate to the role of the auditor, and auditor independence.

The Joint Committee of Public Accounts and Audit, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, concluded with:

> 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.[1]

It is notable that the Corporations Act and the Bill still lack definitions or clear criteria for independence.

While the Bill does not have a definition of auditor independence, it does impose a general independence requirement on auditors. This requirement is not met if a 'conflict of interest situation' exists in relation to an audited body at a particular time and, at that time, the auditor knows but does not take reasonable steps to ensure the conflict of interest ceases to exist.

It seems convoluted, but you could say that in the Bill, the definition of 'conflict of interest situation', in setting a general standard of auditor independence, is really the Bill's definition of what constitutes auditor independence. A conflict of interest situation exists when:

1. the auditor, or a professional member of the audit team is not capable of exercising objective and impartial judgement in relation to the conduct of the audit of the audited body; or
2. a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgement in relation to the conduct of the audit of the audited body.[2]

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1 See pp. 96-8 (paras. 4.20 - 4.29).

2 See proposed subsection 324CD of the Bill and Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 112-113.

That JCPAA Report 391 did pick up the essence of the auditor independence argument as the following excerpt demonstrates:

> The concept of independence is open to various definitions depending on the context in which it is used. In a very general sense, being 'independent' refers to a person or group being self-governing and unwilling to be under obligation to others. More specifically, independence can be seen to have two complementary characteristics:
>
> - a state of mind that allows for opinions to be arrived at without being affected by external influences; and
> - a matter of appearance in that facts and circumstances are avoided that would lead a third party to conclude that a person's ability to arrive at an independent opinion has been compromised.
>
> The independence of the stakeholders in Australia's financial reporting environment is a critical issue and it forms a major part of the analysis and indeed the solutions proposed in this report. Independence is important to ensure that a person or group of persons undertake their work professionally, with integrity and objectivity and free of bias and undue influence.
>
> There are many relevant stakeholders in this process but for the purposes of this report, the Committee has focussed on three central groups – namely, directors, audit committees and auditors. Importantly, these groups have not been considered in isolation because the independence of directors, for example, can impact on the independence of the other stakeholders and they should take an active role in ensuring their independence.
>
> Overall, the independence of these stakeholders is important to ensure that the operation of corporations, including the provision of information to the financial markets, is in the best interests of the wider community. More specifically the independence of directors is important because they must be in a position to effectively monitor the management of a company and be able to ask management the right, and often difficult, questions in the best interests of both shareholders and the company.
>
> The independence of audit committees is important in ensuring that the external auditor is free from management interference. Audit committee independence is also associated with raising the quality of the audit and safeguarding the integrity of corporate financial reporting.[3]
>
> The independence of the external auditor is fundamental to the reliability of and public trust in, the audit reports. The U.S. Securities and Exchange Commission has provided a compelling description of the importance of the independent audit function:

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3 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, pp.71-9.

> Independent auditors have an important public trust. Investors must be able to rely on issuers' financial statements. It is the auditor's opinion that furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an objective, impartial, and skilled professional, and that investors, therefore, can rely on them. If investors do not believe that an auditor is independent of a company, they will derive little confidence from the auditors' opinion and will be far less likely to invest in that public company's securities.[4]

The importance of probity and independence, and the need for audit firms to abide by good corporate governance practices was emphasised in the evidence to the JCPAA Committee's auditor independence inquiry:

> By the very ethical nature of the auditing function, one should not need to be reminded about independence. Nothing should compromise this independence. The external auditor must not only be independent but be seen to be independent. This must be at the forefront of every external auditor.[5]

For each of these stakeholders, the Committee has explored a number of mechanisms to enhance independence. However, a core set of mechanisms and criteria in each of the following areas, are common to enhancing the independence of each group:

- appointment;
- security of tenure;
- termination; and
- remuneration.[6]

At paragraph 5.5 of Chapter 5 (Audit Reform—General Auditor Independence Provisions) the Committee Report quotes what is described as '…the comprehensive definition provided in the ICAA and CPAA *Professional Statement F.1 – Professional Independence*….' This definition covers independence of mind and independence in appearance. The Committee's references here are similar to the JCPAA references.

While these are essential ingredients of a definition of auditor independence, they are incomplete.

What is missing is the vital third part of a definition: 'Independence in fact'.

Full independence is only possible when:

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4 SEC, *Final Rule: Revision of the Commission's Auditor Independence Requirements*, Release No. 33-7919, www.sec.gov/rules/final/33-7919.htm

5 Mr John Hammond, *Submission* No.19, p. S153

6 Quoted from the JCPAA report, paragraphs 1.23-1.30, pp. 6-7.

- the method of appointment is objective, on merit, and not subject to patronage, favour, or inducements;
- remuneration is sufficient, profitable and secure for a reasonable period, and not hostage to other services or retainers;
- tenure is reasonable and secure; and
- objective fair and consistent separation or contract-ending mechanisms exist.

Without these elements in place, full independence is not possible for many, apart from the very strong, the very virtuous, or the very uncommercial.

Turning to remuneration briefly, the Democrats believe that an independent auditor is vital for an effective audit, but to quote Charles Macek, Chairman of the Financial Reporting Council, as reported in the May 2004 CFO Magazine:

> Where does your obligation, where does your loyalty lie? It's going to lie with whoever is paying our salary. It's just human nature.

The greatest weakness is the method of appointment.

Intertwined with any discussion on the appointment of auditors is the relatively new institution of the audit committee.

The audit committee has been held out as a guarantee of probity and good process. It is nothing of the sort.

The problem starts and ends with the board. I will repeat what I said in my Minority Report in the Committee's Part 1 report for CLERP 9, that the board is the central institution in the relationship between shareholders and the company, stakeholders generally, and auditors specifically.

It is self-evident that many boards, directors and companies operate to high standards, but it is the task of legislators to attend to those who do not, and to appraise the public interest.

Companies have such an effect on our society that serious weaknesses in corporations law must be attended to. A major weakness lies in director election processes.

Regrettably, the election of directors is often either deliberately or effectively rigged in favour of dominant shareholder interests. I am told that 52% of ASX corporations have ***a*** dominant shareholder, and many of the rest have a few dominant shareholders.

Such dominant shareholders frequently control the boards of our companies through their voting power. That means many (most?) directors are directly placed by or under the patronage of a dominant shareholder or shareholders, who will quite naturally seek to ensure that their interests are put first.

This dominance and patronage over many directors is reinforced by company constitutions and board behaviour that allow or foster poor director election processes.

This dominance and patronage of the dominant shareholders is reinforced by the absence of compulsory voting by institutional investors, or by their voting apathy, or by their giving proxies to the Chair, or (worst of all) the often disgraceful way in which proxies are voted at the Chair's discretion. Stephen Mayne told the Committee of this instance:

> When I ran for the NRMA board in 2000 they did the usual: 'I'm sorry, there's no vacancy, sir.'
>
> This is what they wrote to the shareholders:
>
> ...four candidates are standing for three Board positions. Only three candidates may be elected. In order to be elected a candidate must receive more votes ... in favour ... than against.
>
> That is, from those presenting votes. They went on to state:
>
> If more than four candidates receive such a majority, the three candidates receiving the most votes in favour of their election will be elected as Directors. If you vote in favour of more than three candidates your vote will be invalid.
>
> So they told shareholders, 'Only tick three of the four boxes.' So most shareholders ticked the three incumbents and left my box vacant, as you would because it said, 'Your vote will be invalid if you tick in favour.' But the then Chairman of the NRMA, Nicholas Whitlam, deemed that it was not invalid to have voted against me. He assumed all those people who left my box vacant, as instructed here, as open proxies and voted them all against me. I had 45 per cent of the primary vote, if you like—the proxy vote: I had 60 million in favour and 72 million against. So it was a reasonable performance: 45 per cent of the vote. He then used 163 million open proxies and got my vote down to 17 per cent when he had put out information to the shareholders saying, 'Don't tick the four boxes.'[7]

The only way to diminish dominant shareholder voting power is to dilute it. The greater the vote and the more thoughtful the vote exercised, the lower will be the real power of the dominant shareholders. These are public companies, but are sometimes treated as private fiefdoms ruled by oligarchs who are openly contemptuous of their often small fellow shareholders.

This combination of methods and practices minimising votes effectively results in the shareholders at large being unable to prevent a dominant shareholder dominating the board.

Under our system non-executive directors are not much protection either, because many are far from independent. This is because they have often been appointed under

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7 *Committee Hansard*, 14 April 2004, p. CFS 29.

the dominant shareholders' patronage, a patronage reinforced by the conformity imposed by the board collegiality rule.

It all ends up being very neat and cosy for the dominant shareholder.

So, here is a likely scenario. The directors under the patronage or subject to the dominant shareholder/s appoint the director members of the audit committee who are also under the patronage or subject to the dominant shareholder/s, and therefore are highly likely to act in the interests of the dominant shareholder/s.

The subordinate/patronised audit committee recommend which auditor should be appointed. The board in turn forwards that appointment to the shareholders, who duly elect the auditor.

The selected auditor is obviously going to be one the board can work with.

Unscrupulous boards might flavour the auditor appointments with some nice non-audit service goodies (a practice so common and so repellent to independence that Sarbanes-Oxley has pretty much ruled it out).

The audit committee dutifully conveys to the auditor the wishes and interests of the dominant shareholder/s, and later on perhaps, the auditor is rewarded by a seat on the board, under patronage of course. Then the whole cycle starts again.

A company appoints an auditor and therefore has a certain amount of power. As recent history and the demise of Arthur Andersen show, sometimes the company has a dangerous level of power over the auditor.

What legislatures and regulators the world over are trying to do is to tighten up on these processes, but without addressing board election practices, compulsory voting of shares by institutional investors, and reducing the power of dominant shareholders, they will be much less effective than they otherwise might be.

I think we should be saying an audit committee is not independent, and an auditor is not independent, if either are subject to the patronage or direction of the dominant shareholder/s, and an auditor is not independent if they receive non-audit services of a kind prohibited in Australia, the EU, or the USA.

Now *that* would be principles-based law!

Let the auditors carry on auditing under the new CLERP 9 regime, but let us not pretend that they will be able to satisfy the full strict criteria of independence.

Without independence being guaranteed through the method of appointment, sufficient remuneration, reasonable tenure, and objective separation/contract-ending mechanisms, despite the changes made by CLERP 9 there will remain a perception that an auditor can almost never be fully independent.

As awkward as it is, regrettably we Democrats can see no other solution than independent tendering and appointment for auditors.

The Democrats' proposal is for a panel comprising representatives of ASIC, corporate representatives and at least representatives of major audit firms to determine on an ASIC-developed basis, the auditor for the top 300 listed entities by market capitalisation.

The audit appointment panel would also be responsible for determining the audit fee.

An alternative to all the new law and to this proposed process of ours would be if the tendering and appointment process was taken out of the hands of the board, but kept in-house.

To repeat what I said in my Minority Report for the Committee's Part 1 Report into CLERP 9, this could be done if the current responsibilities of a board were to be split between a main board and a governance board.

The main board would continue to be elected by shareholding and concentrate on strategic, business and operational issues. It would contain executive and non-executive directors and because of its election method would continue to have a bias towards the dominant or large shareholders.

A small Corporate Governance Board (CGB) would be composed of non-executive independent directors (perhaps three).

It would have a limited remit and would call and chair shareholder meetings, propose changes to the company constitution, resolve conflicts of interest, determine the remuneration of directors and executive management, *appoint auditors* and other advisors such as valuers and manage the process of electing directors.

To protect the interests of *all* shareholders, not just the dominant shareholders, voting rights to elect these CGB directors would be determined democratically by numbers rather than by power based on the number of shares held. In other words it would be determined by shareholder not shareholding. It would be completely free from the dominant shareholder's control or patronage.

Because of its election method, it would have a bias towards all shareholders rather than just the large shareholders.

The greatest danger to corporate governance and ethical corporate behaviour is when the selfish interests of the dominant shareholder and the executive and non-executive directors coincide and are exercised to the detriment of the shareholders at large.

This 'separation of powers' seems a difficult concept for the traditional business community to fully appreciate at present. It has worked well in our broader political democracy.

The Democrats do not seek to attempt amendments to create a CGB requirement in law at this stage. The idea needs to be better understood first.[8] Nor will we move amendments for external audit appointment. It is another idea that lacks sufficient support.

Appointments on Merit

In my Supplementary Report to this Committee's report on the Corporate Law Economic Reform Program Bill in 1998 and in the subsequent Senate debate, I raised the issue of appointments on merit.

Every Democrat Senator has at one time or another called for an end to jobs for the boys and girls. Twenty-three times the Democrats have moved appointments on merit amendments to various bills, and twenty-three times (so far and still counting), the Liberal, Labor and National parties have voted them down. They do love *their* patronage!

Wherever appointments are made to the governing organs of public authorities, whether they are institutions set up by legislation, independent statutory authorities or quasi-government agencies, the processes by which these appointments are made should be transparent, accountable, open and honest.

It is still the case that appointments to statutory authorities are left largely to the discretion of ministers with the relevant portfolio responsibility.

There is no umbrella legislation that sets out a standard procedure regulating the procedures for the making of appointments. Perhaps most importantly there is no external scrutiny by an independent body of the procedure and merits of appointments.

An independent body should be given the responsibility of scrutinising government appointments against a set of established criteria.

This system works well in the United Kingdom after the 1995 Nolan Commission. Lord Nolan managed to persuade the UK government to accept that appointments should be based on merit.

Lord Nolan set out key principles to guide and inform the making of such appointments:

- a minister should not be involved in an appointment where he or she has a financial or personal interest;

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8 Dr Shann Turnbull is a well-known thinker on such matters, and his international and domestic essays are well worth reading.

- ministers must act within the law, including the safeguards against discrimination on grounds of gender or race;
- all public appointments should be governed by the overriding principle of appointment on merit, except in limited circumstances;
- political affiliation should not be a criterion for appointment;
- selections on merit should take account of the need to appoint boards that include a balance of skills and backgrounds;
- the basis on which members are appointed and how they are expected to fulfil their roles should be explicit; and the range of skills and backgrounds that are sought should be clearly specified.

In response to the Nolan Committee's recommendations, the United Kingdom government subsequently created the office of Commissioner for Public Appointments, which has a similar level of independence from the government as the Australian Auditor-General, to provide an effective avenue of external scrutiny.

The Democrats have used the Nolan Committee's recommendations in our amendments for the last five years because they are tried and tested. Meritorious appointments are the essence of accountability.

Until this notion of jobs for the boys or girls is nipped in the bud, there is not that much moral difference between our system and the political patronage that is prevalent in countries where nepotism and favouritism run rife.

We will seek to amend CLERP 9 accordingly.

SENATOR ANDREW MURRAY

LABOR MEMBERS MINORITY REPORT PART 2

Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 ("CLERP 9")

Introduction

The inquiry conducted by the Joint Committee on Corporations and Financial Services into the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003* ("**CLERP 9**") ("**the Bill**") provided valuable insights into the prevailing mood of shareholders, union members, academics, company directors, accountants, regulators, activists, company secretaries, lawyers, auditors (internal and external) and others who will be impacted by the Bill.

This is the second report from the Labor Members in relation to the CLERP 9 Bill. The first report was tabled in the first week of June and relates to issues such as executive remuneration, shareholder participation, management of conflicts of interest and beneficial ownership of shares.

The Explanatory Memorandum states that the underlying objective of the Bill is to:[1]

> *"….improve the operation of the market by promoting transparency, accountability and shareholder activism."*

The Labor members first report into CLERP 9 discusses whether the CLERP 9 Bill sufficiently empowers shareholders and promotes shareholder activism. We conclude that the CLERP 9 bill fails to sufficiently empower shareholders and fails to sufficiently hold board boards accountable. Accordingly, we make a number of recommendations to increase shareholder activism and to increase the accountability of boards.

This second report focuses on the issues of financial reporting and audit. In this report, we consider whether the bill promotes transparency and accountability, particularly in relation to financial reporting and audit.

We conclude that the bill fails to improve transparency in relation to the Financial Reporting Council (FRC). The FRC is the body which oversees the standard setting bodies in the Australia - the Australian Accounting Standards Board (AASB) and the Auditing and Assurance Board (AuASB).

We are also concerned about the accountability of auditors particularly in relation to the provision of non-audit services and the use of aggressive accounting techniques. We make recommendations in relation to these issues as well.

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1 Explanatory Memorandum, CLERP 9, p. 1.

The Committee shares many of Labor's concerns in relation to the CLERP 9 Bill. Accordingly, the Labor members support many of the recommendations made by the Committee. (See Appendix 1 for a discussion of the Labor member's position).

Objectives of the Bill

As the Labor members noted in the first report, it's important that when boards are considering this Bill, the details of the legislation do not obscure the objectives underlying the Bill.

The Australian Council of Super Investors (ACSI) advised the Committee that:[2]

> *"…..we cannot simply rely on the law alone to improve corporate behaviour, although legal mechanisms are critical to ensuring that community expectations are clearly spelt out."*

It's important that the principles which this Bill proposes are considered at a board level.

The Labor members hope that the Bill will have an impact on the culture within companies. If the requirements in this Bill are delegated to the compliance divisions within companies to address, then the Bill will not have achieved its full potential.

To achieve meaningful reform, it is necessary for the boardrooms of corporate Australia to do a "stock-take' and consider whether their culture and their internal processes and procedures implement the principles enshrined in this Bill.

The Labor members reiterate their view that cultural change within Australian boardrooms is as important as the black letter laws which Parliament will pass.

The recent PricewaterhouseCoopers (PwC) report into the National Australia Bank highlighted the importance of cultural issues and made the point that an organisation's culture is a board responsibility.[3]

Similar sentiments have recently been expressed by the Federal Reserve Board Governor, Susan Schmidt Bies. At a recent conference she reminded US corporates that:[4]

> *"It is also important that a strong culture of compliance be established at the top of the organisation and that a proper ethical tone be set for governing the conduct of business….The board and senior management are obligated to deliver a strong message to others in the firm about the importance of integrity, compliance with the law, fair treatment of customers, and overall good business ethics."*

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2 Committee Hansard, 16 March 2004, p. 69

3 PricewaterhouseCoopers, *Investigation into foreign exchange losses at the NAB*, 12 March 2004.

4 Governor Susan Schmidt Bies, *Current Issues in Corporate Governance,* Bank Administration Institute's Fiduciary Risk Management Conference 2004, Las Vegas, Nevada, 26 April 2004.

Beyond CLERP 9

The Labor members reiterate their view that whilst the CLERP 9 Bill provides a vehicle for reform, the reforms proposed by the Bill should not be viewed as completing the task of corporate reform.

The inquiry provided an opportunity to contemplate issues which the Bill has not directly addressed such as the election of directors, beneficial ownership of shares, the role of internal auditors, corporate social responsibility (CSR), the 100 member rule and the application of the Corporations Act beyond listed companies.

Another macro concern is that of enforcement. A strong regulatory framework is important but if the penalties are weak or the regulator does not have sufficient resources to enforce the law, the framework will do little more than pay lip service to the noble principles that it attempts to enshrine.

Penalties for many new offences in the CLERP 9 Bill are low. For example the CLERP 9 Bill sets breaches of the auditor liability regime at between $1,100 and $2,750. Also, a breach of the requirement to give shareholders a non-binding vote at the AGM amounts to a fine of $550.

The Labor members are of the view that these penalties should be increased.
It's also clear that penalties under the *Corporations Act 2001* need reform. The Labor member's believe that penalties for serious breaches of the *Corporations Act 2001* should be doubled.

Labor's Position

Good corporate governance practices ensure that the market is well-informed at all times and that shareholders base decisions on relevant information.
This is essential for the capital market to allocate capital to the most efficient uses and ensure that resources are productively employed.

For the capital market to fulfil this function it must be efficient, fair and transparent.

The Labor members take the view that Parliament needs to strengthen the corporate governance regulatory framework to ensure that Australia's capital market remains efficient, fair and transparent.

The CLERP 9 Bill goes some way to strengthening the framework.

However, it does not go far enough.

The Labor members take the view that the CLERP 9 Bill:

- fails to sufficiently hold boards accountable; and
- fails to sufficiently empower shareholders.

Accordingly, amendments are needed to toughen up the Bill.

On 30 May 2004, Senator Conroy[5] released a Guide to Labor's proposed Amendments to the CLERP 9 Bill. This Guide outlines the amendments which Labor plans to make to the Bill (see Appendix 3 of the first report).

The Guide notes that further amendments are anticipated following the release of this report.

In October 2003, Senator Conroy released a discussion paper in relation to CLERP 9. This paper was released prior to the release of the draft CLERP 9 Bill and outlined the areas of reform that Labor believed should be included in the CLERP 9 Bill.

The Labor members welcome the Government's decision to adopt a number of Labor's proposals including the following:

- Giving shareholders a non-binding vote on the remuneration report;
- Expanding the disclosure requirements for executives from the top 5 executives to the top 10 executives within the corporate group;
- Recognising the need to amend the disclosure obligations in section 300A in relation to executive remuneration; and
- Requiring the auditor to attend and answer questions at the AGM.

Overview of Report

The Labor members have a number of concerns in relation to the audit reforms proposed by the CLERP 9 Bill.

The key issues discussed in this report include:

1. The framework which applies to the financial reporting and standard setting bodies (particularly the role of the FRC).

2. The auditor independence requirements including:
   - non-audit services;
   - cooling off periods;
   - the failure of the bill to address the internal audit function;
   - the failure of the bill to address the use of aggressive accounting techniques; and
   - multiple former audit firm partners.

3. The financial reporting initiatives including the CEO/CFO signoff and the operating and financial review (OFR).

Other concerns include:

- the penalties for breach are dispiritingly low; and
- issues have been raised about flaws with the professional accounting bodies complaints and disciplinary systems.[6]

5 Labor's Shadow Minister for Financial Services and Corporate Governance

1. The Financial Reporting Framework

Introduction

The framework in relation to the financial reporting and standard setting bodies is fundamentally flawed.

The framework is flawed on the basis that:

- The FRC sets the broad strategic direction for the AASB and the AuASB which compromises the independence of both bodies.
- The FRC's consultation processes are defective.
- The accountability and transparency of the FRC is questionable given that:
  - meetings are held in private;
  - cost/benefit analyses are not publicly discussed; and
  - the secretariat is provided by Treasury;
- The funding mechanism for the FRC has not been resolved.

Background

Prior to 2002, the Australian Accounting Research Foundation (AARF) provided research, technical and secretarial support to the Australian Accounting Standards Board (AASB). The AASB was a part-time board which operated on a voluntary basis (although the Chairman was remunerated).

The AAFR was funded by CPA Australia and the Institute of Chartered Accounts in Australia and the Federal Government.

This framework resulted in a reporting regime which was considered one of the strongest in the world with an internationally recognised centre of excellence in relation to accounting research and financial reporting.[7]

According to some commentators, this was:[8]

> *"a remarkable achievement given the relatively small size of our economy and depth of our capital markets compared to the powerhouse economies of the US, UK, Europe and Asia."*

From 1 January 2000, this framework was replaced with a new framework.

The new framework centred on the Financial Reporting Council (FRC). This body was made up of 15 government appointees and was created to oversee the AASB. Also, members of the AASB were appointed by the FRC.

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6 See further: Kath Walters, *CLERP 9 and a flawed trio,* Business Review Weekly, 3-9 June 2004, p. 46-49.

7 Wayne Lonergan, *The emasculation of accounting standard setting in Australia*, JASSA, Issue 3, Spring 2003.

8 Wayne Lonergan, *The emasculation of accounting standard setting in Australia*, JASSA, Issue 3, Spring 2003.

One of the key changes was to allow the FRC to oversee not only the accounting standard setting process but also the *broad strategic direction* of the AASB.

The impact of this decision has now come home to roost. According to some commentators the result is that:[9]

- The AASB is now answerable to the FRC;
- The control of the selection of the board of the FRC and, in turn, the AASB is within the Government's domain;
- The control of the direction of Australian accounting standard setting is now under the influence of the FRC and others such as the ASX (who partly fund the AASB);
- There has been a loss of key staff of the AASB and a watering down of the pool of intellectual capital; and
- The policy of mandatory adoption of international accounting standards has been imposed on the AASB.

The inquiry conducted by the Joint Committee considered many of these issues.

Strategic Direction

The *ASIC Act* sets out the powers and responsibilities of the FRC and the AASB.

The powers given to the FRC include:

- setting the broad strategic direction of the AASB and AuASB;[10]
- approving the priorities, business plans, budgets and staffing arrangements of the AASB and AuASB;[11]

In addition, the AuASB:

- must follow the broad strategic direction determined by the FRC; and[12]
- must comply with a direction by the Minister about the role of international auditing standards in the Australian auditing standard setting system.[13]

These powers impinge on the independence of the AASB and the AuASB.

Proposed section 225(7) states that the FRC does not have the power to direct the AuASB in relation to the development or making of a particular standard. This provision appears incongruous in light of the extent of the FRC's powers in relation to the AuASB.

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9 Wayne Lonergan, *The emasculation of accounting standard setting in Australia*, JASSA, Issue 3, Spring 2003.

10 Proposed section 225(2)(c) - AASB. Proposed section 225(2A)(c) - AuASB

11 Proposed section 225(2)(b) – AASB. proposed section 225(2A)(d) - AuASB

12 Proposed section 234C

13 Proposed section 234D

Mr Tom Ravlic advised the Committee that:[14]

> *"allowing the FRC the luxury of setting strategic directions places it too close to the task of setting of the standards themselves."*

Keith Alfredson (the former Chair of the AASB) concurred advising the Committee that:[15]

> *"The FRC can set strategy but it cannot intervene in the technical content of standards. It is a bit of a strange one. You set up a strategy that says to adopt the international standards and in one fell swoop you have adopted the technical content of international standards. That is always going to be an issue."*

The Labor members are concerned that the legislative framework is fundamentally flawed as it is designed to remove the ability of the standard setting bodies (the AASB and the AuASB) to make independent decisions.

The framework is designed to ensure that the FRC is in control of the direction of Australian accounting (and auditing) standard setting. In our view, this is a retrograde step for Australian standard setting.

International standards

The AuASB will also have a power to make an auditing standard by issuing the text of an international auditing standard (and the international standard can be modified to take account of the Australian legal or institutional environment).[16]

The concern with this provision is that the course of action is pre-determined by the legislation.

Decision making process of the FRC

The decision making processes of the FRC were also cause for concern for some witnesses.

Mr Keith Alfredson raised concerns about the consultation process which the FRC undertook in relation to the decision to adopt international accounting standards.

Mr Alfredson advised the Committee that:[17]

> *"the 2005 decision was made without any FRC paper that firmly debates the issues or all of the arguments in favour and against. I had a paper on a late edition…I do not recall a comprehensive paper setting our the arguments for and against and the issues and implications."*

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14 Submission 1A, p. 7

15 Committee Hansard, 14 April 2004, p. CFS 51

16 Section 227B(3) & (4)

17 Committee Hansard, 14 April 2004, p. CFS 51

He went on to say that:[18]

> *"all I am saying here is that I think the whole process lacked robust and formal consultation…..if you compare our process with what happened in New Zealand and the UK you would have to say it was not as robust."*

The gravity of these comments should not be underestimated. The decision to move towards international accounting standards is one of the most significant decisions that has been made in relation to Australia's financial reporting regime. Yet, it appears that the decision was made without appropriate consideration or consultation.

To overcome the deficiencies in the decision making process, Mr Alfredson suggested that the FRC be required to openly consult on matters through the issue of draft strategy papers or exposure drafts and the holding of public hearings.[19]

The Labor members endorse these recommendations.

Other issues of transparency

A number of witnesses were concerned about the transparency of the FRC and advised the Committee that the FRC should:

- hold its meetings in public (subject to certain matters such as the appointment of board members);
- have a secretariat separate from Treasury; and
- expand the pool of people who sit on the FRC.

In relation to meeting in public, Professor Ramsay saw merit in more openness in proceedings.[20]

Mr Ravlic advised the Committee that:[21]

> *"It is intolerable that the FRC sets key strategic directions for a standards setter without being held accountable by the general community and without being visible."*

Mr Alfredson made the point that the Trustees of the International Accounting Standards Board meet in public. He suggested that to conform with best practice that the FRC was also obliged to meet in public.[22]

In relation to the provision of the FRC's secretariat by Treasury, Mr Ravlic said that:[23]

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18 Committee Hansard, 14 April 2004, p. CFS 51-52

19 Submission from Mr Keith Alfredson, dated 10 December 2004.

20 Committee Hansard, 18 March 2004, p. CFS 8.

21 Committee Hansard, 14 April 2004, p. CFS2.

22 Submission from Mr Keith Alfredson, dated 10 December 2004.

23 Committee Hansard, 14 April 2004, p. CFS 2.

> *"I am in agreement with Charles Macek (the current chair of the FRC) who argues that the secretariat must be independent in order to enure that the FRC gets independent advice, well considered advice and appropriately informed advice and not advice that is tainted by the sort of government policy that we have seen develop over a period of time with respect to accounting standards setting and, indeed audit standards setting."*

A number of witnesses raised the issue of the composition of the FRC.

Professor Ramsay said that:[24]

> *"I see an important role for the public interest and I am not quite sure where that is when I see the current FRC membership. In my report I also made an observation that, in terms of representatives of the public interest, one should give thought even to public advertisement. The relevant minister might want to think about advertising, and choose the best qualified people on the basis of public advertising."*

Mr Alfredson noted that when appointments were made to the AASB the FRC advertised and "some names came out of the woodwork" that would otherwise not have been considered.[25]

The Labor members are concerned about the lack of transparency in relation to the FRC's processes. Accordingly, it is recommended that:

- the powers of the FRC to set the broad strategic direction of the AASB and AuASB are removed;
- the powers of the FRC to approve the priorities, business plans, budgets and staffing of the AASB and AuASB are modified;
- the FRC is required to openly consult on key issues;
- the FRC is required to hold its meetings in public (subject to the consideration of certain sensitive issues such as the appointment of members to the AASB and AuASB); and
- the secretariat provided to the FRC should not be provided by Treasury.

Oversight of audit quality

The FRC's role in relation to oversight of auditor independence was raised by a number of witnesses. The ASX took the view that the FRC should oversee audit quality not audit independence. The ASX submission states that:[26]

> *ASX believes that the oversight role assigned to the FRC as it is currently expressed in relation to auditing and auditors is not entirely clear. The proposals encompass powers and duties which relate partly to auditing in general and partly to auditor independence.*

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24 Committee Hansard, 18 March 2004, p. CFS 9.

25 Committee Hansard, 14 April 2004, p. CFS 54.

26 Submission from the ASX dated November 2003.

> *ASX has previously expressed the strong view that the relevant primary function should be oversight of audit quality, of which auditor independence is an aspect. We submit that the functions of the FRC should focus on and give prominence to the monitoring and assessment of audit quality in general.*

Mr Alfredson raised concerns about whether the FRC was equipped to oversee audit quality.

Administration of AASB and AuASB

Mr Alfredson also proposed that the staffing of the AASB and the AuASB is merged into a new body which could provide the technical and administrative support to both the AASB and the AuASB.[27]

This proposal was endorsed by Professor Boymal who advised the Committee that:[28]

> *"If [the AuASB] is a separate empower as the AASB is, there will be duplication of that administrative effort for very few people.*

Audit by ANAO

Mr Alfredson suggested that before any additional responsibilities were given to the FRC that the Australian National Audit Office (ANAO) should be instructed "as a matter or urgency" to perform an efficiency and effectiveness audit of the activities of the FRC since its creation.[29]

The current Chair of the FRC, Charles Macek supported the idea of a review of the FRC.[30]

The Labor members recommend that:

- the administration of the AASB and AuASB should be re-considered to streamline the administrative functions; and
- a review of the FRC is undertaken.

2. Auditor Independence

Introduction

This report addresses the following issues in relation the auditor independence requirements in the CLERP 9 Bill:

- non-audit services,

27 Submission from Keith Alfredson, dated 10 December 2004.

28 Committee Hansard, 29 April 2004, p. CFS 90.

29 Submission from Keith Alfredson, dated 10 December 2004.

30 Committee Hansard, 29 April 2004, p. CFS 18

- cooling off periods;
- the failure of the bill to address the internal audit function;
- the failure of the bill to address the issue of the use of aggressive accounting techniques; and
- the provisions relating to multiple former audit partners (proposed section 324CK).

Non-audit services

The CLERP 9 bill requires the disclosure non-audit services and a statement that they do not compromise audit independence.

ASIC's submission on the original CLERP 9 policy paper recommended the prohibition of the provision of certain non-audit services.

The submission said:[31]

> *"…the provision of some non-audit services will always, or almost always, threaten the independence, or the appearance of independence, or auditors, regardless of the safeguards adopted……ASIC considers that the best approach is to prohibit the provision of such non-audit services through the Act, rather than through the ethical rules of the professional bodies."*

The Institute of Internal Auditors advised the Committee that in their view the external auditor should not ever provide internal audit services and that other non-audit services should also be prohibited.

Mr Parkinson from the IIA said that:[32]

> *"We believe that the external auditor should be staying out of those things in much the same way as the Sarbanes-Oxley Act suggests. The great danger is that you become financially dependent on a non-audit service or that you end up auditing your own work."*

He went on to say:[33]

> *"The danger that arises when the external auditor does some of this non-financial statement internal audit work is that, once again, it can become a large proportion of their fee or they can be placed in a position where they can be compromised. They may find themselves tempted…….to play down the bad news in order to retain other pieces of work."*

31 ASIC, *Submission on CLERP 9 – Corporate disclosure: strengthening the financial reporting framework,* November 2002.

32 Committee Hansard, 7 May 2004, p. CFS 33.

33 Committee Hansard, 7 May 2004, p. CFS 33.

Similar concerns were expressed by the Australian Shareholders Association and the Australian Council of Super Investors.

The Australian Shareholders Association (ASA) advised the Committee that the CLERP 9 provisions requiring disclosure of non-audit services were not sufficient. Mr Wilson from the ASA said that:[34]

> *"The issue of non-audit services…is two-fold. Firstly, in a financial sense, audit firms use the audit itself as bait for engaging in the non-audit services. A common argument that is thrown forward is that, because the auditor knows the business they are better placed to provide the non-audit services…….So irrespective of what the audit service is, that financial incentive to get those non-audit services fundamentally compromises the independence of the audit."*

The Labor members are of the view the company's auditor should be prohibited from providing certain non-audit services which potentially compromise the independence of the auditor including bookkeeping, financial information systems design, appraisal or valuation services, actuarial services, internal audit services, management functions, broker or dealer services, legal services and others.

In our view, there will still be considerable scope for the provision of non-audit services to clients, although those services which by and large always affect the auditor's independence will be restricted.

Recently, US SEC Commissioner Roel Campos justified the more stringent audit requirements in the US by saying that it was a privilege for companies to raise capital in the US and access the low cost of capital and liquidity that exists there.[35]

In our view, a similar argument can be made for companies which seek to raise capital in Australia.

Cooling off periods

The Labor members are also concerned about the cooling off periods in the bill.

The Government has flip-flopped on the issue and has changed from a two year period in the original consultation paper, to a four year period in the draft bill and back to a two year period in the final bill.

In our view, Justice Owen is correct when he says that a two year cooling off period:[36]

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34 Committee Hansard, 9 March 2004, p. CFS 21.

35 Alan Kohler interview with Roel Campos, *US mulls NAB, KPMG criminal charges,* Inside Business, 29 February 2004.

36 HIH Royal Commission*, The Failure of HIH Insurance, Volume 1 – A Corporate Collapse and its lessons.*

> *"might not be sufficient to arrest a reasonable apprehension that former partners retain an influence over members of the audit team."*

Accordingly, the Labor members support Justice Owen's recommendation that 4 years is an appropriate cooling off period before audit partners can join their former clients.

Alternative Accounting Treatments

The Labor members welcome the CLERP 9 requirement that auditors will be required to attend Annual General Meetings (AGM) and answer questions.

However, the bill has not included Justice Owen's recommendations in relation to alternative accounting treatments.

Justice Owen recommended that:[37]

> *"where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material, the impact of the position taken by the reporting entity should be explained in the audit report."*

Professor Ramsay endorsed Justice Owen's recommendation.

He advised the Committee that:[38]

> *The increased focus in the United States on disclosure of what might be termed 'critical accounting policies' in the reports of companies is a welcome development … As noted by the … Securities and Exchange Commission:*
>
> *... critical accounting policies are those that are both most important to the portrayal of a company's financial condition and results, and require management's most difficult, subjective or complex judgements, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.*
>
> *In brief (as I said before the committee in July 2002) there is a need to improve accounting disclosure.*
>
> *I suggest that a focus upon critical accounting policies—where good faith differences of opinion may have a significant impact, if you like, on the financial results of the company and how they are reported—should be considered.*

The Labor members support Professor Ramsay's comments that there is a need to improve accounting disclosure and that a focus is needed on good faith differences of opinion. Accordingly, we recommend that the CLERP 9 Bill includes a provision requiring the disclosures suggested by Justice Owen.

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37 Paragraph 7.2.6, Chapter 7 (Financial Reporting and Assurance), HIH Final Report.

38 Committee Hansard, 18 March 2004, p. CFS 4-5.

Internal Audit

The role of the internal auditor is not an issue which has been specifically addressed by the CLERP 9 Bill. This is surprising given the importance placed on the role of internal auditors in other jurisdictions such as the United States.

In the US, Federal Reserve policy statements say that the audit committee should provide for an independent, objective and professional internal audit process.

Federal Reserve Governor, Susan Schmidt Bies, recently said that:[39]

> *"Internal audit is one of the few corporate functions with both the ability and the responsibility to look across all of the management silos within the corporation and make sure that the system of internal controls has no gaps and that the control framework is continually reviewed to keep up with corporate strategic initiatives, reorganisations, and process changes."*

The Institute of Internal Auditors (IIA) made a number of recommendations to the Committee about the role of internal auditors. The IIA proposed that the Corporations Act should distinguish between the roles of the internal auditor and the external auditor and that internal auditing should be recognised as a profession.

The Labor members recognise the important role that internal auditors play in relation to monitoring internal systems and controls and recommend that further consideration is given to the recommendations made by the IIA.

Multiple Former Audit Partners

Proposed section 324CK of the Bill prohibits any more than one former partner of an audit firm, at any time, being a director of or taking a senior management position with the audited body.
Professor Ramsay raised a concern with this provision. He said that:[40]

> *"I have some concerns about that particular provision. It appears to have no time limits, so that a person who retired from an audit firm many years previously, and may in fact have expertise and skills that would be of significant benefit to the client, would be prohibited from offering those skills and expertise to the client if indeed there is one other former partner from the audit firm already on that company. "*

The Labor members recommend that the provision is amended to include time limits such that a person who has not worked for the audit firm for a significant number of years is not captured by the provision.

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39 Governor Susan Schmidt Bies, *Current Issues in Corporate Governance,* Bank Administration Institute's Fiduciary Risk Management Conference 2004, Las Vegas, Nevada, 26 April 2004.

40 Committee Hansard, 18 March 2004, p. CFS 4.

3. Financial Reporting

Schedule 2 of the CLERP 9 Bill which relates to financial reporting contains three important reforms:

- the requirement for CEO's and CFO's to provide declarations in relation to a listed entity's financial report;
- The requirement for listed company's to include an "operating and financial review" (OFR) in the director's report; and
- The establishment of the Financial Reporting Panel (FRP) to resolve disputes between ASIC and companies concerning the accounting treatments in financial reports.

The Labor members support these reforms. However, further modifications are required in relation to the CEO/CFO declarations and the OFR to enhance their practical operation and to have a significant impact on financial reporting.

CEO / CFO Signoff

Proposed section 295A of the Corporations Act will require CEOS and CFO's to provide a sign-off in relation to the financial statements.

They will be required to certify to the directors of a listed entity that:

- The entity's financial records for the financial year have been properly maintained as required by section 286 of the Act;
- The financial statements and notes comply with accounting standards;
- The financial statements and notes give a true and fair view.

The CEO/CFO sign-off recommended in the *ASX Corporate Governance Guidelines* is wider that the one proposed by the CLERP 9 Bill.

Under the Guidelines, the certification extends to the internal compliance and control procedures which implement the policies adopted by the board. This requirement is an important component of the certification.

Whether the internal systems are sufficient is a key factor in the integrity of the information which is funnelled up through an organisation to the board.

The Labor members' take the view that the certification under the *Corporations Act* should also extend to internal procedures.

Operating and Financial Review (OFR)

Section 299A of the CLERP 9 Bill inserts a requirement for the annual directors report to contain information that members of the company would reasonably require to make an informed assessment of the company's:

- operations;

- financial position;
- business strategies; and
- future prospects.

The Explanatory Memorandum states that the Group of 100 Guide will provide guidance on the types of issues to be disclosed.

The concept of an operating and financial review was also proposed by Justice Owen in his report into HIH, who said that the OFR:[41]

> *"would significantly assist in addressing the short-comings of audited accounts presented in accordance with the historical cost convention and other standard which can impeded the utility of the accountants as a transparent assessment of the financial progress of the company."*

Unfortunately, the way that the OFR is framed in the CLERP 9 bill lends itself to boilerplate disclosures.

The ACF advised the Committee that disclosures in relation to the existing environmental reporting provision (section 299(1)(f)) tended to be *"brief, very general and of limited usefulness to investors".*[42]

The ASX submission states that:[43]

> *ASX believes that the proposals for additional general requirements for listed public companies relating to the operations, financial position, strategy and prospects could be more specific if they are to be helpful and of use to investors and the market generally.*
>
> *The proposals do not go significantly beyond the current requirements in Section 299(1) regarding operations and activities.*
>
> *In operation, this existing section has produced what may be characterised as generic disclosure which is of limited use to users and is significantly less helpful than that required in equivalent jurisdictions.*
>
> *ASX suggests that a better proposal would be a list of required minimum disclosure topics. ASX is hopeful that the promised International Financial Reporting Standard (IFRS) on "management discussion and analysis" may provide the framework needed to produce this particularly useful information. ASX believes however that it will be some years before the IFRS is issued and adopted in Australia.*

Professor Ramsay also thought that further guidance was needed, advising that:

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41 HIH Royal Commission, *The Failure of HIH Insurance, Volume 1 – A Corporate Collapse and its lessons.*

42 Committee Hansard, 7 May 2004, p. CFS 21.

43 ASX Submission, dated November 2003.

> *"Some additional guidance may be appropriate, but you must fully understand that his additional guidance does not cover all bases and could not ever be expected to."*

Environment and social issues

Another issue is the scope of the OFR. The Association of Chartered Certified Accountants (ACCA) suggested that corporate social responsibility issues should be discussed as part of the review.

Some commentators have suggested that the provisions as currently drafted already include an obligation for listed companies to report on significant environmental and social matters that could impact on the company's future financial prospects.[44] It has been suggested that the following significant environment issues may require disclosure:[45]

- Climate change and greenhouse emissions issues;
- Access to future water resources; and
- Increased salinity resulting from a company's activities.

The ACF advised the Committee that failing to mandate specific disclosures and leaving it up to the market was not sufficient. Mr Berger from the ACF said that:[46]

> *"It is worth noting that financial reporting requirements were fiercely resisted by business for 35 years until the first national laws were enacted in the 1930's in the United States. Regarding financial disclosures, it took a worldwide depression to finally make clear that capital market swill not work efficiently and reliably in the absence of market transparency. I ask what it will take before we understand the similar importance of sustainability reporting. Are we going to wait for a complete environmental and social meltdown analogous to the economic meltdown in the Great Depression before we require disclosure of corporate impacts on the environment?"*

The Labor members believe that significant environment and social issues which may impact on a company's financial position would be captured by the new operating and financial review.

However we are concerned that unless more detailed guidance is provided in the legislation, companies may simply disclose boilerplate information in some cases or not disclose social and environment issues at all. Given the quality of disclosures made in relation to section 299(1)(f), it would appear that in the absence of any mandated requirement to do so, it is unlikely that meaningful disclosure of social and environmental issues will be made.

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44 Freehills Publication, *How will CLERP 9 impact companies and corporate environmental reporting?* 2 March 2004.

45 Freehills Publication, *How will CLERP 9 impact companies and corporate environmental reporting?* 2 March 2004.

46 Committee Hansard, 7 May 2004, p. CFS 22.

The Labor members believe that this is a missed opportunity.

Conclusion

In conclusion, the CLERP 9 Bill strengthens the corporate governance regulatory framework. However, it does not go far enough.

Areas where the framework requires "toughening up" include:

1. The framework which applies to the financial reporting and standard setting bodies (particularly the role of the FRC).

2. The auditor independence requirements including:
   - non-audit services;
   - cooling off periods;
   - the failure of the bill to address the internal audit function;
   - the failure of the bill to address the use of aggressive accounting techniques; and
   - multiple former audit firm partners.

3. The financial reporting initiatives including the CEO/CFO signoff and the operating and financial review (OFR).

SENATOR PENNY WONG
DEPUTY CHAIR

MR ANTHONY BYRNE MP

SENATOR STEPHEN CONROY

MR ALAN GRIFFIN MP

APPENDIX 1

COMMITTEE RECOMMENDATIONS

The Labor members support the following recommendations:

- Chapter 3 – Recommendations 6, 7 & 8 re: streamlining the administrative functions of the AASB and the AuASB.

- Chapter 4 – Recommendations 9, 10, 14, 15,16, 17, 18, 19 to enhance the transparency of the FRC.

- Chapter 5 – Recommendations 20, 21 and 22 relating to the role of the auditor.

  However, the Labor members also recommend that the auditor's report discusses the impact of alternative accounting treatments and significant matters arising in the audit process.

- Chapter 10 – Recommendation 29 – Role of the Financial Reporting Panel (FRP) should be restricted to financial reports which have been published (and not expanded to include a "pre-publication" role).

The Labor members are considering the following recommendations:

- Chapter 1 – Recommendation 1 (CEO/CFO signoff)
- Chapter 1 – Recommendation 2 (OFR)
- Chapter 1 – Recommendation 4 (True and Fair view)
- Chapter 1 – Recommendation 5 (True and Fair View)
- Chapter 4 – Recommendations 11 & 12 (Composition of FRC)
- Chapter 4 – Recommendation 13 (Funding)
- Chapter 9 – Recommendation 28 (Composition of CALDB)

The Labor members do not support the following recommendations:

- Chapter 1 – Recommendation 3 (aggressive accounting techniques). The Labor members support Justice Owen's recommendation in relation to HIH.

  Justice Owen recommended that:[47]

  "where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material, the impact of the position taken by the reporting entity should be explained in the audit report."

47 Paragraph 7.2.6, Chapter 7 (Financial Reporting and Assurance), HIH Final Report.

- *Chapter 6 – Recommendation 23* – The Committee recommends deleting section 324CK re: multiple former audit partners.

  The Labor members recommend that this provision is amended in accordance with Professor Ramsay's suggestion that time limits are imposed so that a person who has retired from an audit firm many years previously is not restricted from joining another former partner at the client company. For example, it may be appropriate that where a person has not worked for the audit firm for at least the 5 previous years that they should be able to join a client where another former partner also works.

- *Chapter 6 – Recommendation 24* – rotation requirements for person who play a significant role in an audit.

  The Labor members support the current requirements in the CLERP 9 Bill.

- *Chapter 6 – Recommendation 25* – restriction of rotation requirements to the top 300 listed companies.

  The Labor members support the general requirement in the CLERP 9 bill for the rotation of auditors who play a significant role in the audit of a listed entity for five successive financial years.

  The Labor members acknowledge that these rotation requirements may impose a greater burden on smaller firms. Accordingly, we recommend that consideration should be given to ways to ameliorate the impact for smaller audit firms. For example, it would be worth considering whether to retain the rotation requirements for larger audit firms but not for smaller audit firms (who audit firms outside the top 300 companies).

  We do not support providing a blanket exemption from the audit rotation requirements for all companies below the top 300 largest companies.

- *Chapter 6 – Recommendation 26* – postponement of rotation by ASIC.

  The Labor members are satisfied with ASIC's powers to grant relief under the CLERP 9 Bill.

- *Chapter 8 – Recommendation 27* – Restricting ASIC's ability to impose restrictions registration

  The Labor members support the retention of ASIC's ability to impose restrictions on the audit company's registration.

- *Chapter 10 – Recommendation 30* – the Committee recommends that lodging entities should be able to refer matters to the Financial Reporting Panel (FRP) without obtaining ASIC's consent.

  The Labor members take the view that ASIC should have the ability to grant consent to refer matters to the FRP. In our view, removing this step may lead

to a situation where some companies refer matters to the FRP as a matter of course. In our view, to protect the efficiency of the regulatory structure, ASIC's consent should be required.

- *Chapter 11 – Recommendation 34* – The Committee recommends that Auditing Standards should not be disallowable instruments.

  The Labor members believe that it is in the public interest to ensure Parliamentary oversight of the auditing standards. Therefore, such standards should be disallowable instruments.

APPENDIX 1

SUBMISSIONS AND TABLED DOCUMENTS[1]

Number	*From*
1	Mr Tom Ravlic
1A	Mr Tom Ravlic
1B	Mr Tom Ravlic
1C	Mr Tom Ravlic
1D	Mr Tom Ravlic
1E	Mr Tom Ravlic
1F	Mr Tom Ravlic
2	Mr Geoff Dunsford
3	Professor Ronald Francis
3A	Professor Ronald Francis
4	Mr Rod Bennett
4A	Mr Rod Bennett
4B	Mr Rod Bennett
4C	Mr Rod Bennett
5	Australian Council of Super Investors Inc
6	Mr Bob Baxt
6A	Mr Bob Baxt
7	The Law Society of Western Australia
8	Chartered Secretaries Australia
8A	Chartered Secretaries Australia
9	Mr Martin Alciaturi
10	Public Sector & Commonwealth Superannuation Schemes
11	Securities Institute of Australia
12	Georgeson Shareholder Communications Australia Pty Ltd
13	Pitcher Partners Accountants Auditors & Advisors
14	ANZ Banking Group Limited
15	Whistleblowers Australia
15A	Whistleblowers Australia
16	Professor Geoffrey George

1 Tabled on 4 June 2004 with Part 1 of the Committee's report on the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003.

17	Australasian Investor Relations Association
18	NSW Young Lawyers
19	The Association of Superannuation Funds of Australia Limited
20	Business Council of Australia
20A	Business Council of Australia
21	Centre for Corporate Governance, University of Technology Sydney
22	Australian Shareholders' Association Ltd
23	Transparency International Australia
24	Law Council of Australia (Corporations Committee, Business Law Section)
24A	Law Council of Australia
24B	Law Council of Australia
24C	Law Council of Australia
25	National Institute of Accountants
25A	National Institute of Accountants
26	The Institute of Internal Auditors
27	PricewaterhouseCoopers
28	Maurice Blackburn Cashman Lawyers
29	STOPline Pty Ltd
30	Deloitte Touche Tohmatsu
31	CPA Australia
32	IA Research
33	KPMG
34	Ernst & Young
35	Australian Institute of Company Directors
35A	Australian Institute of Company Directors
36	The Institute of Chartered Accountants in Australia
37	Baker & McKenzie Solicitors and Attorneys
38	Finance Sector Union of Australia
39	Grant Thornton Association Inc
40	St James Ethics Centre
41	Telstra Corporation Limited
41A	Telstra Corporation Limited
42	The Association of Chartered Certified Accountants Australia & New Zealand
43	Credit Union Services Corporation (Australia) Limited
44	Investment and Financial Services Association Ltd
44A	Investment and Financial Services Association Ltd

45	The Law Society of South Australia
45A	The Law Society of South Australia[2]
46	Group of 100 Inc
46A	Group of 100 Inc
46B	Group of 100 Inc
47	Australian Workers' Union
48	Australian Stock Exchange Limited
49	The Commercial Law Association of Australia Limited
49A	The Commercial Law Association of Australia Limited[3]
50	BDO Chartered Accountants and Advisers
50A	BDO Chartered Accountants and Advisers
51	Premier of New South Wales
52	Mr Keith Alfredson
53	Auditing & Assurance Standards Board
53A	Auditing & Assurance Standards Board
53B	Auditing & Assurance Standards Board
54	Mr Malcolm J Chambers
55	Australian Conservation Foundation
56	Tap Oil Limited
57	Securities and Derivatives Industry Association
57A	Securities and Derivatives Industry Association
58	Corporate Governance International Pty Ltd
59	Professor Graeme Dean and Professor Frank Clarke
59A	Professor Graeme Dean and Professor Frank Clarke
60	Australian Chamber of Commerce and Industry
61	Harding & Associates
62	P M Capital Ltd
63	Mr Stephen Mayne
63A	Mr Stephen Mayne
64	Compliance Logistics Pty Ltd
65	Mr John Fielding

2 This submission was tabled separately with Part 2 of the Committee's report on the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003.

3 This submission was tabled separately with Part 2 of the Committee's report on the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003.

ADDITIONAL INFORMATION/TABLED PAPERS

Date	***Details***
05/11/03	Letter from Mr Donald Magarey, Chairperson of the Companies Auditors and Liquidators Disciplinary Board, enclosing the CALDB's Annual Report for the year ended 30 June 2002
05/03/04	Letter enclosing article, Movie making can make money shrink, from Mr Rod Bennett
09/03/04	*Remuneration – Guidelines for Institutions and Listed Companies*, First Edition, March 2003—tabled at the Committee's public hearing on 9 March 2004 by Mr Sandy Easterbrook, Corporate Governance International Pty Limited
11/03/04	Copy of opening statement and attached article, *Auditor Independence Reforms—Recycled Ideas*, (Dean G, Clarke F and Wolnizer P; 2002, *Abacus*, Vol 38, No 2, pp. i-vi) tabled by Professors Graeme Dean and Frank Clarke at the Committee's public hearing on 11 March 2004
16/03/04	Copy of opening statement tabled by the Investment & Financial Services Association Ltd at the Committee's public hearing on 16 March 2004
13/04/04	Letter from Mr Ralph Evans, Australian Institute of Company Directors, responding to questions taken on notice during the Committee's public hearing on 18 March 2004
14/04/04	Copy of opening statement tabled by Mr Geoff Brayshaw, BDO Chartered Accountants and Advisers, at the Committee's public hearing on 14 April 2004
29/04/04	Copy of speech, The need for an accounting court, (made before the American Accounting Association 1957 convention, University of Wisconsin, Madison, Wisconsin, on 27 August 1957) tabled by Mr Tom Ravlic at the Committee's public hearing on 14 April 2004
07/05/04	Company Auditors and Liquidators Disciplinary Board Annual Report for the year ended 30 June 2003, tabled at the Committee's public hearing on 7 May 2004
07/05/04	Two letters dated 7 May 2004 from Mr Ross Clare, The Association of Superannuation Funds of Australia Limited, one responding to questions taken on notice during the Committee's public hearing on 7 May 2004 and the other providing additional information
07/05/04	Paper tabled by Ms Catherine Wolthuizen, Australian Consumers' Association, at the Committee's public hearing on 7 May 2004

13/05/04	Letter from The Institute of Chartered Accountants in Australia commenting on several issues raised at the Committee's public hearings
14/05/04	Letter from Mr Paul Coleman, Companies Auditors and Liquidators Disciplinary Board, responding to questions taken on notice at the Committee's public hearing on 7 May 2004
17/05/04	Letter with attachments from Mr Charles Macek, Financial Reporting Council, responding to questions taken on notice at the Committee's public hearing on 29 April 2004
20/05/04	Letter with attachments from the Department of the Treasury responding to questions taken on notice at the Committee's public hearing on 29 April 2004 and supplementary questions of 11 May 2004
20/05/04	Letter from the Australian Securities and Investments Commission responding to questions taken on notice at the Committee's public hearing on 29 April 2004
25/05/04	Letter from the Australian Securities and Investments Commission responding to questions taken on notice at the Committee's public hearing on 29 April 2004
26/05/04	Answer from the Department of the Treasury to written questions from the Committee regarding whistleblowing, executive remuneration, infringement notices and shareholder participation
28/05/04	Answer from the Department of the Treasury to written questions from the Committee regarding executive remuneration and quantum of termination payments to directors
31/05/04	Copy of letter to the Department of the Treasury from the Australian Institute of Company Directors regarding the suggested wording of a proposed due diligence defence to certain continuous disclosure obligations
01/06/04	Response from the Australian Accounting Standards Board, dated 1 June 2004, to the Committee's request for a summary of key differences between existing Australian standards and the IASB standards. Encloses a copy of *The Australian Convergence Handbook* published by the AASB in 2002.[4]

4 This response and the enclosures were tabled separately with Part 2 of the Committee's report on the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003.

08/06/04 Letter from the ANZ Banking Group Ltd responding to the Committee's invitation for comments on disclosure of political donations.[5]

5 This response and the enclosures were tabled separately with Part 2 of the Committee's report on the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003.

APPENDIX 2

PUBLIC HEARINGS AND WITNESSES[1]

TUESDAY, 9 MARCH 2004 - CANBERRA

CORPORATE GOVERNANCE INTERNATIONAL PTY LTD
EASTERBROOK, Mr Alexander (Sandy) Arthur Douglas, Principal/Director

AUSTRALIAN SHAREHOLDERS ASSOCIATION LTD
WILSON, Mr Stuart, Chief Executive Officer

THURSDAY, 11 MARCH 2004 - CANBERRA

NATIONAL INSTITUTE OF ACCOUNTANTS
ADAMS, Mr Dennis, Deputy Chief Executive Officer
AGLAND, Mr Reece, Technical Counsel, National Institute of Accountants

CLARKE, Professor Frank Lewis (Private capacity)

DEAN, Professor Graeme William (Private capacity)

INSTITUTE OF CHARTERED ACCOUNTANTS IN AUSTRALIA
HARRISON, Mr Stephen, Chief Executive Officer
PALMER, Mr William, General Manager, Standards and Public Affairs
REILLY, Mr Keith, Technical Adviser

DELOITTE TOUCHE TOHMATSU
McHUTCHISON, Mr Harley Beeman, Chairman

BUSINESS COUNCIL OF AUSTRALIA
MUNCHENBERG, Mr Steven, Director, Policy

TUESDAY, 16 MARCH 2004 - SYDNEY

UNIVERSITY OF TECHNOLOGY SYDNEY
ADAMS, Professor Michael Andrew, Assistant Director, Centre for Corporate Governance

KPMG
COLEMAN, Mr Michael John, National Managing Partner, Risk and Regulation,

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1 Transcripts of the hearings were tabled on 4 June 2004 with Part 1 of the Committee's report on the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003.

FISK, Mr Adrian, Partner, Department of Professional Practice

DUNSFORD, Mr Geoffrey Alan, (Private capacity)

LAW COUNCIL OF AUSTRALIA
FARRELL, Ms Kathleen, Immediate Past Chairman, Corporations Committee, Business Law Section
GOLDING, Mr Greg Ray, Member
KEEVES, Mr John Storrie, Chairman, Corporations Committee, Business Law Section

INVESTMENT AND FINANCIAL SERVICES ASSOCIATION LTD
GILBERT, Mr Richard, Chief Executive Officer
O'REILLY, Mr David, Senior Policy Manager, Investment

AUSTRALIAN STOCK EXCHANGE LTD
HAMILTON, Ms Karen Leslie, Chief Integrity Officer, and Chair, Corporate Governance Council

AUSTRALIAN COUNCIL OF SUPERANNUATION INVESTORS INC
SPATHIS, Mr Phillip, Executive Officer
WALKER, Professor Robert, Adviser

THURSDAY, 18 MARCH 2004 - MELBOURNE

GRANT THORNTON ACCOUNTANTS
ADAM-SMITH, Mr Matthew Alexander, Partner
FENSOME, Mr Martin Edward, Partner

PITCHER PARTNERS
AZOOR HUGHES, Ms Sufiya Dianne, National Technical Director

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS
BAXT, Professor Bob, Chair, Law Committee
EVANS, Mr Ralph, Chief Executive Officer
GUY, Mr Andrew, Board Representative, Law Committee
JOHNSON, Mr Mark, Deputy Chairman, Reporting Committee

AUDITING AND ASSURANCE STANDARDS BOARD
EDGE, Mr William Rodney, Chairman

CHARTERED SECRETARIES AUSTRALIA
GRATION, Mr Douglas, Member, National Legislation Review Committee
JONES, Mr Richard, Chairman, National Legislation Review Committee
SHEEHY, Mr Timothy Brian, Chief Executive

GROUP OF 100
HARRIS, Mr Geoff, National Executive Coordinator
STANHOPE, Mr John Victor , National President

CERTIFIED PRACTISING ACCOUNTANTS AUSTRALIA
LARSEN, Mr Gregory James, Chief Executive Officer
MULCARE, Mrs Catherine, Policy Adviser, Financial Reporting and Governance

AUSTRALIAN ACCOUNTING RESEARCH FOUNDATION
MIFSUD, Mr Richard, Executive Director

UNIVERSITY OF MELBOURNE
RAMSAY, Professor Ian Malcolm, Director, Centre for Corporate Law and Securities Regulation

TUESDAY, 6 APRIL 2004 - SYDNEY

SECURITIES INSTITUTE OF AUSTRALIA
BURKE, Ms Julie Catherine, National Policy Manager
MARSHALL, Mr Scott Edward, Member, Company Reporting Subcommittee
NEAL, Mr Ian Richard, President

SECURITIES AND DERIVATIVES INDUSTRY ASSOCIATION
CLARK, Mr Doug, Policy Executive
HORSFIELD, Mr David, Managing Director and Chief Executive Officer

PRICEWATERHOUSECOOPERS
HARRINGTON, Mr Anthony Patrick David, Chief Executive Officer
WARD, Mr Robert, National Managing Partner

ERNST AND YOUNG AUSTRALIA
LONG, Mr Brian James, Chairman of Board of Partners, Senior Audit Partner

ST JAMES ETHICS CENTRE
LONGSTAFF, Dr Simon, Executive Director

GEORGESON SHAREHOLDER COMMUNICATIONS AUSTRALIA PTY LTD
WILLIAMS, Mr Murray Evan, Executive Director

WEDNESDAY, 14 APRIL 2004 - MELBOURNE

ALFREDSON, Mr Francis Keith, (Private capacity)

BDO CHARTERED ACCOUNTANTS
BRAYSHAW, Mr Geoffrey Frank, Managing Partner
KNOTT, Mr Jeffrey Francis, Partner

REID, Mr Kevin Richard, Partner

AUSTRALIAN WORKERS UNION
GILLAM, Mr Trent, National Corporate Research Officer
SHORTEN, Mr Bill, National Secretary and Victorian Secretary

FINANCE SECTOR UNION OF AUSTRALIA
MASSON, Mr Rodney, National Communications Manager

CRIKEY.COM.AU
MAYNE, Mr Stephen David, Publisher

INSTITUTIONAL ANALYSIS RESEARCH
PAATSCH, Mr Dean, Manager, Governance Information Products

RAVLIC, Mr Tom, (Private capacity)

THURSDAY, 29 APRIL 2004 - MELBOURNE

AUSTRALIAN ACCOUNTING STANDARDS BOARD
BOYMAL, Professor David, Chairman
STODDART, Ms Ellen Kathrine, Senior Project Manager

DEPARTMENT OF THE TREASURY
DYLEWSKI, Mr Michael, Policy Analyst
HEALY, Ms Kate, Governance Insolvency Unit
HOLMBERG, Ms Kyla, Financial Reporting Unit
LEVY, Mr Peter, Policy Analyst
NIGRO, Mr Lenny, Policy Analyst
PASCOE, Mr Les, Financial Reporting Unit
RAWSTRON, Mr Mike, General Manager, Corporations and Financial Services Division
ROSSER, Mr Mike, Manager, Investor Protection Unit
SMITH, Ms Ruth, Manager, Market Integrity Unit
TAFT, Mr Peter, Policy Analyst
WIJEYEWARDENE, Ms Kerstin, Manager, Financial Reporting Unit
WINCKLER, Mr Simon, Policy Analyst
YOUNGBERG, Ms Naomi, Policy Analyst

AUSTRALASIAN INVESTOR RELATIONS ASSOCIATION LIMITED
LAWSON-KERR, Ms Carolyn, Chairman

AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION
MACAULAY, Ms Louise, Director, Enforcement Policy and Practice
PRICE, Mr John, Assistant Director, Regulatory Policy
RODGERS, Mr Malcolm, Executive Director, Policy and Markets Regulation

FINANCIAL REPORTING COUNCIL
MACEK, Mr Charles, Chairman

AUSTRALASIAN INVESTOR RELATIONS ASSOCIATION LIMITED
MATHESON, Mr Ian, Director

FRIDAY, 7 MAY 2004 - SYDNEY

AUSTRALIAN CONSERVATION FOUNDATION
BERGER, Mr Charles, Law and Corporate Responsibility Coordinator

ASSOCIATION OF SUPERANNUATION FUNDS OF AUSTRALIA LTD
CLARE, Mr Ross William, Principal Researcher
PRAGNELL, Dr Bradley John, Principal Policy Adviser

COMPANIES AUDITORS AND LIQUIDATORS DISCIPLINARY BOARD
COLEMAN, Mr Paul John, Registrar
MAGAREY, Mr Donald Rees, Chairman

INSTITUTE OF INTERNAL AUDITORS
McDONALD, Mr Robert, Global Chairman

INSTITUTE OF INTERNAL AUDITORS
PARKINSON, Mr Michael, ex officio Member

FINANCIAL SERVICES, AUSTRALIAN CONSUMERS ASSOCIATION
WOLTHUIZEN, Ms Catherine Nicole, Senior Policy Officer