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Report 391

Review of Independent Auditing by Registered Company Auditors

Joint Standing Committee on Public Accounts and Audit

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Chairman's Foreword

In the last two years there have been a significant number of high profile corporate failures in Australia. While business is an inherently risky activity, the sudden failure of seemingly healthy companies came as a shock. These failures can impact on the community in many ways, most significantly through the personal and financial losses incurred by shareholders, creditors and employees.

Of course the responsibility for corporate failures ultimately lies with a company's management and directors. Nevertheless, the Committee considers investors should be able to retain a reasonable expectation that the statutory audit function will identify and highlight when a company may be in difficulty. In a broader sense, these failures pointed to inadequacies of the corporate regulatory regime and the inadequate nature of corporate governance exercised by some in the business community.

Auditors carry a significant public trust and responsibility that must be at the forefront of all their decisions and actions. There has been a change in the profession over time from an emphasis on professional ethics to a more business-oriented focus. This focus on commercial imperatives has for some, it seems, taken precedence in recent years at the expense of good ethical practice. The same can be said for the business community where we have witnessed a decline in ethical practice and an abrogation of responsibilities and obligations to the broader community. In this light, an associated aim of the Committee's recommendations is to promote enhanced ethical professional culture in the audit and accounting profession and the business community.

It has been said that when Arthur Anderson signed off on an audit he put his reputation, credibility and standing in the community on the line. Arthur Anderson has passed on and sadly, for at least some in the profession, so have his ideals.

Directors of publicly listed companies have clear responsibilities and obligations that must be met. Directors also need to have the appropriate skills, experience

and support mechanisms to effectively analyse and verify information in order to be able to ask the right questions and make well-considered decisions. The Committee has previously inquired into these issues in the context of government business enterprises and maintains that the principles of that inquiry and the subsequent recommendations are generally applicable to the private sector. However, in the course of this inquiry the Committee did not receive enough evidence in this area to enable it to make a major statement at this time.

It is important to recognise that the Australian situation is not the same as that in the United States and we have not witnessed the same level of excesses that are being revealed in the US. The Committee is not convinced that an overly prescriptive reaction is warranted or appropriate. Rather, there needs to be an appropriate mix of principle and prescription. It is impossible to demand infallibility or implement a 'zero-risk' policy. Given the inherent risk of business and the need for risk to drive entrepreneurial activity, a risk management rather than a risk aversion approach is appropriate and increased accountability should be demanded of the corporate sector and audit profession.

The Committee's findings are based on a number of observations of both the audit and accounting profession and the business community, which shaped the ensuing framework of recommendations. Our findings are also influenced by our longstanding involvement in corporate governance and the audit framework governing accountability in the public sector.

Current audit practice is limited to an attestation that financial statements have been prepared according to accounting standards. In forming the opinion, the auditor does not necessarily explore broader issues that may impact on the ongoing viability of a company, such as the adequacy of corporate governance practices, risk management and internal control processes.

In turn, because a company's governance practices, risk management and internal control processes are not regularly and rigorously tested, their continued veracity and importance to the ongoing viability of the company may be overlooked.

Oversight of both audit firms and listed companies is deficient. There is very little transparency regarding the independence (and to a lesser extent competence) of the firms carrying out audits. In regard to listed entities there is a lack of, and incentives for, compliance with accounting standards. The recent spate of corporate earnings restatements demonstrates that, regardless of any changes in audit structure or functions, only concerted action to police management activities will address these problems.

There are also concerns regarding the lack of informative and timely information being available to the market and a low level of public confidence (shared by some academics) in the veracity of the information produced by adhering to the accounting standards framework.

Broader reporting to incorporate governance practices, risk management and internal control processes require an appropriate framework against which these broader issues may be audited. This will force companies to pay due attention to their corporate governance principles and practices. In addition, it will provide more information to shareholders and other stakeholders.

Changes to the current unlimited liability environment are required to protect auditors if they are to comment on a broader range of issues.

Public confidence in the independence of audit opinions needs to be restored. This requires a mechanism to, in effect, 'audit the auditor' on matters of independence and competence.

Increased surveillance of compliance with accounting standards is required to ensure aggressive accounting practices are not used to mislead shareholders, even though such practices may be in accordance with current black letter requirements.

Better disclosure is required to improve the ability of the users of financial reports and the market in general to understand the companies they invest in, and in particular, the risks associated with those investments.

Our proposed solution is designed to address these issues and compel companies and auditors to enhance their management of corporate governance and audit independence. Rather than advocating prescriptive regulation and mandating arbitrary limits or benchmarks, the central element of our reform proposal is to provide a framework enabling a broadening of the scope of the audit function to include, for example, corporate governance, risk management, internal control issues or other performance-type issues. To support this new framework and the process of management improvement (and to promote more transparency) we also propose an enhanced oversight role for the existing regulator, the Australian Securities and Investments Commission (ASIC).

The key findings and recommendations of the report include that:

- The *Corporations Act 2001* be amended:
 - ⇒ to require the Chief Executive Officer and Chief Financial Officer of a company to sign a statutory declaration that the company's financial reports comply with the *Corporations Act 2001* and are materially truthful and complete;
 - ⇒ to require all publicly listed companies to have an audit committee of independent members;
 - ⇒ to require audit firms to report annually to ASIC on independence issues;
 - ⇒ to clarify the relationship between the need for financial statements to comply with accounting standards and provide a true and fair view; and

⇒ to include a general statement on audit independence.

- the Financial Reporting Council develop a set of corporate governance standards, which would be given legislative backing in the *Corporations Act 2001*;
- the Australian Stock Exchange Listing Rules be amended to require additional reporting by companies;
- ASIC explore the cost and benefits of introducing performance audits in the private sector and in conjunction with the ASX, evaluate the costs and benefits of requiring pronouncements and other disclosures under the continuous disclosure listing rule to be subject to a credible degree of assurance; and
- a framework for protected (or whistleblower) disclosure be established in the *Corporations Act 2001*, including clear accountability mechanisms over the administration and management of disclosures.

In addition, the Committee was particularly attracted to the idea of Independence Boards within audit/ accounting firms as proposed by Professor Keith Houghton. One of the 'Big Four' has proceeded with implementation of Professor Houghton's proposal, one is seriously considering implementation and one believes it achieves the same outcomes in a slightly different manner.

It is significant that this is the first time the JCPAA has undertaken an inquiry into private sector issues. Nevertheless, the JCPAA has a long history of actively seeking to strengthen the role and independence of the Commonwealth auditor as an essential agent of government accountability to the Parliament and ensuring good corporate governance in the public sector. This inquiry has been an opportunity for the Committee to bring its expertise in audit and corporate governance matters to bear on the issue of audit independence generally.

It is the Committee's intention to maintain a watching brief on these important national issues.

In conclusion, and on behalf of the JCPAA, I would like to thank all those who have contributed to this inquiry.

Bob Charles MP

Chairman



Contents

Chairman's Foreword	iii
Membership of the Committee.....	xiii
Membership of the Sectional Committee.....	xiv
Duties of the Committee	xv
Terms of reference	xvii
List of abbreviations.....	xix
Glossary of terms.....	xxi
Recommendations.....	xxiii

REPORT

1 INTRODUCTION	1
Background.....	1
The context of the inquiry.....	3
The need for reliable information.....	3
The value of the audit function	4
The importance of independence.....	6
Parliament's contribution to the debate	7
Industry responses	8
International trends	10
The United States.....	10
The United Kingdom.....	12
The European Union	13
Ireland.....	14

The International Federation of Accountants	14
Organisation for Economic Cooperation and Development	14
Regulatory framework	15
Private Sector	15
Public Sector	18
Inquiry objectives, scope and focus	18
Corporate Governance.....	19
Financial reporting and disclosure.....	20
The auditing framework	20
The Ramsay Report	21
Conduct of the inquiry	23
Report structure	23
2 CORPORATE GOVERNANCE	25
Background	25
Corporate governance in publicly listed companies	27
The Board and Directors: role and responsibilities	28
Director education and competency	29
The selection, appointment and independence of Directors	30
Selection of the external auditor	32
Director's remuneration	33
Management perception of the audit function	35
Conclusion.....	37
Management accountability	38
Conclusion.....	40
Internal audit	41
Audit Committees	42
International trends.....	44
Mandating Audit Committees	45
Responsibilities of the Audit Committee.....	49
Conclusion.....	51
Corporate governance standards	53
Current requirements	53
Broadening financial reporting requirements.....	54

A new reporting framework	55
Conclusion.....	55
Corporate governance in audit firms.....	57
Ensuring the independence of the auditor.....	59
Auditing the auditors.....	64
3 FINANCIAL REPORTING	67
Background.....	67
Accounting standards.....	68
Principle-based.....	68
Harmonisation with international accounting standards.....	70
Quality of measurement rules (the reliability of financial information).....	72
Conclusion.....	77
True and Fair View.....	78
Conclusion.....	83
Continuous disclosure.....	84
Conclusion.....	86
Statutory oversight of financial reporting.....	86
Conclusion.....	86
Further reforms in the area of disclosure	87
Internal controls.....	88
Management Discussion and Analysis.....	89
Conclusion.....	90
4 THE AUDITING FRAMEWORK	93
Introduction.....	93
What is an audit	93
Auditing and professional (ethical) standards	94
The qualities of an audit.....	95
Audit independence	96
Ramsay Report.....	97
Independence of the Public Sector auditor	97
Conclusion.....	98
The provision of non-audit services.....	99

The auditors' tenure	103
Recent overseas experience	106
Risk management.....	107
Conclusion.....	107
Expectation gap	108
Enhancing the scope of audits	109
Continuous auditing.....	112
Performance audits	113
The audit report	114
Conclusion.....	116
Auditors' liability.....	117
Conclusion.....	121
Oversight of the accounting profession.....	122
CPA Australia	124
Institute of Chartered Accountants in Australia	125
Audit firms.....	126
United Kingdom.....	126
United States.....	126
Conclusion.....	127
Development of auditing standards.....	128
Conclusion.....	130
Disciplinary processes.....	130
Conclusion.....	132
Whistleblowers	132
Conclusion.....	134

APPENDICES

Appendix A—List of Submissions	135
Appendix B—List of Exhibits.....	139
Appendix C – Witnesses appearing at public hearings	141

LIST OF TABLES

Table 1	Summary of the Ramsay Report.....	22
Table 2	Summary of JCPAA Report No. 372.....	27
Table 3	Risk reduction.....	120
Table 4	Outcome of disciplinary matters provided by ASIC to CALDB.....	131

LIST OF FIGURES

Figure 1	Oversight arrangements in Australia for Registered Company Auditors.....	122
Figure 2	CPA Australia's model	125



Membership of the Committee

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Deputy Chair Ms Tanya Plibersek MP

Members Senator Richard Colbeck

Mr Steven Ciobo MP

Senator Rosemary Crowley
(until 30/6/02)

Mr John Cobb MP

Senator John Hogg

Mr Petro Georgiou MP

Senator Claire Moore
(from 27/6/02)

Ms Sharon Grierson MP

Senator Andrew Murray

Mr Alan Griffin MP

Senator Nigel Scullion

Ms Catherine King MP

Senator John Watson

Mr Peter King MP

The Hon Alex Somlyay MP

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Hon Alex Somlyay MP

Committee Secretariat

Secretary Dr Margot Kerley

Inquiry Secretary Mr Adam Cunningham

Research Officer Mr Bill Bonney

Administrative Officers Ms Maria Pappas

Mr Jeremy O'Connell

Duties of the Committee

The Joint Committee of Public Accounts and Audit is a statutory committee of the Australian Parliament, established by the *Public Accounts and Audit Committee Act 1951*.

Section 8(1) of the Act describes the Committee's duties as being to:

- (a) examine the accounts of the receipts and expenditure of the Commonwealth, including the financial statements given to the Auditor-General under subsections 49(1) and 55(2) of the *Financial Management and Accountability Act 1997*;
- (b) examine the financial affairs of authorities of the Commonwealth to which this Act applies and of intergovernmental bodies to which this Act applies;
- (c) examine all reports of the Auditor-General (including reports of the results of performance audits) that are tabled in each House of the Parliament;
- (d) report to both Houses of the Parliament, with any comment it thinks fit, on any items or matters in those accounts, statements and reports, or any circumstances connected with them, that the Committee thinks should be drawn to the attention of the Parliament;
- (e) report to both Houses of the Parliament any alteration that the Committee thinks desirable in:
 - (i) the form of the public accounts or in the method of keeping them; or
 - (ii) the mode of receipt, control, issue or payment of public moneys;

- (f) inquire into any question connected with the public accounts which is referred to the Committee by either House of the Parliament, and to report to that House on that question;
- (g) consider:
 - (i) the operations of the Audit Office;
 - (ii) the resources of the Audit Office, including funding, staff and information technology;
 - (iii) reports of the Independent Auditor on operations of the Audit Office;
- (h) report to both Houses of the Parliament on any matter arising out of the Committee's consideration of the matters listed in paragraph (g), or on any other matter relating to the Auditor-General's functions and powers, that the Committee considers should be drawn to the attention of the Parliament;
- (i) report to both Houses of the Parliament on the performance of the Audit Office at any time;
- (j) consider draft estimates for the Audit Office submitted under section 53 of the *Auditor-General Act 1997*;
- (k) consider the level of fees determined by the Auditor-General under subsection 14(1) of the *Auditor-General Act 1997*;
- (l) make recommendations to both Houses of Parliament, and to the Minister who administers the *Auditor-General Act 1997*, on draft estimates referred to in paragraph (j);
- (m) determine the audit priorities of the Parliament and to advise the Auditor-General of those priorities;
- (n) determine the audit priorities of the Parliament for audits of the Audit Office and to advise the Independent Auditor of those priorities; and
- (o) undertake any other duties given to the Committee by this Act, by any other law or by Joint Standing Orders approved by both Houses of the Parliament.



Terms of reference

With the spate of recent noteworthy corporate collapses both within Australia and overseas, the Joint Committee of Public Accounts and Audit wishes to explore the extent to which it may be necessary to enhance the accountability of public and private sector auditing.

In particular, the Committee is keen to determine where the balance lies between the need for external controls through government regulation, and the freedom for industry to self-regulate.



List of abbreviations

AARF	Australian Accounting Research Foundation
AASB	Australian Accounting Standards Board
AuASB	Auditing & Assurance Standards Board
ACCA	Association of Certified Chartered Accountants
ACCI	Australian Chamber of Commerce and Industry
AG	Auditor-General
AICD	Australian Institute of Company Directors
AISB	Auditor Independence Supervisory Board
ANAO	Australian National Audit Office
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
CAC	Commonwealth Authorities and Companies
CALDB	Companies Auditors and Liquidators Disciplinary Board
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CLERP	Company Law Economic Reform Program
FRC	Financial Reporting Council

FMA	Financial Management and Accountability
IASB	International Accounting Standards Board
ICAA	Institute of Chartered Accountants in Australia
IFAC	International Federation of Accountants
JCPAA	Joint Committee of Public Accounts and Audit
NIA	National Institute of Accountants
NYSE	New York Stock Exchange
OECD	Organisation for Economic Cooperation and Development
PAAC	Public Accounts and Audit Committee
SEC	Securities and Exchange Commission

Glossary of terms

Emphasis of Matter	A section in the audit report used to draw attention to a relevant matter without affecting the nature of the audit opinion
Joint and several liability	The notion that deems parties acting independently are equally responsible and liable for any loss or injury caused to another party
Market Operator	The term used in the <i>Corporations Act 2001</i> to refer to the entity that manages the listed share market
Management discussion and analysis	Commentary containing an analysis and explanation of a company's financial and operating performance, position and future prospects. It is often described as giving users the ability to view the company 'through management's eyes'
Non-audit services	Consulting services or activities provided to an audit client by the audit firm, which are outside the scope of the external audit engagement
Proportional liability	The notion that equates the extent of a party's responsibility, for any loss or injury caused to another party, to the proportion or degree of fault involved
Share options	A form of remuneration, which gives the recipient the ability to buy nominated shares in the future, usually at the market price at the time option is granted or at a price to be set when the option is exercised



Recommendations

2 CORPORATE GOVERNANCE

Recommendation 1

That the *Corporations Act 2001* be amended to require the Chief Executive Officer and Chief Financial Officer of a company to sign a statutory declaration that the company's financial reports comply with the *Corporations Act 2001* and are materially truthful and complete. This declaration must be attached to the company's financial reports whenever they are lodged with ASIC and provided to the company's members and the market operator pursuant to this Act.

Recommendation 2

That the *Corporations Act 2001* be amended to require all publicly listed companies to have an independent audit committee and the Act prescribe the minimum requirements in regard to the role, responsibilities and composition of an audit committee.

Recommendation 3

That the Financial Reporting Council:

- develop a set of corporate governance standards, including prescriptions for internal audit, taking primary guidance from the findings of the ASX's Corporate Governance Council; and
- take all steps to ensure these standards be given legislative backing in the *Corporations Act 2001*, as either pursuant to or mirroring Section 334.

Recommendation 4

That Section 1288 of the *Corporations Act 2001* be amended to incorporate the following principles:

- require audit firms undertaking assurance audits of publicly listed companies to submit a report to the Australian Securities and Investments Commission (ASIC) on an annual basis detailing how audit firms have managed independence issues in the preceding period and any future independence management issues that are deemed pertinent;
- provide ASIC with the authority to investigate and address independence issues arising from these reports or from other sources as ASIC considers appropriate; and
- require publication of the ASIC benchmark criteria used for determining the adequacy of the internal systems and processes of large audit firms.

3 FINANCIAL REPORTING

Recommendation 5

In the process of adopting the international accounting standards by January 1 2005, as announced by the FRC, the AASB should ensure that those contentious issues and deficiencies identified by the Committee are resolved as a matter of priority at the earliest possible date.

Recommendation 6

That Section 297 of the *Corporations Act 2001* be amended as follows:

- add the requirements 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.

- delete the current 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).

- add the following new sub-sections:

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.

Recommendation 7

It is recommended that Sections 307 and 308 of the *Corporations Act 2001* be amended to require the auditor to form an opinion and report on any additional disclosure made pursuant to Section 297.

Recommendation 8

It is recommended that the Australian Stock Exchange amend the Listing Rules to require additional reporting by companies in the following areas:

- commentary on internal control systems, including risk management processes;
- management discussion and analysis;
- commentary on the main factors affecting reported financial performance and financial position;
- commentary on the key judgements made in the application of accounting policies;
- results for a set of key performance indicators pointing to the health of the organisation; and
- details of directors' and executives' performance appraisal or management systems .

4 THE AUDITING FRAMEWORK

Recommendation 9

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

- the following statement

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

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

Recommendation 10

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

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

Recommendation 11

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

Recommendation 12

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

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

Recommendation 13

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

INTRODUCTION

Background

- 1.1 On 4 April 2002, the Joint Committee of Public Accounts and Audit (the Committee) resolved to conduct a review of independent auditing by registered company auditors.
- 1.2 In Australia over the past decade or so the Committee has actively sought to secure the independence of the Commonwealth Auditor-General and to strengthen the role of the auditor as an essential agent of government accountability to the Parliament. After a series of reports by the Committee during the period 1994 to 1996, legislation giving effect to the essential aspects of these changes was finally passed during 1997.¹
- 1.3 At the same time it has become clear that reforms to public accountability mechanisms have put pressure on the private sector to follow suit. It is an article of faith across the political spectrum that greater levels of scrutiny, transparency and openness, in effect good corporate governance, improves management and performance, reduces the risk of fraud and mismanagement and promotes public confidence in both public and private enterprises.
- 1.4 In 1999 the Committee explored issues of good corporate governance in the commercially structured environment of Government Business Enterprises in Report 372, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*.

¹ See paragraph 1.71 for further discussion on accountability in the public sector.

- 1.5 The continuing trend towards the outsourcing of government functions to the private sector and the increasingly complex levels of interaction between government and business makes it essential that the principles of good corporate governance common to both public and private sectors are commonly understood and acted upon. This interaction is also made easier through moves in the public sector towards the adoption of accounting practices and standards common to the private sector. This inquiry has been an opportunity for the Committee to bring its expertise in audit and corporate governance matters to bear on the issue of audit independence generally.
- 1.6 In the last two years there have been a significant number of high profile corporate failures in Australia. While business is an inherently risky activity, the sudden failure of seemingly healthy companies came as a shock. These failures can impact on the community in many ways, most significantly through the personal and financial losses incurred by shareholders, creditors and employees. The list of high profile corporate failures is extensive: Pasmenco Ltd, Ansett Australia, One.Tel Ltd, Impulse Airlines Ltd, Harris Scarfe Holdings Ltd, Franklins, and HIH Insurance Ltd.
- 1.7 Of course, the responsibility for corporate failures ultimately lies with a company's management and directors. Nevertheless, the Committee considers investors should be able to retain a reasonable expectation that the statutory audit function will identify and highlight when a company may be in difficulty. In a broader sense, these failures pointed to the inadequacy of the corporate regulatory regime, with the One-Tel case providing a graphic example of the inadequate nature of corporate governance exercised by some in the business community.
- 1.8 In relation to corporate failures, the major audit firms in Australia have themselves been engaged in legal cases in relation to alleged failures in accounting and auditing.²
- 1.9 In 2001 and 2002 the United States witnessed two of the largest corporate failures in history with the collapse of energy giant Enron and the communications conglomerate Worldcom. The Enron case led to the demise of the global accounting firm Arthur Anderson (one of the 'big-five' accounting firms) who also faced criminal indictment for destroying documents in the Enron case.

2 Colin James, 'Accounting for Blame', *The Advertiser*, 20 March 2002 reports that both PricewaterhouseCoopers and Ernst & Young face potential claims for over \$200 million in the Supreme Court of South Australia for allegedly failing to detect accounting irregularities that led to the collapse of retailer Harris Scarfe.

- 1.10 The audit failures that have been a feature of these cases are occurring despite regular assurances by members of the accounting and related professions that the present rules and regulatory frameworks concerning audit independence and professional standards are adequate.
- 1.11 The Government initiated a number of inquiries in response to the spate of high profile corporate collapses and indications that the financial reporting framework was failing to protect Australian investors.
- 1.12 In June 2001, the Prime Minister, the Hon. John Howard MP, announced that a Royal Commission would inquire into the circumstances surrounding the failure of the HIH Insurance Group, chaired by Justice Neville Owen. The central goal of the Royal Commission is to investigate the reasons for and the circumstances surrounding the failure of HIH.
- 1.13 In August 2001 the Minister for Financial Services, the Hon. Joe Hockey MP, commissioned Prof. Ian Ramsay (University of Melbourne) to undertake a review of auditor independence. This report was initiated in response to a perceived need to update audit independence requirements in Australia due to changes in international standards, and the collapse of a number of listed Australian companies in the first half of 2001. The final report was released in October 2001.³
- 1.14 In June 2002, the Treasurer, the Hon. Peter Costello MP, announced that the Department of Treasury would undertake a review of auditing and accounting standards as part of the ongoing Corporate Law Economic Reform Program (CLERP). The process will commence with the release of an issues paper (CLERP 9), which will address the Ramsay report on auditor independence together with a number of other issues on financial disclosure. The issues to be addressed by CLERP 9 include audit reform (for example, the market for audit and non-audit services), a review of the present continuous disclosure regime and enhanced shareholder participation.

The context of the inquiry

The need for reliable information

- 1.15 Australia is a share owning nation. According to the November 2000 Australian Stock Exchange Share Ownership Update, 52 per cent of

³ Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001.

Australian adults were involved in the share market, either through director ownership or managed funds (compared to 32 per cent in May 1997). The proportion of direct share ownership was 40 per cent (compared to 20 per cent in May 1997). This can be partly explained by large-scale public share offerings as part of the part sale of Telstra and the demutualisation of the NRMA.⁴

- 1.16 Reflecting increased share ownership over the last decade, the size of the Australian stock market has risen significantly since the early 1990s. Between December 1991 and December 2001, domestic market capitalisation grew from \$191 billion to \$730 billion. Similarly, the volume of shares being traded on the Australian Stock Exchange has risen in the same period from under 10 000 daily trades to over 50 000.⁵
- 1.17 In order to participate fairly in the share market, investors require accurate, timely and reliable information. Investors are able to obtain information of varying quality from a range of sources such as the media, investment analysts, investment brokers, ratings agencies such as Standards and Poor's or Moody's, and the internet.
- 1.18 However, the primary source of information is that provided by companies themselves, particularly in annual reports and other financial statements as required to be disclosed by law. Investors place a great deal of trust in companies providing accurate information. The availability of the financial report and the audit report as public information is an integral part of the regulated capital market.⁶

The value of the audit function

- 1.19 Simply put, an assurance (or financial) audit is an attestation of the truth and fairness (and/or validity) of the financial reports of a company, which are representations of the management and directors of that company.⁷ The Ramsay Report states that audits:
- add value to financial statements by improving their reliability;
 - add value to the capital markets by enhancing the credibility of financial statements;

4 *Shareownership Update, November 2000*, Australian Stock Exchange, Sydney, <http://www.asx.com.au/about/pdf/ShareUpdate150201.pdf>

5 *Australian Market Overview*, Australian Stock Exchange, Sydney, http://www.asx.com.au/about/l3/MarketOverview_AA3.shtm

6 Auditor General of Victoria, *Submission No.25*, p. S206.

7 Professor Keith Houghton, *Submission No.1*, p. S6.

- enhance the effectiveness of the capital markets in allocating valuable resources by improving the decisions of users of financial statements; and
- assist to lower the cost of capital to those using audited financial statements by reducing information risk.⁸

1.20 Australian Auditing Standard 108 (which describes the audit function as an ‘assurance engagement’) provides guidance as to the objective of an audit, stressing the need to address the information needs of the end user:

The objective of an assurance engagement is for a professional accountant to evaluate or measure a subject matter that is the responsibility of another party against identified suitable criteria, and to express a conclusion that provides the intended user with a level of assurance about that subject matter. Assurance engagements performed by professional accountants are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria, thereby improving the likelihood that the information will meet the needs of an intended user. In this regard, the level of assurance provided by the professional accountant’s conclusion conveys the degree of confidence that the intended user may place in the credibility of the subject matter.

1.21 The valued added impact of quality audits is also summed up by Prof. Keith Houghton who argues that:

...differing audit quality levels have differential value adding effects. In addition, and perhaps most importantly, the quality difference in the audit converts to a price differential in the shares traded on the stock market.⁹

1.22 The perceived veracity of financial reports can have a significant impact on the value of a company. The Worldcom case¹⁰ clearly highlighted that accounting practices and financial reports can be used to artificially inflate the share value of a company. Conversely, it may be assumed that a company whose financial reports are seen to be accurate and true by investors will attract capital. The ability of financial reports and audits to influence the market value of a company, places a great deal of responsibility on all those engaged in the audit process—the company, the auditor and the regulator.

8 Ramsay Report, p 20, para 4.02, citing Independence Standards Board, *A Conceptual Framework for Auditor Independence*, Discussion Memorandum (February 2000), paras 11-14.

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

10 In June 2002, the US communications company WorldCom admitted to falsifying profits by \$US 3.8 billion by incorrectly manipulating its financial accounts over a period of five quarters and has since filed for bankruptcy.

The importance of independence

- 1.23 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 complimentary 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.
- 1.24 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.
- 1.25 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.
- 1.26 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.
- 1.27 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.¹¹

11 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.

1.28 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:

Independent auditors have an important public trust. Investors must be able to rely on issuers' financial statements. It is the auditors 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.¹²

1.29 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 Committee:

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.¹³

1.30 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.

Parliament's contribution to the debate

1.31 The issue of audit independence is a matter of concern to the Committee particularly because auditors have been seen to have signed off on the financial health of companies which have subsequently failed. Parliament

12 SEC, *Final Rule: Revision of the Commission's Auditor Independence Requirements*, Release No. 33-7919, www.sec.gov/rules/final/33-7919.htm

13 Mr John Hammond, *Submission* No.19, p. S153

also has a role in addressing public concerns regarding audit independence by virtue of the *Corporations Act 2001* having a number of sections that deal with auditor independence.

- 1.32 While many commentators have argued that corporate failure is ultimately the responsibility of directors, the community also expects auditors to report fairly and accurately on the financial state of the companies they are auditing. Shareholders and the public have legitimate expectations of the effectiveness of auditors, which are clearly not being satisfied. The millions of Australian who now participate in the share market – whether as individuals or through their pension funds – look to government to ensure that the financial reporting regime is as honest, transparent and effective as possible.
- 1.33 Corporate leaders of publicly listed companies—directors, Chief Executive Officers and senior managers—also have significant and broad responsibilities. Listing on the stock exchange and reaping the potential benefits of selling shares and raising capital brings with it certain costs, obligations and responsibilities. Shareholders and employees of the companies themselves, have legitimate expectations of their corporate leaders.
- 1.34 The public interest is best served by a transparent, accurate and accountable financial reporting system on which investors can rely to make investment decisions and a robust corporate governance culture. There is now a rigorous debate in the public arena concerning the adequacy of the financial reporting system, including audit independence and corporate governance in general. The Committee believes it is essential that Parliament contribute to this debate.
- 1.35 The findings of this review, along with the Ramsay Report, the CLERP 9 review and most probably the findings of the HIH Royal Commission, will feed directly into the Government's consideration of what steps need to be taken to ensure the future integrity of our financial reporting system.

Industry responses

- 1.36 The corporate failures mentioned above have prompted the accounting profession and some listed companies to take action in regard to the independence of the audit function. The Committee welcomes and supports the initiatives being taken by the industry.
- 1.37 CPA Australia and the Institute of Chartered Accountants in Australia have recently released *Professional Standard F1*, which adopts new

international standards aimed at reducing threats to audit independence. The standards include:

- retired auditors wait at least two years before becoming directors of companies that they have audited;
- a ban on audit firms providing non-audit services if there is a risk that the auditor will be checking their own work, and
- compulsory rotation of audit partners for listed entities every seven years.

1.38 There are indications that the corporate sector have learnt some lessons as a result of high profile corporate collapses and are responding to public concern regarding audit independence and corporate governance in general. For example:

- a recent survey of the top 500 Australian firms indicated that 28% of the 471 respondents are moving away from allowing a single firm to provide both audit and non-audit services;¹⁴
- ANZ has introduced a policy prohibiting their auditor from performing a range of non-audit work and improve disclosure and transparency of information provided to the market;¹⁵ and
- BHP Billiton policy precludes an audit firm providing non-audit services where independence may be compromised or conflicts of interest arise.¹⁶

1.39 Audit firms have also begun adopting measures aimed at enhancing auditor independence. For example:

- KPMG has formed an ethics board to deal with ethical dilemmas and conflicts of interest and introduced a rotation policy for auditing services.
- PricewaterhouseCoopers has established an independence board to oversee audit standards, quality and independence. The board will review audit processes, risk management, quality control, policy partner remuneration, training and produce a publicly available annual report.

14 Tim Boreham, 'Corporates get tidy over audit practices', *The Australian*, 13 June 2002. The survey was conducted by East & Partners exclusively for *The Australian*.

15 ANZ media release, 24 April 2002.

16 Correspondence received from Karen Wood, Company secretary, BHP Billiton, 24 July 2002.

- Deloitte Touche Tohmatsu advised the Committee they were considering the establishment of an 'independence' board to bolster their quality and integrity processes.
- Ernst & Young continue to strive, through its quality control mechanisms and risk management structure, to embed an awareness of independence issues into its culture.¹⁷

International trends

1.40 The problems related to audit independence and financial reporting are not confined to Australia. The financial markets are a truly global system, and failure in any part of the system has global consequences. Governments in a number of countries have, since the late 1990's, undertaken a range of reviews looking at various issues related to the auditing of public companies and the accountancy profession in general. The recent spate of corporate collapses has refocussed Government attention on the issue, and increased public concern has given the issue a heightened sense of urgency.

The United States

- 1.41 In November 2000, the Securities and Exchange Commission (SEC) developed a set of detailed rules regarding audit independence and disclosure applicable to auditors of listed entities. These rules, which were amended in early 2001, include provisions that reduce potential conflicts of interest between auditors and clients, address the issue of the provision of audit and non-audit services to the same client and increase the transparency of information required to be supplied by public companies and their audit committees.
- 1.42 The four principles underpinning the conceptual approach adopted by the SEC specify that an auditor would not be considered independent when the auditor:
- has a mutual or conflicting interest with the audit client;
 - is placed in the position of auditing their own work;
 - acts as management or an employee of the audit client; and
 - is in a position of being an advocate for the client.

- 1.43 On 28 June 2002 the SEC published a list of over 900 companies whose chief executives and chief financial officers would be required to personally certify, in writing, under oath, and for publication, that their most recent reports filed with the SEC are both complete and accurate. Officers making false certifications face personal liability.¹⁸
- 1.44 In what is perhaps the toughest action taken by any Government to date, on 25 July 2002 both houses of the US Congress passed the *Public Company Accounting Reform and Investor Protection Act of 2002*, signed by the President on 30 August 2002. The Act aims to address the issues surrounding recent corporate failures and fraud and restore public confidence in the financial reporting framework. The key points of the Act include:
- the introduction of new penalties for corporate fraud and prison terms of up to 20 years for destroying or altering documents sought in federal investigations;
 - establishment of a five-member, private-sector board to oversee the accounting industry;
 - the restriction of a wide range of consulting and other non-auditing services that accounting firms may provide to their audit clients, including bookkeeping, financial systems design and personnel and legal services;
 - new powers given to the SEC to bar corporate wrongdoers for life from serving as officers or directors of any public company, without having to go to court;
 - provides increased funding to the SEC to hire additional auditors and investigators; and
 - prevents individuals who violate securities laws from using bankruptcy protection to avoid paying judgments to defrauded investors and other victims.
- 1.45 Two of the world's most influential stock markets have adopted a range of reforms aimed at addressing corporate governance issues. In July 2002, the Nasdaq Stock Market (the world largest market with 4000 listed companies) announced a range of new corporate governance reform proposals designed to increase accountability and transparency. The reforms included measures to: increase board independence; empower audit committees; mandate director continuing education; enable

18 *Corporate Law Bulletin*, No.59, July 2002.

shareholder approval of stock option plans; mandate codes of conduct; and mandate accelerated disclosure of insider transactions.¹⁹

- 1.46 The New York Stock Exchange (NYSE) has adopted the recommendations made by its Corporate Accountability and Listing Standards Committee. The reforms include: enhancing the role and authority of independent directors; tightening the definition of 'independent' director and adding new audit committee qualification requirements; fostering a focus on good governance; giving shareholders more opportunity to monitor and participate in the governance of their companies, and; establishing new control and enforcement mechanisms. In addition, the NYSE Committee recommended that the NYSE encourage all listed companies to establish an orientation program for new members.²⁰

The United Kingdom

- 1.47 In 2000 the Government announced the establishment of a new system of non-statutory independent regulation of the accountancy profession. The new system incorporates five new bodies: The Accountancy Foundation; the Review Board; the Ethics Standards Board (ESB); the Auditing Practices Board (APB); and the Investigation and Discipline Board (IDB).
- 1.48 In light of the Enron issue, the Secretary for the Department of Trade and Industry established a Coordinating Group on Audit and Accounting Issues in February 2002 incorporating the Treasury, the Financial Services Authority and the Accountancy Foundation. The group was set up to ensure that the effectiveness of UK systems of financial reporting and audit regulation is reviewed thoroughly by the appropriate regulators.
- 1.49 The Coordinating Group on Audit and Accounting Issues released an interim report in July 2002. The key features of this report include:
- strengthening the role and responsibilities of audit committees through defining their role in relation to shareholders, enhancing responsibility for approval of purchases of non-audit services and appointment of auditors and possibly underpinning the role and responsibilities of audit committees through company law;
 - further work to be undertaken to identify the types of non-audit services that are incompatible with the underlying principles of auditor independence;
 - improved disclosure of the nature and value of non-audit work;

19 *Corporate Law Bulletin*, No.59, July 2002

20 New York Stock Exchange Accountability and Listing Standards Committee, 6 June 2002.

- rotation of the audit partner every five years and rotation should extend beyond the lead audit partner;
- audit firms should improve transparency by providing better information on their processes and practices, publishing full financial statements and accounts, and making more information publicly available on the structure of their international networks;
- a continuing emphasis on accounting standards which stress the need for ‘substance over form’;
- the need for international standards to be in place by 2005 which promote transparency in company accounts and address issues such as accounting for share-based payments and revenue recognition; and
- more proactive and wide-ranging enforcement of accounting standards in financial statements made by companies.

1.50 The UK Government response to the interim report was broadly supportive of the recommendations, particularly in regard to strengthening audit committees and audit partner rotation. The Government announced it would investigate the need for further tightening of the rules governing the extent to which auditors can provide non-audit services to audit clients.²¹

The European Union

1.51 In December 2000 the European Commission published a draft Commission Recommendation to member States on the independence of the statutory auditor.²² The framework outlined in the draft Recommendation outlines the general issues of statutory auditors’ independence, and would require auditors and audit firms to consider:

- the expectations of those directly affected by their work;
- the public interest; and
- threats to independence that may arise in practice and the safeguards available to eliminate those threats or to reduce them to an acceptable level.

21 *Corporate Law Bulletin*, No.59, July 2002, pp.6-7

22 Media Release, The European Commission, 18 December 2000.

Ireland

- 1.52 In April 2001 the Irish Minister for Enterprise, Trade and Employment announced the establishment of the Irish Auditing and Accounting Supervisory Authority (IAASA) to supervise the regulation by the accountancy bodies of their members' professional standards. The Government and the accountancy profession jointly fund the IAASA.²³

The International Federation of Accountants

- 1.53 In March 2002 the Board of the International Federation of Accountants (IFAC) approved a project focused on restoring the credibility of financial statements in the global marketplace. The project will address worldwide problems, issues, and best practices in the areas of financial and business reporting, corporate governance, and auditor performance. It will be developed by a task force comprised of members representing IFAC, audit committees, boards of directors, the investment community, and financial management.

Organisation for Economic Cooperation and Development

- 1.54 The Organisation for Economic Cooperation and Development (OECD) has made a number of important contributions to improving corporate governance, including independent auditing and financial reporting. For example, in 1997 it reported on the importance of companies maintaining fulsome accounting records, providing detailed disclosure in financial statements, maintaining standards to ensure the independence of the external audit function and developing a strong system of internal controls.²⁴
- 1.55 Further in 1999, it published a series of corporate governance principles to assist governments in the formation and development of good governance frameworks. These principles include commentary on:
- the roles and responsibilities of boards;
 - the rights of shareholders; and
 - disclosure and transparency (including the importance of an independent auditor).²⁵

23 Media Release, Department of Enterprise, Trade and Employment, 26 April 2001

24 *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, Organisation for Economic Cooperation and Development, 1997

25 *Principles of Corporate Governance*, Organisation for Economic Cooperation and Development, SG/CG(99)5, 1999

Regulatory framework

- 1.56 Providers of public and private audit and financial services, both external and internal, are held accountable through a number of mechanisms.

Private Sector

Regulation

- 1.57 Australia currently has a ‘co-regulatory’ regime.²⁶ The professional accounting bodies, notably CPA Australia, the Institute of Chartered Accountants in Australia (ICAA) and the National Institute of Accountants (NIA) oversee their members compliance with the audit and accounting standards through their professional requirements and codes of ethics.
- 1.58 At the same time the Australian Securities and Investments Commission (ASIC) enforces company and financial services laws including the *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001*. ASIC also supervised the listing of the Australian Stock Exchange and undertakes the day-to-day supervision of its compliance with the listing rules to ensure it is subject to the same independent scrutiny as all other listed entities.²⁷
- 1.59 The Australian Stock Exchange (ASX) describes its fundamental role as promoting the integrity of the share market. This is achieved by:
- the development and implementation of Business Rules and Listing Rules designed to ensure orderly and fair markets;
 - supervision of those markets;
 - the active pursuit of technological improvements to meet market participants’ requirements for system reliability, integrity, performance, capacity and cost effectiveness; and
 - close co-operation with other regulators, notably the Australian Securities & Investments Commission.

²⁶ Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.21

²⁷ ASIC also administers the: *Insurance (Agents and Brokers) Act 1984*; *Insurance Contracts Act 1984*; *Superannuation (Resolution of Complaints) Act 1993*; *Superannuation Industry (Supervision) Act 1993*; *Retirement Savings Accounts Act 1997*; *Life Insurance Act 1995*; and *Insurance Act 1973*. Parts of the last four Acts mentioned dealing with prudential regulation are administered by the Australian Prudential Regulation Authority (APRA).

- 1.60 Although both ASIC and the ASX are often referred to in the context of 'regulators', it is important to distinguish between the two. Importantly, the Australian Stock Exchange should not be seen as a regulatory body.
- 1.61 Prior to the announcement of the establishment of a Corporate Governance Council (see paragraph 1.63), the role of the ASX in respect to corporate governance has been passive and it does not prescribe particular corporate governance practices. Importantly, the core responsibility of the ASX is to set appropriate corporate *disclosure* standards, and to monitor compliance with them. Any serious breaches in market disclosure are referred to ASIC for investigation and prosecution. These disclosure standards, however, do not prescribe the form of business practices or corporate governance structures that a company might put in place.²⁸ The ASX informed the Committee that, as it was not an arm of government, its 'powers are limited and based on a contract between the ASX and each listed entity'. As a result of these factors, the 'approach the ASX has adopted to date has been to require the disclosure of corporate governance practices to investors'.²⁹
- 1.62 Against a background of intense public pressure and criticism ASIC and the ASX recently announced initiatives to increase their respective oversight of audit independence and corporate governance. ASIC has committed itself to a new accounting surveillance project related to the full-year financial reports for the financial year ended 30 June 2002. A special taskforce drawn from ASIC's Office of Chief Accountant and the Corporate Finance and Enforcement Directorates will focus on compliance with accounting standards relevant to capitalised and deferred expenses, recognition of revenue and recognition of controlled assets.³⁰
- 1.63 The ASX announced in August 2002 that it would convene a Corporate Governance Council to develop in consultation with the business community a set of consolidated and up-to-date corporate governance standards for Australian listed companies. The ASX also proposed to enhance the Listing Rule disclosure requirements where appropriate to ensure that listed companies fully report to the market and shareholders on their adherence to these standards.³¹

28 Hamilton, K, ASX, *Speech to CEDA on launch of 'Enhanced Disclosure'*, 19 July 2002, Sydney

29 Mr Richard Humphry, *Transcript*, p.40

30 ASIC media release, 12 July 2002. The accounting standards under review are: AASB 1040 Statement of Financial Position; AASB 1018 Statement of Financial Performance; AASB 1004 Revenue; and AASB 1024 Consolidated Accounts.

31 Australian Stock Exchange media release, 1 August 2002

Institutional arrangements for standards setting

- 1.64 The institutional arrangements for accounting standard setting involve a Financial Reporting Council (FRC) with oversight responsibility for the Australian Accounting Standards Board (AASB). The FRC is the peak body responsible for the broad oversight of the accounting standard setting process for the private and public sectors. It comprises key stakeholders from the business community, the professional accounting bodies, governments and regulatory agencies. The Treasurer appoints members of the FRC.
- 1.65 Key functions of the FRC are to advise the Government on the accounting standard setting process and the development of international accounting standards, and to determine the broad strategic direction of the AASB. The FRC may give the AASB directions, advice and feedback on matters of general policy, and will be responsible for approving its priorities, business plan, budget and staffing arrangements. However, the FRC does not influence the AASB's technical deliberations and hence the content of particular accounting standards.
- 1.66 The AASB deals with standard setting in the private and public sectors and has its own research and administrative staff. This replaced an arrangement under which the AASB worked jointly with the accounting profession's Public Sector Accounting Standards Board and used the services of the staff of the Australian Accounting Research Foundation.
- 1.67 The Auditing & Assurance Standards Board (AuASB) operates under the Australian Accounting Research Foundation (AARF). The AARF was established jointly by CPA Australia and the ICAA in 1966. The AARF is responsible to CPAA and the ICAA through their Joint Standing Committee (JSC), which comprises the executive committee of each body.
- 1.68 A primary role of the AuASB is the development of professional standards and related guidance for auditors and providers of other assurance services, as a means to enhance the relevance and reliability of information provided to users of audit assurance services. Representation on the AuASB comes from the public and private sectors, academia and financial report users.

Discipline

- 1.69 The Companies Auditors and Liquidators Disciplinary Board (CALDB) deals with disciplinary matters concerning auditors. Cases are referred to the CALDB by ASIC.

- 1.70 In addition both major professional accounting bodies, CPA Australia and ICAA, have their own disciplinary bodies and procedures.

Public Sector

- 1.71 The framework for the accountability of Commonwealth public sector organisations, including auditing, reporting and financial process and practices centres around the *Public Accounts and Audit Committee Act (PAAC) Act 1951*, the *Financial Management and Accountability (FMA) Act 1997*, the *Commonwealth Authorities and Companies (CAC) Act 1997* and the *Auditor-General (AG) Act 1997*.
- 1.72 The PAAC Act establishes this Committee which, amongst other things, is empowered to examine the financial affairs of Commonwealth entities.
- 1.73 The FMA Act sets out the fundamental principles and rules for the proper use and management of public money and public property, including financial reporting and auditing requirements for public sector agencies.
- 1.74 The CAC Act establishes a standard set of core financial, audit, accountability, reporting and corporate governance requirements for Commonwealth authorities and companies.
- 1.75 The Auditor-General Act provides the legislative framework for the Office of Auditor-General and the Australian National Audit Office (ANAO) and outlines the functions, responsibilities and powers of the Auditor-General and the ANAO. The Act also enshrines the independence of the Auditor-General and the public sector audit function.³²
- 1.76 Similar frameworks are in place to govern and support the independence of the public sector auditors in the state jurisdictions.³³

Inquiry objectives, scope and focus

- 1.77 It became clear early in the inquiry process that the Committee would be required to extend the scope of the inquiry beyond audit independence. Auditors do not operate in a vacuum, but work within a wider framework of duties, responsibilities and obligations. In order to be able to make effective recommendations, it was necessary for the Committee to also

32 Australian National Audit Office, *Submission No. 27*, pp S239-240

33 See for example, Auditor-General of Queensland, *Submission No. 10* and Department of Premier and Cabinet, Tasmania, *Submission No. 49*

explore issues related to corporate governance and the standards setting bodies and processes.

- 1.78 The focus of this report will be the private sector auditing and corporate governance framework. The Committee has tabled a number of reports on public sector accountability and corporate governance in the last two years.³⁴ In addition, the Committee argues that there are a number of public sector accountability mechanisms that may be appropriate for introduction to the private sector. These have been referred to in this report where appropriate.

Corporate Governance

- 1.79 Effective Corporate Governance is an essential part of the modern corporate entity. Public and private sector organisations will ultimately be judged by how well they direct, control and deliver their corporate objectives. Many commentators have noted that the issue of corporate responsibility is as important as auditor independence and that, audit failure notwithstanding, those with the ultimate responsibility in any collapse are the directors and managers of companies.
- 1.80 The Committee is interested in introducing reforms to the corporate governance framework for both listed entities and audit firms to entrench good governance mechanisms and processes that are transparent, accountable and demonstrable. However, legislation can only go so far and an associated aim of the inquiry is to encourage positive changes in corporate culture. In this regard, the Committee notes that apathy amongst key stakeholders, for example, the failure of institutional shareholders to properly participate, through their voting power, in the operations of a company can have a detrimental impact on governance practices.
- 1.81 In approaching the issue of corporate governance in the context of this inquiry, guidance was taken from the Committee's *Report 372 Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*. While the focus of that report was on government

34 Recent examples include Report 386, Review of the Auditor Generals Act 1997 (2001); Report 379, Contract Management in the Australian Public Service (2000); and Report 372, Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises (2000). In addition, the Committee has tabled two influential reports focused on the issue of the independence of the Auditor General: Report 346, Guarding the Independence of the Auditor General (1996); and Report 296, The Auditor General: Ally of the People and Parliament (1989).

business enterprises, many of the underlying principles are applicable to the private sector.

Financial reporting and disclosure

- 1.82 Public concern has recently focused on shortcomings in the level of reliable and timely information for the market and referred to a low level of public confidence in the veracity of the information produced by companies under the accounting standards. For example, the availability of different options under a number of the accounting standards means that only by going through the disclosure would you be able to understand the type of accounting that is applied so to enable better comparisons between companies.
- 1.83 The Committee believes that better and more informative disclosure will improve the ability of the users of financial reports and the market in general to understand the companies they invest in, and in particular, the risks to those investments. Accordingly the Committee's objective was to investigate whether the current financial reporting and disclosure requirements were appropriate and to consider if they were meeting the expectations of the market.
- 1.84 The Committee considered whether the type of information being disclosed and signed off on by management and auditors was meaningful in identifying the major issues being faced by companies, and also considered whether qualitative considerations, for example, that accounts truly and fairly report the financial condition of a corporation, were being sufficiently addressed.

The auditing framework

- 1.85 The Committee considered a range of issues associated with the audit function and the performance of auditors, including independence issues, the expectation gap, nature of audit reporting, processes for monitoring performance and legal liability issues.
- 1.86 The Committee explored ways of ensuring that audit independence was embedded throughout the financial reporting framework, particularly in relation to the most significant issues, that is, matters related to the auditor's tenure and the simultaneous provision of audit and non-audit services.
- 1.87 Several witnesses have argued that the statutory audit function is not meeting the reasonable demands and expectations of the market and public in general. The Committee considered how the scope and nature of

the statutory audit might be expanded, including processes for better reporting, to better address these concerns. Concomitantly the Committee explored issues associated with auditors' liability and the extent to which these may impede reforms regarding the scope of the statutory audit.

- 1.88 It has been reported that the processes for the development of the technical and professional standards governing the audit function and the processes for monitoring performance against those standards should be reformed. The Committee explored a number of alternative reforms designed to ensure these processes, including processes for disciplining breaches of the standards, might better reflect the public interest, including levels of transparency and accountability.
- 1.89 Further, although there are some significant differences in the operating environments of the private and public sectors, the Committee explored whether there are aspects of the functions of the public sector auditor and in the standards of public sector accountability, which could be adapted to enhance the effectiveness of the audit function in the private sector. The measures which have the most direct relevance are:
- conduct of performance audits;
 - public sector auditor reports all significant matters to shareholders (the Parliament) and ultimately to the public; and
 - legislative provisions to establish and protect the independence of the public sector auditor.

The Ramsay Report

- 1.90 The review titled *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform*, conducted by Professor Ian Ramsay (the 'Ramsay Report'), submitted to the Government in October 2001, provides a comprehensive and focused investigation of audit independence. The report's recommendations cover five key issues concerned with either audit independence (employment relationships, financial relationships and provision of non-audit services) or with matters designed to enhance audit independence (audit committees and a board to oversee audit independence issues). The report envisages the continuation of the existing co-regulatory regime under which some requirements are included in the corporations legislation and others are in the ethical rules of the professional accounting bodies.

- 1.91 While the Committee agrees with the general thrust of the Ramsay Report's recommendations, the Committee took a fresh view of the issues and extended the examination of audit independence to include broader corporate governance and financial reporting, including accounting standards and disclosure issues. A summary of the major recommendations from the Ramsay Report and the Committee's view of these recommendations are contained in Table 1.

Table 1 Summary of the Ramsay Report

Recommendation	Committee's View
Include a general statement of principle requiring the auditor to be independent in the Corporations Act	Agree. This matter is considered further in Chapter 4.
Include a list of core circumstances creating a lack of independence in each of the following areas: <ul style="list-style-type: none"> • Employment relationships; • Financial relationships; and • Business relationships. 	Agree. However, in the Committee's view a more effective outcome is likely when solutions are principle-based and supported by an appropriate level of description and prescription. This matter is considered further in Chapter 4.
Increased regulation of the provision of non-audit services in the Professional Rules of Conduct.	Agree. This matter is considered further in Chapter 4.
Increased disclosure of the value of non-audit services and a statement as to whether audit committees or boards have assessed whether the provision of non-audit services has impacted on the independence of the auditor.	Agree. This matter has not been considered further in this report.
Establishment of an Auditor Independence Supervisory Board	The Committee believes the principles underlying this recommendation can be effectively addressed through: <ul style="list-style-type: none"> • Improving the processes in audit firms, for dealing with independence issues; • Broadening the role of the Australian Securities & Investments Commission; and • Assessing the need for structural reform to the existing processes for oversight of the auditing profession. These matters are considered further in Chapters 2 and 4.
Amending the ASX Listing Rules or the Corporations Act to require all listed companies to have an audit committee.	Agree. The Committee considers the more effective vehicle to mandate Audit Committees for listed companies is the Corporations Act. This matter is considered further in Chapter 2.
A series of recommendations concerning the operation of the Companies Auditors and Liquidators Disciplinary Board.	Agree. These matters are considered further in Chapter 4.

Conduct of the inquiry

- 1.92 On 12 April 2002, the Committee advertised, in the Australian Financial Review, terms of reference for a review of independent auditing by registered company auditors. In addition, regulatory agencies were requested to provide submissions addressing the terms of reference. The terms of reference were also sent to a range of industry organisations.
- 1.93 As with all inquiries in recent times, the terms of reference and other information about the inquiry were advertised on the Committee's internet homepage at:
- <http://www.aph.gov.au/house/committee/jpaa/index.htm>
- 1.94 Over 70 submissions were received which are listed at Appendix A. The Committee also received 16 exhibits, which are listed at Appendix B.
- 1.95 Evidence was taken at public hearings held in Canberra, Sydney and Melbourne in June and July 2002. A list of witnesses appearing at the hearings can be found at Appendix C.
- 1.96 Copies of the transcripts of evidence from the public hearings and the volume of submissions are available from the Committee secretariat and for inspection at the National Library of Australia. The transcripts of evidence are also available on the Hansard website at:
- <http://www.aph.gov.au/hansard/joint/commtee/comjoint.htm>

Report structure

- 1.97 This chapter outlines a number of background issues pertinent to the inquiry and provides a summary of the material covered in the succeeding chapters. The remaining report structure reflects the key inquiry objectives. Chapter Two focuses on the issue of corporate governance in both listed entities and audit firms.
- 1.98 Chapter Three examines the adequacy of the current financial reporting and disclosure framework.
- 1.99 The fourth chapter examines the auditing framework. A key part of this chapter is an assessment of the nature and scope of the audit function.

CORPORATE GOVERNANCE

Background

2.1 Effective Corporate Governance should be an essential part of the modern corporate entity. Public and private sector organisations will ultimately be judged by how well they direct, control and deliver their corporate objectives, as well as by the integrity of their accountability mechanisms.

2.2 The importance of good corporate governance in the global and domestic economic environment has been stressed by the Organisation for Economic Cooperation and Development (OECD):

If countries are to reap the full benefits of the global capital market, and if they are to attract long-term “patient” capital, corporate governance arrangements must be credible and well understood across borders. Even if companies do not rely primarily on foreign sources of capital, adherence to good corporate governance practices will help improve the confidence of domestic investors, may reduce the cost of capital, and ultimately induce more stable sources of financing.¹

2.3 For the purposes of this report, corporate governance is broadly understood as:

...the process by which organisations are directed, controlled and held to account. It encompasses authority, accountability,

¹ *Principles of Corporate Governance*, Organisation for Economic Cooperation and Development, SG/CG(99)5, 1999, p.3

stewardship, leadership, direction and control exercised in the organisation.²

- 2.4 Deficient corporate governance culture inhibits the conduct of comprehensive and independent audits. Conversely, good corporate governance should lead to accountable, transparent and independent accounting and auditing practices. Ernst & Young drew attention to the close relationship between corporate governance and audit independence, commenting that ‘the most effective way to achieve genuine reform of the audit process is at the company-to-auditor level, as an integral component of best practice corporate governance’.³
- 2.5 In exploring the issue of corporate governance as it related to audit independence in this report, the Committee will focus on corporate governance requirements in publicly listed companies and audit firms. The key issues to be addressed are:
- ensuring Board effectiveness;
 - enhancing the internal audit function;
 - developing mechanisms to provide assurance of corporate governance practices;
 - enhancing the effectiveness of audit committees; and
 - increasing the public accountability of audit firms.

Report 372: Corporate Governance and Accountability arrangements for Commonwealth Government Business Enterprises.

- 2.6 In 1999, the Committee tabled a comprehensive report, *Report 372: Corporate Governance and Accountability arrangements for Commonwealth Government Business Enterprises*. The Committee made a range of recommendations aimed at addressing conflicts of interest on Boards of government business enterprises, enhancing transparency and accountability, and improving the education and training of government business enterprise Board members.⁴ The Committee maintains that the principles underlying Report 372 and the subsequent recommendations are generally applicable to the private sector.

2 Joint Committee of Public Accounts and Audit, Report 372, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*, Canberra, Canprint, 1999, p. 7

3 Ernst & Young, *Submission No.32*, p.S277

4 Joint Committee of Public Accounts and Audit, Report 372, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*, Canberra, Canprint, 1999

2.7 Table 2 contains a summary of the recommendations made in Report 372 and an indication of the status of the Government's response.

Table 2 Summary of JCPAA Report No. 372

Recommendation	Government's Response
1. The Minister for Finance and Administration review the applicability of administrative law to current and future GBEs.	Supported in the Executive Minute of 18 May 2000
2. Portfolio Ministers be removed from their government business enterprise shareholder responsibilities but remain as the responsible Minister under the GBEs' enabling legislation.	Government has not responded to date
3. The Minister for Finance and Administration amend the <i>1997 Governance Arrangements for Commonwealth GBEs</i> to require that all Ministerial directions to GBE boards should in writing and tabled in both Houses of Parliament.	Government has not responded to date
4. The Minister for Finance and Administration amend the <i>1997 Governance Arrangements for Commonwealth GBEs</i> to require that GBE boards ensure that appropriate and effective induction, education and training programs are offered to new and existing board directors.	Supported in the Executive Minute of 18 May 2000
5. The Minister for Finance and Administration amend the <i>1997 Governance Arrangements for Commonwealth GBEs</i> to require confidential board and director performance appraisal.	Supported in the Executive Minute of 18 May 2000
6. The Minister for Finance and Administration develop draft guidelines for scrutiny by Parliamentary Committees of commercially confidential issues relating to GBEs.	Government has not responded to date
7. The Minister for Finance and Administration amend the <i>1997 Governance Arrangements for Commonwealth GBEs</i> to set out the risk management responsibilities of audit committees.	Supported in the Executive Minute of 18 May 2000

Source JCPAA

Corporate governance in publicly listed companies

2.8 A cursory investigation of companies involved in recent corporate failures and fraud would reveal that they may have exhibited the trappings of good corporate governance, such as an audit committee, a statement of corporate governance practices in the annual report, and the existence of non-executive directors on the Board.

- 2.9 Outward compliance with good corporate governance principles is not sufficient guarantee of their effective operation.
- 2.10 In recognition of the relationship between independent auditing and corporate governance, the Committee is interested in strengthening the corporate governance framework in order to give greater effect to the practices that most companies profess to follow. Such practices should be transparent and demonstrable, not mere window dressing. The areas of concern to the Committee in this section are the role and responsibilities of the Board and Directors, developing a mechanism for providing assurance of corporate governance practices, and more effective audit committees.

The Board and Directors: role and responsibilities

- 2.11 Boards are a central part of corporate governance. Boards are responsible and accountable to shareholders and other stakeholders for delivering policies that promote shareholder and investor interests and for ensuring that the enterprise is operating as efficiently and effectively as possible. The Committee's focus is on the organisational performance of Boards, reflecting Professor Hilmer's statement that the 'key role of boards should be to ensure that corporate management is continuously and effectively striving for above-average performance, taking account of risk'.⁵
- 2.12 Boards have a range of duties and responsibilities. The Australian Institute of Company Directors (AICD) broadly defines the responsibilities of a Board as:
- *Strategy*: to participate with management in setting goals, strategies and performance targets for the enterprise;
 - *Resources*: to make available to management the resources to achieve the strategic plan;
 - *Performance*: to monitor the performance of the enterprise against its business strategies and target, with the objective of enhancing its prosperity over the long term;
 - *Conformance*: to ensure there are processes in place to conform with legal requirements and corporate governance standards, and that risk exposures are adequately managed;

5 Hilmer, F.G., *Strictly Boardroom, Improving Governance to Enhance Company Performance*, 2nd Edition, Information Australia, Melbourne, 1998, p.5

- *Accountability to shareholders*: to report progress to the shareholders as their appointed representatives, and seek to align the collective interests of shareholders, boards and management.⁶
- 2.13 Taking these criteria as a guide, evidence emerging from cases of corporate failure and fraud in Australia and overseas suggests a significant breakdown in the performance of Boards in the private sector. This has resulted in increasingly negative public perceptions with potentially serious economic consequences.
- 2.14 While much of the debate on audit independence has focused on the external audit function, the external auditor's responsibilities need to be balanced against the responsibilities of management and, importantly, the Board of Directors.⁷ Audit failure notwithstanding, those with the ultimate responsibility for the audit and financial statements are the directors of a company.
- ...it is the Board that must bear full responsibility for the financial statements and as a result the outcome of the audit and be responsible to the shareholders (who appoint the auditor) for the decisions that it takes.⁸
- 2.15 The Committee's Report 372 addressed a range of issues associated with Board performance and effectiveness, including Board independence, the selection and appointment of directors, induction, education and training for directors, performance appraisal, assessment of individual directors and director remuneration. Similar issues arose in the course of the Committee's current inquiry.

Director education and competency

- 2.16 Boards need to have the appropriate skills, experience and support mechanisms to effectively analyse and verify information in order to be able to ask the right questions and make well-considered decisions. At the same time, there must be a focus on continuous improvement by the board in general and by individual directors.
- 2.17 Mr Rob Elliot of the AICD outlined to the Committee the range of corporate governance courses run by the AICD, including the company director course and purpose built courses such as the role of the chairman

6 Dunlop, Ian, 'Broadening the Boardroom', *Address to the Federation of Australian Scientific and Technological Societies Forum*, National Press Club, Canberra, 2 August 2000.

7 AuASB, *Submission* No.12, p.S96

8 AICD, *Submission* No.26, p.S219

and the selection of the board.⁹ The Committee is aware that record numbers of directors and executives are reportedly enrolling in corporate governance courses.¹⁰ While somewhat belated, this trend is to be encouraged and we urge all publicly listed company Boards to pay close attention to the on-going induction, education and training needs of directors.

- 2.18 The Committee also notes that the Nasdaq has gone as far as mandating director continuing education and has directed the Nasdaq Listing and Hearing Review Council to develop appropriate rules.¹¹
- 2.19 The Committee reiterates the view, made in Report 372, that boards ensure that effective and on-going induction, education and training programs are offered to new and existing Board directors.¹²

The selection, appointment and independence of Directors

- 2.20 A company's performance depends largely on the capabilities and performance of its executive management and its board. In turn, the skills, experience and qualifications of individual directors influence the overall ability and performance of the board. In this regard, a lack of strong election processes, including the existence of patronage and weak selection mechanisms create a risk that boards may be 'captured' by management or other factions thus reducing the board's ability and willingness to question and oversee management.¹³ In addition, a collegiate focus or cooperative attitude is important to foster a good working relationship in boards.
- 2.21 Both the *Corporations Act 2001* and the ASX Listing Rules are relatively quiet on the issue of what qualities, skills and experience a director should have. Section 201B of the *Corporations Act 2001* merely states that:
- (1) Only an individual who is at least 18 may be appointed as a director of a company.
 - (2) A person who is disqualified from managing corporations under Part 2D.6 may only be appointed as director of a company if

9 Mr Rob Elliot, *Transcript*, pa.173

10 'Directors Sent back to School', *The Australian Financial Review*, 5 July, pp.1 and 17.

11 *Corporate Law Bulletin*, No 59, July 2002

12 Joint Committee of Public Accounts and Audit, Report 372, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*, Canberra, Canprint, 1999, p.66

13 For example, See Hilmer, F.G, *Strictly Boardroom, Improving Governance to Enhance Company Performance*, 2nd Edition, Information Australia, Melbourne, 1998

the appointment is made with permission granted by ASIC under section 206F or leave granted by the Court under section 206G.¹⁴

- 2.22 A number of submissions raised the issue of how a board should be composed in order to protect and enhance basic audit independence and good governance, including a focus on independent non-executive directors. Mr Rodney Bennett submitted a range of requirements for the composition of a Board, including:
- all former auditors of an entity be banned from being directors of that entity for a period of two years;
 - that there be a maximum number of directors representing major shareholdings;
 - that the Corporations Law require that all listed entity boards include a certain number of independent non-executive directors; and
 - that an independent director be a person who has no existing commercial links with the company and would be allowed to own minimal shareholding in the company.¹⁵
- 2.23 Mr Stephen LaGreca commented that independent directors underpin best practice corporate governance, but that Australia lags behind international best practice by not requiring listed companies to appoint a majority of independent non-executive directors.¹⁶
- 2.24 In terms of the process of electing independent directors the Committee raised the issue of ‘one-vote-one shareholder’ as one way of ensuring independence from management. While the Australian Consumers’ Association saw advantages in such an approach, particularly for disenfranchised smaller investors¹⁷, in general, however, the evidence was not supportive of the proposal. PricewaterhouseCoopers told the Committee that such a proposal would not be a ‘fair reflection of the economic interest or entitlement that the broad shareholder group clearly have in the corporate entity’.¹⁸ Deloitte Touche Tohmatsu stated that the current mechanisms were adequate and that ‘at the end of the day, the quality of the directors on boards is really the issue’.¹⁹

14 Section 201B, *Corporations Act 2001*. Part 2D.6 and Section 206F of the Act refer to ASIC’s power of disqualification from managing corporations.

15 Mr Rodney Bennett, *Submission No.4*, p.S49

16 Mr Stephen LaGreca, *Submission No.14*, p.S105

17 Ms Catherine Wolthuizen, *Transcript*, pa.149

18 Mr Tony Harrington, *Transcript*, pa.142

19 Mr Robert Wylie, *Transcript*, pa.188

- 2.25 In response to a proposal put forward by the Committee that ASIC and the ASX develop a best practice guide for the election of directors, what criteria should be met and what kind of training and experience directors should have, Ernst & Young replied that the ASX should be responsible for developing a guidance note on the processes for the election of directors and that there is precedent for this measure in the UK Listing Rules.²⁰
- 2.26 The AICD submitted that their organisation has a wide range of products and services that cover, amongst other things, the election of directors and the appropriate mix of attributes required by board members.²¹ Ultimately, it is the shareholder that elects independent directors, which may not always result in the desired outcome. As the AICD pointed out to the Committee:
- There could well be a potential conflict between what might be logically and demonstrably best practice and, if you like, the almost sovereign right of shareholders who own a company to pick the directors they want anyway'.²²

Selection of the external auditor

- 2.27 Given the importance of the audit function, the process of selecting the external auditor is an important aspect in ensuring independence and good corporate governance. The process must be transparent and accountable.
- 2.28 The Association of Chartered Certified Accountants (ACCA) submitted that 'although in theory this process is a matter for shareholders, in practice the appointment is controlled by management.' The ACCA suggested that non-executive directors and corporate audit committees should have a much higher profile role in the auditor appointment process.²³
- 2.29 In response to the claim that management had too much influence over the appointment of the external auditor, the ASX argued that management did not have any role in selecting the external auditor, commenting that 'if that were the practice, it is an inappropriate practice'. The ASX did agree to a proposal put to them by the Committee that the constitution of a

20 Ernst & Young, *Correspondence*, 19 July 2002

21 Mr Rob Elliott, *Transcript*, pa.173

22 Mr Gavin Campbell, *Transcript*, pa.173

23 ACCA, *Submission* No.8, p. S68

company must have a mechanism for ensuring that the appointment and management of the external auditor was independent.²⁴

- 2.30 **As discussed in the context of audit committees in this chapter, the function of selecting and monitoring the external auditor is generally agreed to belong to a properly functioning audit committee reporting to the board.**

Director's remuneration

- 2.31 The issue of director remuneration in government business enterprises was discussed in Report 372. At that time it was the Committee's view that director remuneration is an important element in attracting top applicants to Boards. The practice of providing share options as part of the remuneration package was considered to increase 'the likelihood of directors interests being aligned with those of other shareholders'. This view requires revision, with some commentators arguing that 'the options culture of the 1990s is dead'.²⁵
- 2.32 In the wake of corporate collapses such as One-Tel and HIH, the issue of director and executive remuneration is under the spotlight. The practice of providing share options as part of the directors' and executives' remuneration packages has been an alleged catalyst for corrupt behaviour such as the manipulation of profit figures to boost share prices, and thus the value of share options. There have been examples of highly paid directors and senior executives cashing in their share options and receiving substantial performance bonuses prior to the company collapse. The Committee is concerned that excessively generous remuneration packages, often incorporating share options, have led to a growth in short-term reasoning and have not necessarily improved the performance of Boards or individual directors, particularly over the medium to long term.
- 2.33 Professor Houghton saw the problem of remuneration partly in the context of the conflict between the short-term interests of management and the longer-term interests of shareholders, which he termed the 'time horizon' problem. He argued that the difference between the two 'does give rise to different incentives for the different stakeholders'.²⁶ The difficulty in arriving at suitable remuneration packages for managers and directors that align their interests with the interests of shareholders was highlighted by Professor Houghton:

24 Mr Richard Humphry, *Transcript*, pa.49

25 'Sun sets on once lucrative stock options', *Australian Financial Review*, 23 July 2002, p.37

26 Professor Keith Houghton, *Transcript*, pa.6

If you have an incentive structure for management that focuses largely on the immediate, then they will respond to that. The alignment of the management interest with the shareholder interest is, in theory, an appropriate way of proceeding, but the actual practical implementation of that is extraordinarily hard.²⁷

- 2.34 PricewaterhouseCoopers commented that generous share options and schemes distort the focus of management:

Those managing companies now have the real prospect of making themselves seriously wealthy through generous share and option schemes. This prospect has created an overemphasis on managing the share price and the drivers of share price.²⁸

- 2.35 Brian Long of Ernst & Young argued that appropriate equity based compensation packages can be formulated which align the interests of executives with the interests of shareholders. He also recognised that equity based compensation arrangements may also disalign management and shareholder interests.²⁹

- 2.36 In terms of setting the boundaries or guidelines for remuneration Ernst & Young argued against legislation, stating that this is a corporate governance issue for boards of directors:

They have the skills and competence to exercise judgment in those areas. If you look at the fundamental premise of why you are rewarding executives and at mechanisms and determine whether or not those mechanisms are effective, to me that is the heart of corporate governance.³⁰

- 2.37 PricewaterhouseCoopers suggested that Boards reconsider remuneration arrangements so that:

...executives are only rewarded for actual wealth accumulated by the companies they are managing rather than simply reaching a target share price on a fixed date.³¹

- 2.38 On the related question of how to improve the transparency and accountability of remuneration arrangements, Ernst & Young submitted that 'the fresh air of disclosure is usually the best disinfectant to a problem' and that enhancing disclosure of remuneration arrangements

27 Professor Keith Houghton, *Transcript*, pa.6

28 Mr Rob Wylie, *Transcript*, pa.182

29 Mr Brian Long, *Transcript*, pa.91

30 Mr Brian Long, *Transcript*, pa.91

31 Mr Rob Wylie, *Transcript*, pa.182

may well be the best answer.³² The Committee has examined the issues associated with the accounting for share options in Chapter 3.

- 2.39 It was recently reported that several of Australia's leading corporations had, or were likely to review the practice of granting share options to their executives. For example, the Commonwealth Bank recently announced that it has eliminated the use of share options from the remuneration packages available to its executives.³³
- 2.40 Arriving at suitable remuneration packages for directors and senior executives is a matter for the Board and shareholders. As discussed in Report 372, a rigorous performance appraisal system, in association with identified incentives, will help develop a competitive and performance oriented culture.
- 2.41 **Appropriate remuneration will always be required to attract qualified people. Recent events and public disquiet regarding what are seen to be excessive levels of remuneration highlights the need for Boards to arrive at remuneration criteria that are fair, transparent, open to performance appraisal and reflect the interests of shareholders. The criteria upon which the remuneration of directors and executive management is based, the level of remuneration and any performance appraisal system should be fully disclosed as a matter of good corporate governance.**

Management perception of the audit function

- 2.42 Competent, transparent and independent auditing practices and processes are critical in the efficient operation of mature financial markets and the value of quality audits cannot be overstated. Evidence submitted to the Committee suggests, however, that companies do not see audits as value-adding to their business and 'all too often' audits are seen as 'another cost subject to reduction where possible'.³⁴ A key indicator of the value placed on audits is the fee allocated to audits.
- 2.43 The Australian Chamber of Commerce and Industry (ACCI) told the Committee that most businesses would view audits as an essential compliance mechanism. In this context the audit merely states that a business is compliant with the law and meeting its obligations. Mr Davis

32 Mr Brian Long, *Transcript*, pa.98

33 Commonwealth Bank, Media Release, 21 August 2002

34 Mr John Shanahan, *Submission* No.35, p.S317

of ACCI said that ‘a lot of firms would treat it like that. I think most firms would regard it as just part of their business affairs.’³⁵

- 2.44 Mr John Shanahan told the Committee that while audit firms have developed effective and efficient systems for dealing with large volume and systematic transactions these are not suited to more complex auditing situations. Most audit firms also have more costly risk-based approaches for dealing with unusual or complex transactions and accounting treatments. However, companies, in seeking to minimise costs, tend to prefer low cost audits that, while appropriate for low risk areas, are not adequate for auditing high risk areas.³⁶
- 2.45 Mr Shanahan asserted that as transactions become more complex companies should be prepared to pay more to ensure higher risk areas are properly addressed. As such, rather than audits being a cost to be minimised, ‘more effective audits will require an increase in the level of audit fees paid’.³⁷
- 2.46 It was suggested by the Committee that ASIC or ASX should set a minimum level for audit fees sufficient to ensure an audit of adequate breadth and depth. In response, CPA Australia told the Committee that setting minimum fees is difficult and in any case there is always a minimum fee level with any particular audit. CPA Australia explained that fees for undertaking an audit were based on varied criteria such as the complexity of the organisation, the risks of the organisation, diversity, international spread, geographic locations and different underlying forms of business’. Therefore, ‘it is very hard to talk in generalities about fee floors’.³⁸
- 2.47 A key question in regard to audit fees is ascertaining where responsibility lies for ensuring that the audit fee adequately reflects the audit requirements of the company and the interests of shareholders. A low-cost audit may accord with management’s objective to reduce costs but not be in accordance with shareholders interests in having a full and complete audit, particularly in regard to areas of high risk. In evidence to the Committee, CPA Australia highlighted the obligations of the Board in ensuring strong audits:

We have heard how important it is to have strong corporate governance and strong audits and we have heard about research

35 Mr Brent Davis, *Transcript*, pa.69

36 Mr John Shanahan, *Submission* No.35, p.S317

37 Mr John Shanahan, *Submission* No.35, p.S317

38 Mr Brian Blood, CPA Australia, *Transcript*, pa.23

on what that does in terms of share price. So one would think that, if the audit committees and boards were acting for the shareholders, that would be a matter they would take on board and, therefore, the fees would be set at the appropriate level.³⁹

- 2.48 It is precisely the high-risk areas of a company's transactions that need to be identified and audited properly. Moreover, the audit fee should reflect the depth and breadth of the audit being undertaken. Rather than mandating minimum fees for audits, the Committee believes that like many issues faced in this inquiry, arriving at the appropriate audit fee is a risk management issue and a critical part of the corporate governance obligations and responsibilities to which the Board and the audit committee should be held.

Conclusion

- 2.49 Corporate governance embodies processes and systems by which corporate enterprises are directed, controlled and held to account. Good corporate governance should also lead to accountable, transparent and independent accounting and auditing practices. Boards, therefore, are a central part of corporate governance. Boards of publicly listed companies are accountable to shareholders for delivering policy objectives and ensuring that the enterprise is operating as efficiently and effectively as possible. As discussed below, a well constituted and independent audit committee reporting to the board can play a very important role in ensuring good corporate governance.
- 2.50 In the Committee's report on corporate governance in government business enterprises, two recommendations were made in relation to the operation of and government business enterprise boards. We recommended that the *1997 Governance Arrangements for Commonwealth GBEs* be amended to include:
- a requirement that government business enterprise boards ensure that there are appropriate and effective induction, education and training programs offered to new and existing board directors; and
 - a section requiring confidential board and director performance appraisal.
- 2.51 The principles underlying these recommendations are applicable to the private sector. The Committee urges all private sector Boards to take note of these recommendations.

- 2.52 In addition, the education and training for board members, the process for appointing board members, remuneration arrangements for directors and executives, the appointment of external auditors and the value placed on the audit function should be dealt with as part of a board's risk management and corporate governance processes. **As such, the Committee recommends that the Australian Stock Exchange's Corporate Governance Council incorporate these views into their work in developing consolidated and up-to-date corporate governance standards for Australian listed companies.**

Management accountability

- 2.53 The relationship between management and boards is crucial to the effective functioning of companies. Senior management has a significant responsibility for ensuring accurate information is provided to the Board as well as ensuring that a company complies with the *Corporations Act 2001*. Division 1 of Part 2D.1 of the *Corporations Act 2001* sets out the duties of other officers, particularly in regard to having a duty to report breaches of the Act or irregularities in the management of the company.⁴⁰
- 2.54 The United States has taken very firm measures in enforcing management accountability. As of August 2002, the US Securities and Exchange Commission requires top executives of large publicly listed companies with annual revenues in excess of US\$1.2 billion to certify in writing, under oath and for publication that their financial reports are 'materially truthful and complete or explain why such a statement would be incorrect'.⁴¹
- 2.55 The Committee also notes that the New York Stock Exchange now requires each listed company CEO to certify annually that he or she is not aware of any violation by the company of the New York Stock Exchange corporate governance standards.⁴²
- 2.56 The Committee received similar recommendations in the course of the inquiry. One submission proposed that the CEO and Chief Financial Officer be required to provide the Board of Directors and the external auditor with a statement of representation which states that the financial statements do present a complete and accurate picture of the companies

40 Australian Consumers' Association, *Submission No.47*, p.S425

41 Securities and Exchange Commission Press Release, www.sec.gov/news/press/2002-96.htm

42 New York Stock Exchange press release, 1 August 2002.

financial position as far as they are reasonably aware, with significant penalties attached for providing misleading information.⁴³

- 2.57 In the course of the public debate regarding the issues surrounding corporate failures there have been calls for increased penalties for directors and senior executives who provide misleading information to the market and the external auditor, as well as increased penalties associated with directors abusing their powers and position. The Committee notes that the US *Public Company Accounting Reform and Investor Protection Act of 2002* significantly increased penalties for a range of crimes related to corporate fraud, including goal terms of up to 20 years and fines ranging from \$US1 million to US\$5 million.
- 2.58 The Australian Consumers' Association (ACA) argued that the present sanctions were too lenient and strongly recommended goal terms for breaches of directors' duties. By way of example, the ACA referred the Committee to a recent decision of the NSW Supreme Court whereby a number of directors who had improperly exercised their powers as directors in making a payment of \$10 million to a company on which one of them served as a director only received a 20 year disqualification. Highlighting the leniency of the sanction the ACA stated that 'the misappropriation of \$10 million in any other context would result in likely imprisonment.'⁴⁴
- 2.59 While the threat of heavy financial penalties and possible lengthy goal terms may provide incentive for managers to ensure the information they provide is true and correct there are significant issues to be addressed. PricewaterhouseCoopers argued that increased penalties might actually restrict the flow of information and inhibit working relationships between auditors and clients. They also identified the danger of lengthy legal actions arguing the legal definition of 'misleading' and whether the actions of executives were 'intentional'.⁴⁵
- 2.60 Given the existence of legal penalties regarding fraud, PricewaterhouseCoopers proposed that a simpler approach would be to require both the Chief Executive Officer and Chief Financial Officer to personally attest that the company's annual report complies with the *Corporations Act 2001*.⁴⁶ This would provide a clear and unarguable indication of management's responsibility for the financial information being provided to the market and the external auditor.

43 Joshua Institute, *Submission No.48*, p.S435

44 Australian Consumers' Association, *Submission No.47*, p.S426

45 PricewaterhouseCoopers, *Submission No.60*, p.S552

46 PricewaterhouseCoopers, *Submission No.60*, P.S552

Conclusion

- 2.61 The Committee takes the issue of director and management responsibility very seriously. The Committee believes that the vast majority of directors and managers are honest and act in good faith. However, although boards carry a great deal of the responsibility for corporate failure, management must also carry a fair share of the responsibility. It 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. The large remuneration packages that are paid to senior management also bring clear and significant responsibilities.
- 2.62 A crucial link in the corporate governance chain is the flow of information from management to the board and the market in general. Managers have an obligation to provide not only accurate information that accords with accepted accounting standards, but also truthful and complete information in order for the Board to make decisions that are in the best interests of the shareholders and to allow investors to properly weigh the risks of any investment decisions. In order to strengthen this chain, and establish a clear line of accountability the Committee recommends that the *Corporations Act 2001* be amended to require Chief Executive Officers and Chief Financial Officers to personally attest that the company's annual report complies with the *Corporations Act 2001* and are materially truthful and complete.
- 2.63 By signing such a declaration the Chief Executive Officer and Chief Financial Officer assume personal responsibility for financial reports failing to meet the requirements of the *Corporations Act 2001* and not being materially truthful and complete. To give proper effect to this recommendation appropriate sanctions need to be developed and applied to any breaches of this requirement.

Recommendation 1

- 2.64 **That the *Corporations Act 2001* be amended to require the Chief Executive Officer and Chief Financial Officer of a company to sign a statutory declaration that the company's financial reports comply with the *Corporations Act 2001* and are materially truthful and complete. This declaration must be attached to the company's financial reports whenever they are lodged with ASIC and provided to the company's members and the market operator pursuant to this Act.**

Internal audit

- 2.65 An effective and relatively autonomous internal audit function is a key aspect of good corporate governance. It is a tool that enables managers to obtain valuable information and insights regarding the performance of their company.
- 2.66 Internal auditing is defined by the Institute of Internal Auditors as:
- ...an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.⁴⁷
- 2.67 All companies should evaluate the need for an internal audit function because an effective internal audit function can significantly strengthen their internal control environment. In this regard the Institute of Internal Auditors suggests the following factors should be considered in determining the need for, and size of an internal audit function:
- stakeholders' expectations and the need to sustain their confidence;
 - risk levels; and
 - size and complexity of the organisation, including level of sales or assets, volume of activity and number of operating facilities.
- 2.68 Companies should establish appropriate processes so that the internal auditor is sufficiently independent from management and from any day-to-day operational responsibilities. In addition companies should strive to avoid any restrictions being placed on the scope of internal audit work, in order, as far as possible, not to impair its objectivity and effectiveness. In this regard, better practices for the protection of the independence of the internal auditors include:
- reporting directly to the Board Audit Committee (or equivalent); and
 - existence of a charter, approved by the Board Audit Committee (or equivalent), which amongst other things, defines their authority, rights of access, scope of their work and contains an approved budget.
- 2.69 Australia's auditing standards recognise the importance of a robust internal audit function. *Australian Auditing Standard AUS 604* –

47 Institute of Internal Auditors, *Submission* No.17, p.S122

Considering the Work of Internal Auditing sets down the following as important criteria when evaluating an internal audit function:

- organisational status, including lines of accountability and responsibility;
- scope of activity, including the nature, timing and extent of work;
- technical competence of the members of the internal audit function; and
- use of due professional care in assignments.

2.70 The following instances are two practical examples, which recognise the importance of the role of internal audit.

2.71 *Prudential Standard APS 310 – Audit & Related Arrangements for Prudential Reporting* indicates that locally incorporated Authorised Deposit-Taking Institutions (ADIs) should have a comprehensive and independent internal audit process to evaluate their internal controls and risk management systems. The standard goes on to say that where the scale of operations does not justify a full time internal audit function, alternative internal review arrangements must be in place.

2.72 The recently announced reforms to the New York Stock Exchange's Corporate Accountability and Listing Standards require every listed company to have an internal audit function.

2.73 An effective and relatively autonomous internal audit function is a key aspect of good corporate governance. The existence of an effective internal audit function would assist Chief Executive Officers and Chief Financial Officers to meet the requirements of the Committee's recommendation (Recommendation 1) that they personally attest that the company's annual report complies with the *Corporations Act 2001* and are materially truthful and complete.

Audit Committees

2.74 Properly constituted audit committees play a central role in good corporate governance, particularly in managing and monitoring the external audit process. The Committee outlined its support for audit committees in the public sector in its report on corporate governance in government business enterprises (Report 372).

2.75 The *Audit Committees: Best Practice Guide 2nd Edition*, published by the Australian Accounting Research Foundation, Institute of Internal Auditors

and Australian Institute of Company Directors, states that an audit committee is a 'vehicle that facilitates the participation of independent directors in the governance process', which:

...can play a key role in assisting the board of directors to fulfil its corporate governance and overseeing responsibilities in relation to an entities financial reporting, internal control system, risk management system and the internal and external audit functions.⁴⁸

- 2.76 There was substantial agreement throughout the evidence received by the Committee that audit committees were a valuable and desirable mechanism for ensuring audit independence and promoting good governance.
- 2.77 The AuASB submitted that 'the existence of an active and effective audit committee provides an excellent market mechanism to strengthen corporate governance and oversee the audit function in a company.'⁴⁹
- 2.78 CPA Australia emphasised the audit committees' role in providing a link between the internal and external audit function and the board. They stated that 'audit committees have a vital role to play in providing comfort to directors on areas of financial significance, as well as providing a link between internal and external audit functions, and the Board.'⁵⁰
- 2.79 Audit committees also support the board in ensuring that the interests of shareholders are recognised and addressed. This was emphasised by Mr Stephen La Greca who stated that audit committees, along with independent directors, ensure a company makes decisions in the best interests of the company and shareholders. He also argued that unless reforms were adopted to bolster audit committee efficacy Australia would continue to lag behind best practice in corporate governance.⁵¹
- 2.80 Publicly listed companies have had the freedom to develop and implement their own corporate governance mechanisms. Although there is a range of models to choose from, such as corporate governance boards and corporate senates, audit committees appear to be the preferred model for managing and overseeing the audit process and fulfilling corporate governance responsibilities. The ASX reports that 93 per cent of the top 200 companies (representing 94 per cent of capitalisation) have established

48 Mr Rob Elliott, *Exhibit* No.8, p.4

49 AuASB , *Submission* No.12, p.S100

50 CPA Australia, *Submission*, No.33, p.S293

51 Mr Stephen LaGreca, *Submission* No. 14, p.S104

audit committees. For companies outside the top 200, forty-five per cent have established audit committees.⁵²

- 2.81 Although audit committees are commonplace in the private sector, a study conducted by Westpac and Monash Sustainability suggested that audit committees are not always structured in a way that would ensure audit independence. One of the findings of the study was that a small but significant number of top 200 companies had audit committees that were structured in a way as to pose a risk to independence, for example by having executives or chief financial officers either on or chairing the audit committee.⁵³
- 2.82 In the course of this inquiry, the two key issues that emerged in relation to audit committees were whether audit committees should be mandated in either the ASX listing rules or the *Corporations Act 2001* and how to enhance the effectiveness of audit committees.

International trends

- 2.83 One of the international trends in corporate governance is towards enhancing the role and function of audit committees.
- 2.84 The US *Public Company Accounting Reform and Investor Protection Act* contains a number of provisions that strengthen audit committees role in ensuring the independence of the external auditor. The provisions of the Act include mandatory auditor reports to audit committees and vesting audit committees with responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services.⁵⁴
- 2.85 Similarly, the NYSE has mandated audit committees for listed companies in its response to recommendations made by its Corporate Accountability and Listing Standards Committee.⁵⁵ The Nasdaq has empowered audit committees with the sole power to hire and fire auditors, sole authority to approve all non-audit related services and the authority to retain legal, accounting and other experts.⁵⁶
- 2.86 The Committee notes that the success of these provisions relies on the Audit Committee being truly independent.

52 Mr Richard Humphry, *Transcript*, pa.39.

53 Macken, J, 'Transparent the Only Way to Go', *The Australian Financial Review*, 20 May 2002.

54 *Corporate Law Bulletin* No 59, July 2002, section 1 (a)

55 New York Stock Exchange press release, 1 August 2002.

56 *Corporate Law Bulletin*, No 59, July 2002, section 1(b)

- 2.87 The UK Coordinating Group on Audit and Accounting Issues in its interim report handed down in July 2002, recommended strengthening the role and responsibilities of audit committees through defining their role in relation to shareholders, enhancing responsibility for approval of purchases of non-audit services and appointment of auditors and possibly underpinning the role and responsibilities of audit committees through company law. In response to the report the UK Government agreed that the role of audit committees must be strengthened and enhanced.⁵⁷
- 2.88 Under Canadian law it is mandatory for listed companies to establish audit committees. The *Canada Business Corporations Act* requires publicly listed corporations to have an audit committee composed of not less than three directors of the corporation, a majority of which are not officers or employees of the company or any of its affiliates. It must also be noted that the regulator may permit a company to dispense with the audit committee if it is satisfied that shareholders will not be prejudiced by such a decision.⁵⁸

Mandating Audit Committees

- 2.89 Requirements for establishing audit committees differ between publicly listed companies and government business enterprises.
- 2.90 A government business enterprise is required to have an audit committee. Sections 32 and 44 of the *Commonwealth Authorities and Companies Act (CAC Act)* require directors of Commonwealth authorities and wholly owned Commonwealth companies to establish an audit committee. The CAC Act requires that audit committees have the following functions:
- helping the authority/company and its directors to comply with obligations under the CAC Act and (for companies) the *Corporations Act*; and
 - providing a forum for communication between directors, the senior managers of the authority/company and the internal and external auditors of the authority/company.⁵⁹

57 *Corporate Law Bulletin*, No 59, July 2002, section 1(c)

58 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.74

59 Joint Committee of Public Accounts and Audit, Report 372, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*, Canberra, Canprint, 1999, p.91.

- 2.91 Similar requirements are not mandated in the relevant legislation or rules for publicly listed companies. Neither the *Corporations Act 2001* nor the ASX Listing rules require a company to have an audit committee.
- 2.92 Although audit committees are not mandated in the ASX Listing Rules, rule 4.10 does require entities to report on corporate governance practices, including whether or not an entity has an audit committee and if not, why (section 4.10.2). In addition, *Guidance Note 9 (GN9)*, issued by the ASX in July 2000, provides guidance on the disclosure of corporate governance practices as required by Listing Rule 4.10.

Arguments against mandating audit committees

- 2.93 Despite calls for mandated audit committees in the past, the initiative has been resisted for a number of reasons. The Parliamentary Joint Statutory Committee on Corporations and Securities (PJSC) report *Matters Arising from the Company Law Review Act 1998* concluded that audit committees not be mandated due to cost and resource implications for small to medium companies, the belief that there was no single good model of corporate governance and the perceived adequacy of existing ASX rules.⁶⁰
- 2.94 Contrary to the evidence received by the PJSC's inquiry, there was a limited negative response to the idea of mandatory audit committees in evidence to this review.
- 2.95 The potential cost associated with requiring all listed entities to have audit committees was raised with the Committee. The Australian Stock Exchange echoed the findings of the PJSC, arguing that 'the cost burden and the loss of flexibility which results from mandating audit committees and prescribing minimum standards is likely to impact significantly on small to medium size companies'.⁶¹
- 2.96 Organisations representing the business community emphasised the argument that a 'one-size-fits-all' approach was not appropriate given the diversity of the business community. The Australian Institute of Company Directors submitted that the current approach in the Australian Stock Exchange Listing Rules is appropriate and audit committees should not be mandated. While the AICD recognised that audit committees represent good practice, they argued that 'establishing audit committees may not be appropriate or possible for all companies'.⁶² The Australian Chamber of Commerce and Industry stated that while they encouraged

60 Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on Matters Arising from the Company Law Review Act 1998*, Parliament House, Canberra, 1999, pp.99-107

61 Mr Richard Humphry, *Transcript*, pa.40

62 AICD, *Submission No.26* (including attachments), p.S219

members to establish audit committees they have generally regarded audit committees 'as a matter for the individual enterprise' rather than something that should be mandated.⁶³

- 2.97 A number of submissions downplayed the potential contribution audit committees could make to improved corporate governance. The Australian Stock Exchange told the Committee that 'mandating audit committees will not necessarily ensure auditor independence or audit quality'.⁶⁴ Similarly, Professor Wolnizer said that 'if the community was to look at to audit committees as a profound solution to the problem of corporate governance and to increase the quality of audited financial statements, I fear that we may be disappointed'.⁶⁵
- 2.98 Professor Wolnizer also argued that audit committees are 'constrained by the nature of the information to which they have access' and audit committees 'have no way of finding out whether the information provided to them is reliable and factually based'.⁶⁶ Similarly, in response to the Ramsay proposals for small to medium companies to only be required to have one independent director on the audit committee, the AICD suggests that a single independent director in a small company would be ineffective in the face of management's monopoly of internal information and control systems.⁶⁷
- 2.99 Dr Shann Turnbull argued that an independent audit committee with directors in its membership is essentially an 'oxymoron' because an audit committee will always have links to the company that override independence since directors are principals of the company.⁶⁸

Support for mandating audit committees

- 2.100 Notwithstanding the above, the proposal to mandate audit committees for all publicly listed companies attracted a great deal of support during the inquiry.
- 2.101 In recognition of the important role of audit committees in protecting auditor independence Professor Ramsay recommended that the ASX Listing Rules or *Corporations Act* be amended to require all listed companies to:

63 Mr Brent Davis, *Transcript*, pa.67-8

64 Mr Richard Humphry, *ASX, Transcript*, pa.39

65 Professor Wolnizer, *Transcript*, pa.108

66 Professor Wolnizer, *Transcript*, pa.108

67 AICD, *Submission* No 26, p.S215-222

68 Dr Shann Turnbull, *Exhibit* No.4

- have audit committees;
- specify the composition of the audit committee; and
- require the Board to adopt a written charter to govern the audit committee.

- 2.102 A number of State and Commonwealth Government inquiries, including the Cooney (1989), Bosch (1991) and Lavarch (1991) committees have advocated the mandatory establishment of audit committees for publicly listed companies.⁶⁹
- 2.103 In the evidence received by the Committee, one of the central reasons for mandating audit committees was their perceived role enhancing corporate governance, particularly the independence of the external auditor. The Institute of Chartered Accountants in Australia (ICAA) submitted that a key recommendation arising from the *Expectation Gap Report*, published by them and CPA Australia, was the need for mandatory audit committees. ICAA informed the Committee that it is ‘vital’ that listed companies have mandatory audit committees that have oversight of external audit activity on behalf of the Board (such as appointment, reporting and remuneration). Further, the ICAA proposed that the audit committee ‘should have responsibility to the Board for all corporate governance activity and in the case of any disagreement between the Board and the committee, have responsibility to report direct to shareholders’.⁷⁰
- 2.104 Similarly, the Trustee Corporation Association of Australia strongly supported the Ramsay recommendation that audit committees be mandated for all listed companies, stating that ‘we see a properly structured and functioning audit committee as a fundamental element in ensuring auditor independence, and as an important part of an effective corporate governance framework’.⁷¹
- 2.105 Others saw audit committees as a way of restoring public confidence in the financial reporting of Australian corporations. Deloitte Touche Tohmatsu submitted that, ‘while the Board of directors bears the ultimate responsibility for corporate governance...it should be mandatory for listed companies to have an independent audit committee’. Deloitte argued that mandating audit committees is ‘fundamental to the restoration of confidence in the financial reporting of Australian corporations, and in

69 Wolnizer, P, ‘Are Audit Committees Red Herrings’, *Abacas*, Vol.31 (1), 1995, pp.49-51.

70 ICAA, *Submission* No.29, p.S259

71 Trustee Corporations Association of Australia, *Submission* No.22, p.S181

resolving the perception that the independence of auditors has been compromised'.⁷²

- 2.106 It was also argued that boards had a key role to play in ensuring the effectiveness of audit committees. CPA Australia endorsed the Ramsay recommendations for mandatory audit committees, adding that effective audit committees required support from the Board to ensure adequate resources and independence from management.⁷³
- 2.107 The public sector auditors also supported mandatory audit committees. The Auditor-General of Victoria supported 'proposals for mandatory audit committees with an appropriate charter to enhance the corporate governance structure'.⁷⁴ The NSW Auditor-General submitted that there was little evidence that there are any disadvantages to the establishment and operation of audit committees and that the legislative, mandatory establishment of audit committees for listed companies was supported.⁷⁵
- 2.108 The Australian National Audit Office supported the introduction of legislation to enhance the role and existence of audit committees, with due regard being given to variations in company size and structure. The ANAO informed the Committee that it has observed 'enhanced corporate governance in the public sector arising from the stronger role being adopted by audit committees', including audit committees having independent members that bring external views and experience to committee meetings'.⁷⁶

Responsibilities of the Audit Committee

- 2.109 The *Audit Committees: Best Practice Guide 2nd Edition* outlines a range of responsibilities for audit committees in the areas of external reporting, related party transactions, internal control and risk management, external audit and internal audit.⁷⁷ The Ramsay Report also endowed audit committees with significant responsibilities and functions.⁷⁸
- 2.110 It was also submitted to the Committee that audit committees should play a stronger role in overseeing management activities. The AuASB argued that company management should 'report formally to the audit committee

72 Deloitte Touche Tomatsu, *Submission* No. 23, p.S192

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

74 Victorian Auditor General, *Submission* No.25, p.S210

75 Auditor General of NSW, *Submission* No.28, p.S248

76 ANAO, *Submission* No.27, p.S236

77 Mr Rob Elliott, *Exhibit* No.8, pp.22-5.

78 See Ramsay Report, para 6.78 and Appendix D

annually on the effectiveness of a company's internal control and governance procedures'.⁷⁹ In regard to ensuring the independence of the external auditor, ACCA submits that there should be a mandatory review by the company's audit committee of the independent status of the external auditor and the publication of a statement that it is satisfied with the results.⁸⁰ Stephen LaGreca argues that the audit committee should be responsible for the appointment and fees of the external auditor.⁸¹

- 2.111 A key aspect of an effective audit committee is its independence. The US Blue Ribbon Committee highlighted the importance of independence in their comment that 'several recent studies have produced a correlation between audit committee effectiveness and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud'.⁸²
- 2.112 Clearly prescribing and monitoring the criteria for membership of the audit committee is the central mechanism in ensuring independence. The *Audit Committees Best Practice Guide 2nd Edition* suggests:
- the chairperson of the committee and all committee members need to be either an independent non-executive director or an independent non-director with no operating responsibilities;
 - the managing director should not be a member of the committee; and
 - the committee should always reserve the right to meet with management in attendance.⁸³
- 2.113 Independence also requires access to accurate and verifiable information. Requiring CEOs and CFOs to personally attest to the veracity of financial reports, as recommended in this report, would ensure that audit committees have access to accurate and truthful information. Further, requiring that the internal audit function report directly to the audit committee is another important mechanism to ensure the audit committee is fully informed. Similarly, audit committees should have the resources available so that they can access independent sources of information and advice, for example, the Nasdaq listing rules provide audit committees with the authority to retain legal, accounting and other experts.

79 AuASB, *Submission* No.12, p.S100

80 ACCA, *Submission* No.8, p.S68

81 Mr Stephen LaGreca, *Submission* No.14, p.S103-104

82 Blue Ribbon Committee, cited in Ramsay Report, para 6.62

83 Mr Rob Elliott, *Exhibit* No 8.

Conclusion

- 2.114 The Committee has carefully considered the arguments made in the course of this inquiry in regard to audit committees, with due reference to previous inquiries.⁸⁴ The great weight of submissions received by the Committee support mandating audit committees in legislation and in providing audit committees with significant responsibilities.
- 2.115 The key issue is ensuring a high level of independence for the audit committee. The composition, authority and responsibilities of the audit committee must promote and protect independence. The Board must also take a very active role in ensuring the independence of the audit committee.
- 2.116 The argument that audit committees are an unreasonable cost burden for small to medium companies is increasingly tenuous. Listing on the stock exchange and reaping the potential benefits of selling shares and raising capital brings with it certain costs, obligations and responsibilities. One of these costs should be a properly constituted audit committee. The question that should be asked is whether companies who cannot afford to implement an audit committee, with at least one independent director, be able to publicly list? In recognition of the circumstances of small to medium companies, the Ramsay report makes allowances that would mitigate the cost burden. For example, smaller capitalisation companies would only be required to have one independent director (rather than three as recommended for large companies), which Professor Ramsay rightly described as a 'modest requirement'.⁸⁵
- 2.117 The problem of audit committee reliance on management for information is a vexed one and is a potential problem regardless of how many independent directors are involved. Issues such as this are risk management issues for the whole board to consider and manage. As many submissions have suggested, an effective audit committee requires strong board support to ensure independence and resources. Further, audit committees, and individual directors, should not be passive recipients of information. They should be proactive in verifying information received from management and in seeking out independent sources of information against which internally generated information can be tested. The Committee's recommendation that CEOs and CFOs

84 For example, Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on Matters Arising From the Company Law Review Act 1998*, Parliament House, Canberra, 1999.

85 Ramsay, Ian, *Independence of Australian Company Auditors*, Department of Treasury, Canberra, 2001, p.82.

personally attest to the veracity of the financial reports provided to the board will greatly assist in this respect (Recommendation 1).

- 2.118 In response to the argument that an independent audit committee with directors in its membership is essentially an ‘oxymoron’, the Ramsay report recommends that the chairperson of the Board of Directors not be the chairperson of the audit committee and that directors on the audit committee must meet comprehensive ‘independence’ requirements, which are clearly outlined in Appendix D of the Ramsay report. Adherence to these criteria will provide adequate safeguards to ensure the independence of non-executive directors sitting on audit committees.
- 2.119 Given the passive nature of the ASX role and their lack of statutory powers of inspection and enforcement (as discussed in Chapter 1), the Committee is of the opinion that the *Corporations Act 2001* would be the most appropriate vehicle for mandating the establishment of audit committees. This not only provides firm legislative backing but also allows for ASIC to exercise its inspection and enforcement powers if necessary to ensure compliance.
- 2.120 While recognising the value of audit committees, the Committee recognises that audit committees will not, by themselves, address all the corporate governance and audit independence issues being faced. Nevertheless, a properly constituted audit committee goes a long way towards enabling a company to meet the responsibilities and obligations expected of them by stakeholders. In addition, the Committee agrees with the view that audit committees should always be considered a sub-committee of the Board and should not in any way diminish the overall responsibility of the Board.⁸⁶
- 2.121 In summary, the Committee recommends the following:
- unless exempted upon application to ASIC, all publicly listed companies be required to establish an audit committee comprised of independent members, which is answerable to the full Board of directors;
 - the *Corporations Act 2001* is the best vehicle for requiring publicly listed companies to establish an audit committee, with appropriate provisions to enable small to medium companies to meet the requirement without undue cost burdens; and
 - the *Corporations Act 2001* should clearly set out the basic role, responsibilities and composition of the audit committee so that

compliance can be effectively monitored and policed. Guidance on the role and function of audit committees should be taken from Appendix D of the Ramsay Report.

- 2.122 This recommendation would also assist companies meet the proposed statutory requirement that the auditor be independent (as discussed at Chapter 4).

Recommendation 2

- 2.123 **That the *Corporations Act 2001* be amended to require all publicly listed companies to have an independent audit committee and the Act prescribe the minimum requirements in regard to the role, responsibilities and composition of an audit committee.**

Corporate governance standards

- 2.124 As discussed in the preceding section all companies should have effective corporate governance practices in place. The professional bodies, major audit firms and industry representative bodies have all developed guidelines of one sort or another promoting best practice in corporate governance.
- 2.125 Internationally, the OECD has developed a set of corporate governance principles. While recognising that no single model of good corporate governance exists, the OECD identified 'some common elements that underlie good corporate governance'.⁸⁷

Current requirements

- 2.126 Where companies do profess to abide by corporate governance principles and practices, such practices are not demonstrable. In other words, they are not tested or independently verified in order to assure shareholders that such principles accord with best practice and are actually being put into practice.
- 2.127 There are no mandated requirements in Australian legislation for companies to have prescribed best practice standards for corporate governance in place. The ASX Listing Rule 4.10.3 only requires a

⁸⁷ *Principles of Corporate Governance*, Organisation for Economic Cooperation and Development, SG/CG(99)5, 1999, p.3

statement of the main corporate governance practices the entity had in place during the reporting period. This is supported by *Guidance Note 9* (GN9), issued by the ASX in July 2000, which provides guidance on the disclosure of corporate governance practices as required by Listing Rule 4.10. In effect, however, a company with no recognised corporate governance mechanisms is not required to report nor are they required to implement any corporate governance practices.

Broadening financial reporting requirements

2.128 It is clear from submissions received by the Committee that information beyond the financial statements, such as the quality of corporate governance, is important to shareholders and other stakeholders:⁸⁸

In the current climate, reporting on issues that provide confidence to the Australian public regarding corporate Australia, including corporate governance, internal controls and risk management, the “going-concern” assumption, the health of the business, quality of earnings, management estimates, risks and liquidity, is important.⁸⁹

2.129 The issue faced by the Committee was how to model a broader reporting framework that would address the increasingly comprehensive and sophisticated information needs of investors. The term ‘expectation gap’ has been used to describe the ‘difference between expectations of users of financial reports and the perceived quality of financial reporting and auditing services delivered by the accounting profession’.⁹⁰ The public debate in the wake of recent corporate failures reflects the general public’s concern that key non-financial indicators of impending failure were not addressed by the auditor.

2.130 At present the only assurance shareholders receive from the audit report is limited to the financial statements and whether they are in accord with the accounting standards and provide a true and fair view. However, one important aspect of the ‘audit expectation gap’ is the extent to which an auditor can or should be reporting on aspects of corporate governance other than the financial reports.⁹¹

2.131 In addition to corporate governance standards there was strong support in the evidence to the inquiry for broader and more comprehensive auditing

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

89 PricewaterhouseCoopers, *Submission* No 60, p.S551

90 ICAA, *Exhibit* No.5

91 Victorian Auditor-General, *Submission* No.25, p.S211

as a way of addressing the broader information needs of shareholders. These issues are discussed in more detail in Chapter 4.

A new reporting framework

2.132 The central issue in this section of the report is how and in what form this additional information is to be provided, and by what mechanism is it to be tested so that shareholders can have confidence that the information is accurate. According to PricewaterhouseCoopers, although firms have developed criteria for measuring non-financial areas,⁹² there is no framework in place governing additional disclosures:

For financial statements, directors follow accounting standards and auditors report against these. There is no generally accepted framework for other areas, particularly the behavioural areas.⁹³

2.133 To give effect to these concerns, a possible initiative considered by the Committee is to embed corporate governance standards in the accounting and auditing framework. This would require the development of a set of testable corporate governance standards and their incorporation into the *Corporations Act 2001*.

2.134 The Committee notes the ASX initiative to tighten corporate governance through establishing a Corporate Governance Council. The ASX reported that the Council will develop best practice guidance on issues critical to investor confidence, including audit committees, financial reporting, convergence of reporting standards, independence of directors, and executive options.

2.135 The Committee welcomes and supports this very positive initiative. However, this will not provide a framework for enabling broader and more comprehensive reporting as called for in the submissions to this inquiry.

Conclusion

2.136 The Committee considers that broader reporting, based on a considered framework of governance principles will provide more useful and broad ranging information to shareholders and other stakeholders. As discussed in relation to audit committees, listing on the stock exchange and reaping

92 The auditing standards also provide guidance for auditors to provide opinions on non-financial issues. For example Auditing Standard AUS 402 defines 'internal control structure' and AUS 810 provides auditors with professional guidance on the conduct of engagements of this nature.

93 PricewaterhouseCoopers, *Submission* No.60, p.S551

the potential benefits of selling shares and raising capital brings with it certain costs, obligations and responsibilities. The following recommendation is aimed at ensuring companies meet these responsibilities and obligations.

- 2.137 The Committee holds the view that embedding corporate governance standards in the *Corporations Act 2001* alongside the present accounting standards would require companies to pay due attention to corporate governance and report fully to shareholders. In a speech to the Monash Governance Research Unit on 16 July 2002, the Chairman of ASIC, Mr David Knott, posed the question ‘Should the regulator have powers to prescribe and enforce governance standards?’ He recognised that this is a ‘radical notion’ and would represent a major shift in the responsibilities of the regulator. While not necessarily advocating this change, he made the point that ‘if you are not in control of governance, you cannot prevent failure.’⁹⁴ In light of repeated failures in corporate governance going back to the 1980s, the Committee considers that it is time to take more control of corporate governance.
- 2.138 In order to give effect to this proposal the Committee recommends that the Financial Reporting Council be directed to develop a set of corporate governance standards. The Committee suggests that guidance should be taken from the findings of the ASX’s Corporate Governance Council in developing these standards.
- 2.139 In addition, the final corporate governance standards should reflect international best practice rather than minimum acceptable standards, and incorporate criteria such as risk management and internal controls. The Committee recognises that this cannot be a static exercise. It must be dynamic and ongoing in order to keep abreast of changes in the broader economy.
- 2.140 Finally, the standards must be given legislative authority. The accounting standards are given legal authority in Section 334 of the *Corporations Act 2001*. The Committee therefore recommends that corporate governance standards be given equivalent legislative authority. The Committee has identified two possible ways of giving legislative effect to this recommendation. The first approach is to recognise corporate governance standards as part of the suite of accounting standards and provide legislative backing to the corporate governance standards pursuant to Section 334 of the *Corporations Act 2001*. The alternative approach would be to create a new section in the *Corporations Act 2001* (ie Section 334 (A)), mirroring Section 334 but giving legislative authority to corporate
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94 Knott, David, *Inaugural Lecture, Monash Governance Research Unit*, 16 July 2002, Melbourne.

governance standards as a discreet set of standards alongside the accounting standards. In this case, the standards would also need to be included in the current compliance requirements in sections 295 and 296 of the Act.

- 2.141 In considering this proposal the Committee has given due recognition to the argument that a ‘one-size-fits all’ approach may not be appropriate. Nor is the Committee wishing to impose unnecessary burdens on business. However, as evidenced by the OECD guidelines, there are basic principles relating to best practice in governance, risk management and internal control to which all companies should adhere. There is also a clear public demand for more extensive reporting of non- financial information, including information on corporate governance and commentary on the health of the organisation. The reporting of this information is addressed in Recommendation 3 and also discussed further in Chapter 3.
- 2.142 In addition to broadening financial reporting, there was strong support in the evidence to the inquiry for broader and more comprehensive audits. The issue of establishing a framework for broadening the scope of audits is discussed in Chapter 4.

Recommendation 3

- 2.143 **That the Financial Reporting Council:**
- **develop a set of corporate governance standards, including prescriptions for internal audit, taking primary guidance from the findings of the ASX’s Corporate Governance Council; and**
 - **take all steps to ensure these standards be given legislative backing in the *Corporations Act 2001*, as either pursuant to or mirroring Section 334.**

Corporate governance in audit firms

- 2.144 The independence of audit firms is important for maintaining public trust in the financial reporting framework. Investors must be able to rely on issuers’ financial statements. Consequently, the effectiveness of the

mechanisms audit firms have in place to manage risks to their independence is a matter of public interest.

- 2.145 Each of the major audit firms conveyed to the Committee the view that the current arrangements in place to address risks to their independence were satisfactory. For example, Ernst & Young advised the Committee that its internal policies dealing with independence were regularly updated to ensure they meet international best practice⁹⁵ and Deloitte Touche Tohmatsu told the Committee:

...to satisfy the quality and the integrity of the services that we deliver, there is a very comprehensive process in place which encompasses internal quality assurance processes, peer reviews and reviews by the Institute of Chartered Accountants.⁹⁶

- 2.146 More generally, PricewaterhouseCoopers stated that the 'auditing profession in Australia and the standards supporting the profession are sound and reflect world's best practice'.⁹⁷ Similarly, KPMG stated that 'Australia has a strong, dedicated audit profession that operates in line with world's best practice'.⁹⁸
- 2.147 PricewaterhouseCoopers also informed the Committee that processes in place to ensure the independence of audit firms are monitored internally by the firms themselves, by the professional bodies through their ongoing monitoring programs and are implicitly covered by the tri-annual declaration made by registered auditors to ASIC. Many audit firms voluntarily provide independence declarations to their clients' audit committees on an annual basis.⁹⁹
- 2.148 In terms of public accountability, auditors are required by the *Corporations Act 2001* (sect. 1288) to lodge a triennial statement with ASIC setting out such information as is prescribed.
- 2.149 Australian auditors generally ascribe to very high standards and audit firms have comprehensive quality control and risk management mechanisms in place. However, recent events have raised questions of their independence. Negative perceptions are reinforced by the lack of informed public exposure to the mechanisms audit firms have in place to ensure their independence and the lack of any real public oversight or scrutiny of audit firms. To remedy this negative perception and rebuild

95 Ernst & Young, *Submission* No. 32, p.S278

96 Mr Robert Wylie, *Transcript*, pa.182

97 PricewaterhouseCoopers, *Submission* No.18, p.S129

98 KPMG, *Submission* No.34, p.S311

99 PricewaterhouseCoopers, *Submission* No.60, p.S550

confidence in the audit function the Committee is interested in ensuring that the governance processes and practices used by audit firms are best practice, transparent and accountable. The Committee acknowledges that the major audit firms have recently taken steps to enhance their internal independence and quality control practices.

Ensuring the independence of the auditor

2.150 Various initiatives have been adopted or recommended in order to ensure audit firms maintain their independence and to protect the reliability and integrity of financial reporting by publicly listed companies. These initiatives range from highly prescriptive rules-based regimes to self-regulatory frameworks.

U.S Securities and Exchange Commission

2.151 At one end of the spectrum is the prescriptive approach taken by the U.S. Securities and Exchange Commission. In November 2000, the Securities and Exchange Commission adopted a set of detailed prescriptive rules regarding audit independence and disclosure applicable to auditors of listed entities. These rules were revised in 2001. The rules are based on four principles for measuring auditor independence. Under these principles, an accountant is not independent when the accountant:

- has a mutual or conflicting interest with the audit client;
- audits his or her own firms work;
- functions as management or an employee of the audit client; or
- acts as an advocate for the audit client.

2.152 The SEC rules (Rule 2.10.2-01(d)) outline a range of features that should be present in an audit firms quality control system if it is to provide adequate assurance, including:

- written independence policies and procedures;
- an automated system to identify investments that might impair independence;
- an on-going firm wide training program about auditor independence;
- an annual internal inspection and testing program to monitor adherence to independence requirements;
- notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence policies;

- written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from the audit client's engagement and to review promptly all work the professional performed related to the audit client's engagement; and
- a disciplinary mechanism to ensure compliance with the SEC rules.¹⁰⁰

2.153 Since adopting the audit independence rules the SEC has initiated and settled cases against a number of large audit firms. Recent examples include:

- July 2002: PricewaterhouseCoopers settled a SEC initiated audit independence case against them where the SEC had found that PricewaterhouseCoopers had violated audit independence rules involving 16 separate audits of public companies.¹⁰¹
- June 2002: the SEC brought a case against a foreign accounting firm for engaging in 'improper professional conduct' within the meaning of the SEC's independent auditing rules.¹⁰²
- January 2002: the SEC censured KPMG for violating audit independence rules by engaging in 'improper professional conduct' because it purported to serve as an independent accounting firm for an audit client at the same time that it made substantial financial investments in the client.¹⁰³

Professional Statement F.1: Professional Independence

2.154 At the other end of the spectrum is the self-regulatory approach taken by the auditing and accounting profession in Australia under the *Professional Statement F.1: Professional Independence* developed by the Institute of Chartered Accountants in Australia and CPA Australia. As a self-regulatory mechanism, the *Professional Statement F.1*

...adopts a conceptual framework for assurance engagements that requires the identification and evaluation of threats to independence and the application of safeguards to reduce any threats created to an acceptable level.¹⁰⁴

100 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.70

101 SEC Press Release 2002-105, 17 July 2002.

102 SEC Press Release 2002-95, 27 June 2002.

103 SEC Press Release, 2002-4, 14 January 2002.

104 *Professional Statement F.1: Professional Independence*, p.44

2.155 In terms of monitoring and enforcement of the principles, *Professional Statement F.1* requires that:

...members should be prepared to justify to the Institute of Chartered Accountants in Australia and CPA Australia, if called upon, any apparent transgression from all the provisions and spirit of this Statement.¹⁰⁵

2.156 Both the ICAA and the CPA told the Committee that adherence to *Professional Statement F.1* will be monitored through their respective quality review programs. Non-compliance will be investigated and disciplinary action taken consistent with existing regulations and processes.¹⁰⁶ The ICAA added that it would expect ASIC and the CALDB to enforce the requirements of *Professional Statement F.1* or bring alleged breaches to the attention of the ICAA (and presumably the CPA).¹⁰⁷

2.157 A number of the major audit firms informed the Committee that for the most part their internal independence and quality control policies already comply with the *Professional Statement F.1*.¹⁰⁸

Independence Boards

2.158 Professor Keith Houghton submitted to the Committee the proposal that audit firms should be required to establish Independence Boards. An Independence Board would have the authority to define, review and decide upon all threats and potential threats to independence. It would also have responsibility for the quality control and educational programs in respect of an audit firm's independence decision making.¹⁰⁹

2.159 According to Professor Houghton, research suggests that markets prefer companies where ultimate policy decisions are made by a body separate from the executive, and are transparent and objective. A process within audit firms that parallels this corporate control mechanism would enhance audit quality and independence. Audit firms with transparent and objective quality control processes will be more competitive in attracting business and will force other audit firms to follow suite. Subsequently, a company with verifiably independent and competent audits will have a

105 *Professional Statement F.1: Professional Independence*, p.2

106 CPA Australia, *Submission No. 56*, p.S527 and ICAA, *Submission No. 53*, p.S505

107 ICAA, *Submission No. 53*, p.S505

108 Deloitte Touche Tohmatsu, *Submission No. 52*, p.S485, Ernst & Young, *Submission No. 57*, p.S530 and PricewaterhouseCoopers, *Submission No.60*, p.S550

109 Professor Keith Houghton, *Submission No.1*, pp.S24-25

lower risk and higher value compared to companies with audits perceived to be lacking independence and competence.¹¹⁰

2.160 The key proposals to establish this control mechanism are:

- Legislation requiring audit firms to have observable quality control for independence.
- Audit firms of a certain size be required to establish external Independence Boards to oversee all issues related to audit independence.
- Small to medium audit firms that audit publicly listed companies would have access to an independence board established under the auspices of the professional bodies.
- Public disclosure by audit firms of quality controls in place for mitigating risks to audit independence.¹¹¹

2.161 The Committee understands that two of the four major audit firms have established mechanisms that reflect the proposal put forward by Professor Houghton and a third, Deloitte Touche Tohmatsu, informed the Committee they were currently considering Professor Houghton's proposal.¹¹²

2.162 PricewaterhouseCoopers informed the Committee that they had established an Audit Standards Oversight Board, comprised of three external members, to 'oversee the manner in which the firm gains assurance that audit quality and independence standards are being met'.¹¹³ KPMG recently established an Ethics and Conflicts Committee to review the firm's policies and procedures relating to ethics and independence and to provide advice on specific matters. The four member Committee, chaired by the firm's National Chairman, has one external member.¹¹⁴

2.163 Ernst & Young, the other major firm, has a comprehensive risk management structure, including a Risk Management Committee. The Committee understands that its internal policies endeavour to imbue staff with a strong risk management focus, including dealing with independence issues.¹¹⁵

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

111 Professor Keith Houghton, *Submission* No.1. pp.S33-34

112 Mr Robert Wylie, *Transcript*, pa 185

113 PricewaterhouseCoopers, *Submission* No.18, p.S130

114 KPMG, Media Release 11 July 2002

115 Ernst & Young, *Exhibit* No. 15

- 2.164 The Committee considers the adoption of independence boards to be a profitable measure to improve the ability of audit firms to deal with independence issues. To be fully effective, these boards must be able to operate transparently and objectively. As suggested by Professor Houghton, they must be able to operate in real time, have no commercial interests in the outcome of their decisions and be supported by mechanisms that ensure they are not captured by the audit firm.¹¹⁶
- 2.165 The establishment of independence boards complements the Committee's call for increased public accountability for the audit firms and its proposal for a broader role for ASIC in this process (Recommendation No. 4). In the Committee's view, the existence of a properly constituted and functioning board would enable audit firms to more readily address independence issues with ASIC.

Auditor Independence Supervisory Board

- 2.166 The Auditor Independence Supervisory Board (AISB) proposed in the Ramsay report (discussed in more detail in Chapter 4) incorporated an audit firm oversight function. It was envisaged that the AISB would 'monitor the nature and adequacy of systems and processes used by Australian audit firms to deal with issues of auditor independence and advise on the adequacy of these systems and practices'.¹¹⁷
- 2.167 Professor Ramsay proposed that the AISB use the SEC rules (described above) as a benchmark for monitoring audit firms. In addition, the accountancy firms should be prepared to enter into an agreement with the AISB to provide reasonable access to people and papers to help the AISB with this monitoring process.¹¹⁸

Independent Audit Commission

- 2.168 Mr Rodney Bennett recommended to the Committee the creation of an Independent Audit Commission, a government body independent of ASIC and answerable to Parliament. Audit firms would be required to report to the Commission on each listed entity they audit, reporting on all issues discussed, issues uncovered, issues discussed with management or at an audit committee meeting.¹¹⁹

116 Professor Keith Houghton, *Transcript*, pa.265 and pa.267

117 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.70

118 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.70

119 Mr Rodney Bennett, *Submission No.4*, p.S50

Auditing the auditors

- 2.169 Investors, both small investors saving for retirement and large institutional investors, place a great deal of trust in audit firms and the independence of their assurances. The public expects auditors to ‘discover and disclose instances of poor corporate governance’.¹²⁰
- 2.170 There are clearly some questions regarding the success of self-regulation. The alleged audit failures of recent times have occurred despite regular assurances by members of the accounting and related professions that the present rules and regulatory frameworks concerning audit independence and professional standards are adequate. The failure of auditors to warn of the pending troubles at One-Tel, HIH and Harris Scarfe, regardless of the actual role of the auditor, have created a very negative public perception of the audit function.
- 2.171 A key factor that must not be lost sight of in the debate is that the principal client of an audit is not management, it is the shareholder. Despite protestations from the profession that there is no need for any external oversight mechanism the Committee considers that the way audit firms protect and promote their independence is a matter of great public importance and as such requires some form of oversight.
- 2.172 The Committee recognises that audit firms already have an array of comprehensive quality control mechanisms and processes in place to identify and address risks to independence. The Committee is also encouraged by the way audit firms have responded to the crisis in confidence in the audit function. However, the problem is not necessarily with the quality of these mechanisms and processes but the lack of public scrutiny and public knowledge of how audit firms operate. Opening up audit firms to public view will assist in lifting confidence in the veracity of financial reporting. Given that the major audit firms have great confidence in their quality control processes, they should have nothing to fear from allowing for regular public scrutiny of those processes. In fact, they have everything to gain by encouraging public confidence in their ability to provide independent opinion and advice.
- 2.173 The Committee has carefully considered both the prescriptive and self-regulatory models applying to the oversight of audit firms. The Committee does not support a highly prescriptive regulatory approach such as that in place in the United States. The Committee notes, however, as highlighted by the second case referred to in paragraph 2.153, that the

120 Australian Consumers’ Association, *Submission* No.47, p.S424

rules applying in the United States may have an impact on the operation of audit firms outside of that jurisdiction.

- 2.174 The situation in Australia does not necessitate an overly prescriptive regime. Conversely, the Committee believes that the self-regulatory model has failed to adequately protect investors and the approach of *Professional Statement F.1* does not provide a sufficient level of public assurance or transparency.
- 2.175 In taking a 'middle ground' approach between prescription and self-regulation the Committee recognises the public demand for more accountability of audit firms while allowing audit firms to have the flexibility to develop and implement quality assurance processes that fit their particular circumstances. To provide public confidence in the independence and veracity of the audit function there is a need to provide a mechanism for 'auditing the auditor' with the objective of providing public assurance that the internal systems and processes of audit firms accord with best practice.
- 2.176 The Committee is not convinced of the need to establish a new regulatory body to oversee audit firms. The Committee envisages that ASIC, as the regulator, should take on a broader and more vigorous role in ensuring audit independence. The Committee does not aim to add an additional layer of regulation, but seeks to revise and build on the existing system.
- 2.177 In light of the preceding discussion, the Committee proposes a mechanism for the public oversight and scrutiny of audit firms. This may be achieved through amending section 1288 of the *Corporations Act 2001*, which currently states that auditors need only provide triennial statements setting out such information as are prescribed.
- 2.178 First, audit firms undertaking audits of publicly listed companies should be required to submit verifiable 'independence performance reports' to ASIC on a regular basis detailing how they have managed independence issues and any future independence management issues that are deemed pertinent.
- 2.179 Second, ASIC should have the authority to investigate and address, through recommendations or penalties, matters arising from those reports.
- 2.180 The third point, in keeping with the monitoring role envisaged for the AISB in the Ramsay Report, suggests that ASIC refer to the quality control systems and procedures outlined in the SEC audit independence rules (Rule 2.10.2-01(d)), and other systems and procedures ASIC thinks appropriate, as a benchmark for determining the adequacy of the internal systems and processes of large audit firms.

- 2.181 Finally, to ensure transparency and accountability these benchmarks should be published so that both audit firms and investors are aware of the requirements that must be met.

Recommendation 4

- 2.182 **That Section 1288 of the *Corporations Act 2001* be amended to incorporate the following principles:**
- **require audit firms undertaking assurance audits of publicly listed companies to submit a report to the Australian Securities and Investments Commission (ASIC) on an annual basis detailing how audit firms have managed independence issues in the preceding period and any future independence management issues that are deemed pertinent;**
 - **provide ASIC with the authority to investigate and address independence issues arising from these reports or from other sources as ASIC considers appropriate; and**
 - **require publication of the ASIC benchmark criteria used for determining the adequacy of the internal systems and processes of large audit firms.**

FINANCIAL REPORTING

Background

3.1 Disclosures made by companies must provide a reliable portrayal of their financial condition and performance, be informative, and timely in order to sustain an informed market and ensure the development of market confidence. Currently companies provide financial and non-financial information to the market through a variety of means, including their annual financial statements and pursuant to the disclosure and reporting requirements contained in the Australian Stock Exchange's Listing Rules.

3.2 A number of submissions have suggested to the Committee that the financial reporting model in Australia needs to be improved. For example, KPMG told the Committee:

The financial reporting model must be improved to more transparently describe business operations, disclose leading indicators and trends and better inform investors about risks and performance.¹

3.3 PricewaterhouseCoopers succinctly summarised the need to consider reform in the area of financial reporting when they told the Committee:

Public trust in our capital markets can be strengthened, if all the participants in corporate reporting commit to...a robust global corporate reporting framework grounded in transparency, accountability and integrity. Transparency is the obligation to willingly provide to shareholders the information needed to make decisions.²

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

2 Mr Anthony Harrington, *Transcript*, pa.136

- 3.4 This chapter will address some of the contemporary issues related to financial reporting in Australia, including a discussion of potential reforms.

Accounting standards

- 3.5 The accounting standards prescribe the rules and measures, which largely govern the form and content of a company's financial statements. Taken together, the more than 40 standards provide a comprehensive and complex financial reporting and disclosure framework. Several of the standards run to more than 50 pages in length and one, *AASB 1020 – Income Taxes* is nearly 150 pages in length.
- 3.6 The current framework for the development of accounting standards in Australia is contained in Part 12 of the *Australian Securities and Investments Commission (ASIC) Act 2001*. Heading this framework is the Financial Reporting Council (FRC), whose functions are listed in Section 225 of the Act and which include, providing broad oversight of the accounting setting process in Australia and providing direction to the Australian Accounting Standards Board (AASB). The AASB is responsible for the technical development work associated with the accounting standards.
- 3.7 The Committee has considered issues associated with Australian accounting standards under the following headings:
- Principle-based;
 - Harmonisation with international accounting standards; and
 - Quality of the measurement rules.

Principle-based

- 3.8 A number of submissions to the Committee contended that the accounting standards should be 'principle-based' rather than contain a series of prescriptive rules as this is the most effective way to best ensure that financial reporting practices reflect the economic substance, not the form, of the transaction.
- 3.9 For example, the Australian National Audit Office (ANAO) advised the Committee that accounting standards should clearly set down the intent of the standard setters so that companies and auditors are discouraged from

adopting schemes or techniques or using accounting practices designed to subvert those intentions.³

- 3.10 The ANAO further described the concept of moving to a more principle-based framework as follows:

I think we need to get the standards right. I like the idea...of principles based or making a clear message of what this standard is seeking to achieve and what it is seeking to stop...⁴

- 3.11 Mr Robert K. Herman, Chief Accountant with the United States Securities and Exchange Commission (SEC) recently commented that principle-based accounting standards are the best foundation for making financial reporting more relevant to investors and are more effective than prescriptive rules in enabling preparers and auditors to evaluate whether the overall impact of the method of reporting a transaction is consistent with the objective of the standard.⁵

- 3.12 The preparation of financial statements involves a large degree of subjectivity and the use of professional judgement. Ernst & Young nominated the area of judgement in the selection of accounting methods and in the selection of a method of disclosure as perhaps the area of greatest risk to auditors. They told the Committee:

One of the difficult issues in auditing and, I suppose in financial statement preparation, is exercising judgement in certain areas around the sorts of rules contained in the accounting standards.⁶

- 3.13 Mixed views were expressed to the Committee concerning the nature of Australia's accounting standards. For example, Ernst & Young described Australia's accounting standards as 'principle-based' which, with some exceptions (which are discussed below), largely reflect the international accounting standards.⁷

- 3.14 On the other hand, Mr John Shanahan told the Committee that Australia's accounting standards contained a lot of prescription and the Australian Institute of Company Directors suggested to the Committee that:

3 Australian National Audit Office, *Submission No. 27*, p.S234

4 Mr Ian McPhee, *Transcript*, pa.58

5 Herman, R, '*Testimony Concerning The Roles of the SEC and the FASB in Establishing GAAP*', House Sub-Committee on Capital Markets, Insurance and Government Sponsored Enterprises, US Congress.

6 Mr Brian Long, *Transcript*, pa.91

7 Ernst & Young, *Submission No. 57*, p.S530

...what we have at the moment in accounting standards is a mixture, it is a composite of principles combined with some prescription.⁸

- 3.15 In the Committee's view, accurate and relevant financial reporting is more likely to occur when the disciplines contained in accounting standards are principle-based but supported by an appropriate level of description and prescription.

Harmonisation with international accounting standards

- 3.16 Since 1996 Australia has pursued a policy of harmonising its accounting standards with the international accounting standards. The AASB, under the auspices of the FRC, has played an important role in this program.
- 3.17 The FRC announced on 3rd July 2002, that it had directed the AASB to work towards the full adoption of international accounting standards in Australia from January 1, 2005.
- 3.18 This announcement is consistent with the views expressed by the European Commission, which had previously endorsed the application of the international accounting standards within the European Union by the same date.
- 3.19 In the United States, the Financial Accounting Standards Board (FASB) has the stated objective of participating in international activities so as to increase the international comparability and the quality of standards used in the United States. It hopes the ultimate outcome of these efforts will be the worldwide use of a single set of high-quality accounting standards.
- 3.20 Strong support for the processes of developing international accounting standards and Australia's commitment to harmonising with those standards has been expressed to the Committee. For example, PricewaterhouseCoopers told the Committee:

...what we have achieved in setting accounting standards over the years is the establishment of a global board with the right skills and experience...⁹

- 3.21 Typical of the comments the Committee received in submissions was:
- '...(due to) the interconnection of global financial markets and the increasing number of Australian corporations either operating or seeking capital in international markets the harmonisation of Australian Accounting Standards with the International

8 Mr Stuart Grant, *Transcript*, pa.169

9 Ms Jan McCahey, *Transcript*, pa.143

Accounting Standards is an imperative. Improving the efficiency of Australian capital markets requires improvement in the accountability of private and public sector reporting, which leads to increasing demand for high quality, internationally comparable financial information'.¹⁰

- 3.22 KPMG told the Committee that increases in the comparability of financial information flowing from the process of harmonisation will lower financial information risk in the market and enable more efficient movement of capital.
- 3.23 However, they also identified that the process of harmonisation is likely to require companies to expend significant amounts of time and money understanding the differences between Australian and International accounting standards and in reflecting these differences in their financial reporting systems.¹¹ Pitcher Partners told the Committee that the relative cost of compliance was likely to be much greater on proprietary companies and identified that there is:
- ...a serious risk that changes to the financial reporting framework in Australia will not respond to the needs of privately owned Australian business, and will stifle rather than encourage growth.¹²
- 3.24 There is also evidence of some risks in adopting international standards. For example, Professor Bob Walker was recently reported as saying that the process of harmonisation had weakened several pre-existing Australian standards. He indicated there have been a number of initiatives that have been removed in the process of harmonising with international accounting standards, which have actually weakened some of our reporting rules.¹³
- 3.25 In addition, a number of submissions, while supportive of the policy of harmonisation, have highlighted that Australia should not accept lower standards while pursuing the goal of harmonisation nor that significant gaps are left or created in our accounting standards. For example, Ernst & Young told the Committee that:
- ...some Australian standards are of higher quality than their IAS equivalents – eg AASB 1017 – Related Party Disclosures. This standard has been effective as a deterrent to related party transactions and has had a positive effect on corporate governance in Australia. It would be a loss for Australian corporate

10 Deloitte Touche Tohmatsu, *Submission* No.23, p.S192

11 KPMG, *Submission* No.71, p.S652

12 Pitcher Partners, *Submission* No.72, p.S655

13 'Account Standards Third-Rate', *The Sun-Herald*, 30 June 2002

governance to substitute AASB 1017 with IAS 24, which, in our opinion, is a weak standard.¹⁴

- 3.26 Given these concerns the Committee notes that the processes leading to the adoption of international accounting standards must be sufficiently robust to deal with difficulties and disagreements as they arise and in particular, ensure that due recognition is given to good financial reporting practices in Australia. Moreover, sound processes are important to ensure that any contentious issues are resolved before the international accounting standards are presented to the Parliament for its consideration.¹⁵

Quality of measurement rules (the reliability of financial information)

- 3.27 A number of concerns have been expressed, in the media and to the Committee, as to whether the existing accounting standards are sufficiently robust to fulfil the role of ensuring the production of relevant and reliable financial reporting. For example, Professor Ian Ramsay was recently reported as saying:

We need to ask whether what is being disclosed and signed off on is meaningful. There is a real question about how much information is meaningful in terms of identifying major issues for companies.¹⁶

- 3.28 In their submission, Professors Dean, Clarke and Wolnizer suggested that financial statements prepared in accordance with the prescribed accounting rules will not disclose a company's financial performance or its financial position in any meaningful or serviceable way.¹⁷
- 3.29 In addition, Professor John Ryan contended in his submission that the proper application of the accounting standards does not guarantee consistent measurement of profit over time within a company nor for the same period amongst different companies.¹⁸
- 3.30 Mr Keith Alfredson, Chairman of the AASB, advised the Committee that the value at which assets and liabilities are recognised in financial statements is governed by the measurement rules contained in the accounting standards. He also indicated that, at the present time,

14 Ernst & Young, *Submission* No.57, pp.S530-531

15 Section 334 of the *Corporations Act 2001* makes accounting standards disallowable instruments for the purposes of section 46A of the *Acts Interpretation Act 1901*.

16 'Check the Change' *The Bulletin*, April 30, 2002, p.44

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

18 Professor John Ryan, *Submission* No. 9, p.S73

Australia's *Statements of Accounting Concepts* do not address the issue of measurement.¹⁹

- 3.31 On the other hand, the International Accounting Standards Board's *Framework for the Preparation and Presentation of Financial Statement* does include discussion on the bases of measuring the elements of financial statements. This framework, which is not inconsistent with the measurement practices contained in Australia's accounting standards, recognises that different measurement bases may need to be applied, depending on the circumstances, to produce relevant and reliable information in the financial statements. In summary, the measurement bases commonly used in accounting standards include the following:
- historical cost - assets are recorded at the amount of cash (or cash equivalents) paid to acquire the asset or at the fair value of the consideration, and liabilities are recorded at the amount of proceeds received for the obligation, or at the amounts of cash (or cash equivalents) expected to be paid to satisfy the liability in the normal course of business;
 - current cost - assets are carried at the amount of cash (or cash equivalents) that would have to be paid if that asset was acquired currently, and liabilities are carried at the amount of cash or cash equivalents that would be required to settle the obligation currently;
 - market or realisable value - assets are carried at the amount of cash (or cash equivalents) that could currently be obtained by selling the asset in an orderly disposal and liabilities are carried at the amount of cash (or cash equivalents) expected to be paid to satisfy the liabilities in the normal course of business; and
 - present value - assets are carried at the discounted value of the future net cash inflows that the item is expected to generate in the normal course of business, and liabilities are carried at the discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.
- 3.32 Mr Tom Ravlic told the Committee²⁰ that mandating one method of measurement was not appropriate, rather, it is more critical to have a framework in place to ensure that the most appropriate measurement rule, in the particular circumstances, is selected. In this way, the financial information produced is more likely to be reliable and relevant. He

19 Mr Keith Alfredson, *Correspondence*, 5 August 2002. The statements of accounting concepts form part of the conceptual framework, which is a principle-based model used by the AASB for the purpose of developing and evaluating accounting standards.

20 Mr Tom Ravlic, *Submission* No. 61, p.S553-564

contends that the measurement rules, per se, do not give rise to unreliable results, but rather, the inappropriate application of those rules results in unreliable and irrelevant financial results.

3.33 In addition to general concerns about the veracity of the accounting standards, a number of submissions pinpointed contentious issues and deficiencies in the recognition and measurement rules in the Australian accounting standards. For example, PricewaterhouseCoopers told the Committee:

...there are a number of gaps in Australian accounting standards which mean that they do not reflect world's best practice in several areas. Some significant issues are not dealt with by Australian standards and while others are addressed, the requirements of the Australian standards on these issues are not as robust as those in the relevant international standards.²¹

3.34 Amongst the areas of concern referred to the Committee were issues associated with the accounting for:

- leases;
- financial instruments, including derivatives;
- intangible assets;
- executives' and directors' remuneration;
- share options;
- investment properties;
- pensions or superannuation accounting; and
- accounting for the impairment of assets, in particular, the veracity of the *recoverable amount* test.

3.35 The Committee explored two of these issues in further detail during the inquiry. These issues, which are indicative of the shortcomings highlighted above, highlight the need for further and continuing work to tighten Australia's and the International accounting standards to ensure they remain relevant to the production of meaningful and reliable financial information.

Leases

3.36 Mr John Shanahan suggested to the Committee that accounting practices allowed under the Australian accounting standard on leasing (*AASB 1008*) may not, in all cases, accurately reflect the true economic position of the

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

leasing transaction, that is, that the leasee has acquired an asset and a corresponding liability.²² Further he told the Committee:

Clearly most leases are financing transactions...our accounting standard is so badly drafted (that) you can keep a lease off balance sheet. You can analyse the standard in such a way as to achieve your desired result.²³

3.37 PricewaterhouseCoopers told the Committee that these concerns should be addressed by proposals currently being considered by the International Accounting Standards Board (IASB) which should:

...revamp the rules on lease accounting so that all non-cancellable leases would be seen on balance sheets as liabilities and assets...²⁴

3.38 The ANAO suggests current concerns might be addressed if the stated purpose of *Accounting Standard AASB 1008 – Leasing* was expanded to say:

The purpose of this leasing standard is to prescribe the accounting for leasing transactions so that the use of leases as a means of off-balance sheet financing is to be restricted to a limited number of circumstances.²⁵

3.39 In conclusion, the Committee considers that the effectiveness of this standard should be reviewed to determine if it is sufficiently robust to ensure that the true economic outcome of all leasing transactions is reflected in financial reports.

Share-options

3.40 A number of respondents have expressed to the Committee their concerns as to the lack of an accounting standard dealing with share options, in particular the introduction of rules requiring the expensing of the value of these share options. For example, Ernst & Young told the Committee:

...legislation, perhaps through accounting standards, will assist in getting consistency in treatment (of equity-based compensation arrangements)...²⁶

3.41 In Australia at present, accounting standard *AASB 1017- Related Party Disclosures* requires the disclosure of certain information surrounding stock options in the notes to the accounts. Some enhancements to this level of disclosure is proposed in *Exposure Draft ED 106 – Director*,

22 Mr John Shanahan, *Submission* No.35, p.S325

23 Mr John Shanahan, *Transcript*, pa.164/165

24 Ms Jan McCahey, *Transcript*, pa.137

25 Australian National Audit Office, *Submission* No.27, p.S234

26 Mr Brian Long, *Transcript*, pa.91

Executive and Related Party Disclosures. Further, under the *Corporations Act 2001*, the Annual Directors' Report (which is not part of the annual financial report) must also disclose details of share options granted to the company's Directors.²⁷

3.42 The Institute of Chartered Accountants in Australia (ICAA) was recently reported as saying that there was a need to go beyond disclosure in the notes, to a requirement to expense the value of these share options in the determination of operating profit or loss. This is because incentive arrangements to managers made through share issue schemes are in essence, substitute payments for salaries and that by not doing so, a company can distort its reported financial performance.²⁸

3.43 In the United States, *Financial Accounting Statement 123 - Accounting for Stock-Based Compensation* establishes the financial accounting and reporting standards for stock-based employee compensation plans in the US. The standard indicates that it is preferable for the value of stock options to be recognised as an expense but allows companies to disclose the value in a footnote and therefore not in the determination of profit or loss. The Committee understands that virtually all companies chose the latter course of disclosure.²⁹

3.44 It was reported on 16 July, that the Coca-Cola company had announced it was changing its accounting treatment to expense the value of options granted to executives and employees. Mr Douglas N. Daft, the Chairman and Chief Executive was reported as saying:

...stock options are a form of employee compensation expense and the change in accounting ensures that our earnings will more clearly reflect economic reality...³⁰

3.45 It has recently been reported that the IASB plans to release an exposure draft on accounting for share based payments by September, which is expected to propose that stock options awarded to employees should be charged as an expense based on a fair value measurement method.

3.46 Mr Keith Alfredson, Chairman of the AASB, while expressing his support for the notion of expensing the value of share options, advised the Committee:

In Australia there is a serious impediment to charging share options in the profit and loss account.³¹

27 Section 300 of the *Corporations Act 2001*.

28 'Expensing share options urged by ICAA', available from <http://www.icaa.org.au/news>

29 It has been estimated that, as result of not expensing stock options, in aggregate US profits were overstated by nearly 20 per cent in 2000, *The Australian Financial Review*, 7 June 2002.

30 'Coke to Report Stock Options as an Expense', available from <http://www.nytimes.com>

- 3.47 He advised the Committee that he had raised this matter in writing with Senator the Hon. Helen Coonan, Minister for Revenue and Assistant Treasurer. In that letter he outlined the board's concern that the current taxation rules, in particular, those relating to the tainting of share capital, may present a serious impediment to the recognition of the value of share options.
- 3.48 The Committee supports the introduction of better accounting rules in relation to expensing share options. It notes, however, there are a number of practical issues that are likely to impact on both companies and individuals. These issues relate to taxation matters such as reduction in profits available for distribution, timing and recognition of income distribution and the treatment of dividends.
- 3.49 In conclusion, the Committee believes the value of share options should be recognised as an expense in the determination of operating profit or loss. However, the Committee understands that the introduction of changes to accounting rules may give rise to a number of practical issues that will need to be addressed.

Conclusion

- 3.50 As an integral part of the process of the adoption of the international accounting standards, the FRC and the AASB need to continue to address identified deficiencies in Australia's accounting standards, and where Australia's standards are of high quality or meet international best practice, ensure our standards are not diminished.
- 3.51 Rather than mandating any particular measurement rule or method, the Committee believes the more fundamental issue to be addressed, is the establishment of a clear framework governing the formulation of those rules. That framework must require that the method chosen best reflects, in the individual circumstances, the value of the assets and liabilities controlled by the company. In this regard, the most appropriate value will be the one, which objectively provides the most reliable and relevant result for the users of those financial statements.³²

31 Mr Keith Alfredson, *Transcript*, pa.252

32 As indicated at para 3.64, the terms 'reliable' and 'relevance' are key attributes of useful financial reporting. AASB 1001 (*Accounting Policies*) says that information is 'reliable' when users can depend on it to represent faithfully and without bias the transactions of a company and is 'relevant' when it assists users make decisions concerning their resources.

Recommendation 5

- 3.52 In the process of adopting the international accounting standards by January 1 2005, as announced by the FRC, the AASB should ensure that those contentious issues and deficiencies identified by the Committee are resolved as a matter of priority at the earliest possible date.

True and Fair View

- 3.53 In light of deficiencies in the accounting standards, it is of considerable concern to the Committee that it received conflicting interpretations of the application of true and fair view requirement in the *Corporations Act 2001*.

- 3.54 In regard to financial reporting, the *Corporations Act 2001* says:

- the financial report of a company, which is not a small proprietary company, must be prepared in accordance with the accounting standards (Section 296);
- the financial report must give a true and fair view of the financial position and performance of the company (Section 297);
- if the financial statements and notes prepared in accordance with accounting standards do not give a true and fair view, additional information must be included in the notes to give a true and fair view (Section 297); and
- Auditors are required to form an opinion as to whether the financial report is in accordance with the Act, including section 296 and section 297 (Section 308).

- 3.55 There was considerable disagreement among the respondents on the notion of true and fair in the *Corporations Act 2001*. Some submissions have contended that the primary obligation should be to report on compliance with accounting standards and that the true and fair view should only be given secondary consideration. The Australian Institute of Company Directors advised the Committee:

The predominant requirement (in the *Corporations Act*) is compliance with the rules, which are embraced, in accounting standards. There is a secondary requirement, which is true and fair view, which we believe is somewhat neglected because of the focus on the specific requirements, because they are so extensive.³³

3.56 They added:

...the true and fair view has tended to be only if you do not agree with the standard, so it is one-sided assessment instead of an all-embracing assessment.³⁴

3.57 On the other hand, some respondents have suggested that the primary obligation should be to report a true and fair view, rather than compliance with the accounting standards or that the *Corporations Act 2001* should contain what is commonly termed a true and fair override.

3.58 The Australian Auditing and Assurance Standards Board told the Committee that the *Corporations Act* already contains an override, in the sense that it requires the disclosure of extra information if there are concerns that compliance with accounting standards doesn't give a true and fair view.³⁵

3.59 Mr Mark Leibler told the Committee that he considered that much of the evidence offered to, and the discussions before the Committee suggested that people did not properly understand the notion of the true and fair requirement. He indicated he was concerned that there may be a fundamental gap between audit practice, in relation to the true and fair view and what the *Corporations Act* requires.

3.60 Mr Leibler contends that the obligations to comply with accounting standards and to provide a true and fair view of the financial position and financial performance are separate tests, both of which must be satisfied. He told the Committee that the provisions of the *Corporations Act* provide the best of both worlds because:

...comparability and objectivity are enhanced by the requirement to ensure that the body of the accounts comply with accounting standards. On the other hand, the integrity of corporate financial reporting is preserved by the requirement to include in the notes to the accounts such information which may be necessary to give a true and fair view of the company's financial position and performance.³⁶

3.61 It has been suggested to the Committee that complying with accounting standards will, in most cases, produce financial statements, which portray a true and fair view. For example, the Australian Securities and Investments Commission (ASIC) told the Committee that the application

34 Mr Stuart Grant, *Transcript*, pa.169

35 Mr William Edge, *Transcript*, pa.80

36 Mr Mark Leibler, *Submission* No.68, p.S631

of accounting standards, should provide an expectation that the financial reports are reliable and present a true and fair view.³⁷

3.62 ASIC subsequently advised the Committee that the basis on which accounting standards are developed (contained in Part 12 of the *ASIC Act*) is designed to ensure that proper adherence to the standards should, ordinarily result in financial statements that produce a true and fair view.³⁸

3.63 In addition, Mr Keith Alfredson, Chairman of the AASB expressed similar views when he told the Committee that the accounting standards:

...provide an essential underpinning to the *Corporations Act* requirement that accounts are required to give a true and fair view.³⁹

3.64 The following extracts provide some justification for that reasoning. *Statement of Accounting Concept SAC 3 - Qualitative Characteristics of Financial Information*⁴⁰, identifies relevance and reliability as the key attributes that financial information should possess in order for financial reports to be useful to the users of that information. SAC 3 requires that these two attributes should be central to the selection of accounting policies and in the exercise of judgement.

3.65 The principles in SAC 3 are reinforced throughout the accounting standards, most significantly in Australian Accounting Standard AASB 1001 '*Accounting Policies*'. This standard requires that, for the substance of transactions to be reported, accounting policies should be selected and applied so as to ensure the resultant financial information is both relevant and reliable. The standard goes on to say:

For financial information to satisfy both the relevance and reliability concepts, it is necessary that the substance rather than the form of a transaction or other events is reported (in situations) where the substance and form differ. Reporting the substance of a transaction or other event requires that the information reported reflects its economic effect.

Determining the substance of a transaction or other event involves identifying all of its aspects and implications, and considering the position of each of the parties to it, including their expectations and motivations for entering into the transaction or other event.

37 Mr Malcolm Rodgers, *Transcript*, pa.233

38 Australian Securities and Investments Commission, *Submission* No. 66, p.S600

39 Mr Keith Alfredson, *Transcript*, pa.247

40 SAC 3 is part of the conceptual framework mentioned at paragraph 3.30.

- 3.66 While compliance with accounting standards may provide a strong expectation that the financial statements present a true and fair view. The Committee considers it inappropriate to conclude that, by meeting the requirements of section 296 (compliance with accounting standards), directors can be automatically taken to have satisfied (wholly or partly) the requirements of section 297 (true and fair view). For example, the effects on profit measurement and on the statement of financial position arising from shortcomings in the accounting rules over leases and share options, illustrate how compliance with accounting standards may not result in financial reports which give a true and fair view.
- 3.67 The Committee considers that the subjectivity and exercise of judgement, necessarily involved in the interpretation of accounting standards, and in light of the deficiencies in those standards (as illustrated above) means that compliance with accounting standards cannot guarantee that overall, financial statements will reflect a true and fair position in all cases.
- 3.68 Accordingly, the Committee considers, that to satisfy the requirements of section 297, directors and auditors make a separate assessment as to whether, in light of the totality of the circumstances, the financial statements present a true and fair view.
- 3.69 In other words, the Committee considers that directors and auditors must separately consider whether the financial statements comply with accounting standards and, at the same time, provide a true and fair view.**
- 3.70 However, the Committee does not consider this is the end of the issue. More fundamentally, it needs to be explained how a true and fair assessment should be made. There is currently no guidance in the *Corporations Act 2001* as to how to complete the assessment and, in the Committee's opinion, this is a major weakness. It is considered the *Corporations Act* should better enunciate how to meet the true and fair test.
- 3.71 The Committee considers attempting to define the term, true and fair would be difficult and may have the effect of limiting its interpretation. As Mr Leibler told the Committee:
- There is no agreement or authoritative judicial pronouncement on the meaning of the expression 'true and fair view'. Accordingly, in any given case, there may be a range of acceptable 'true and fair views'.⁴¹
- 3.72 Professor R. G. Walker told the Committee that in 1983, a review of corporate reporting by the former National Companies and Securities

41 Mr Mark Leibler, *Submission* No. 68, p.S632

Commission developed the following definition of the requirement for financial statements to provide a true and fair view:

...a true and fair view...means a representation which affords those who might reasonably be expected to refer to those accounts...information which is relevant to the decisions which may be made by those persons in relation to the purchase, sale or other action in connection with their securities or interests.⁴²

3.73 The Committee considers a better approach would be to establish a series of principles or a framework against which the assessment can be made.

3.74 To this end, the Committee agrees with Mr Tom Ravlic who told the Committee that the truth and fairness of financial statements is largely dependent on the interpretation and application of the accounting standards. He said:

A sensible interpretation of accounting rules needs to be ensured before you even begin to address the proposition that accounts must be both in compliance with accounting standards and true and fair.⁴³

3.75 Given this and in light of ASIC's comments at paragraph 3.62, the Committee considers a reasonable interpretation of true and fair can be made by reference to Part 12 of the *ASIC Act*. This part, as mentioned at paragraph 3.6, contains the framework within which Australia's accounting standards are developed.

3.76 Particularly relevant is Section 224 of the *ASIC Act*, which sets out the objectives of that Part of the Act. Amongst these objectives is facilitating the development of accounting standards to produce financial information exhibiting, amongst other things, the following 'qualitative characteristics'⁴⁴:

- allowing users to make and evaluate decisions about allocating scarce resources;
- of relevance to assessing performance, financial position, financing and investment; and
- are reliable and understandable.

42 Professor R G Walker, *Submission* No 41, p.S384

43 Mr Tom Ravlic, *Submission* No. 61, p.S562

44 These qualitative characteristics are consistent with the qualitative characteristics expressed in SAC 3.

- 3.77 Also relevant in this regard is Section 228 of the *ASIC Act*, which requires accounting standards to be interpreted in a way that is consistent with the objectives in Section 224.

Conclusion

- 3.78 The Committee believes a separate assessment is required to consider whether the financial statements, prepared in accordance with the accounting standards, produce a result which is true and fair.
- 3.79 The Committee considers that to provide a means for greater clarity and consistency, the assessment of true and fair should be made in light of the essential characteristics of financial information contained in Section 224 (a) of the *ASIC Act*. Including a reference to this section in Section 297 of the *Corporations Act 2001* would have the added benefit of ensuring that a true and fair view outcome is considered in the interpretations of accounting standards.
- 3.80 In order to further reinforce the application of the true and fair assessment, the Committee considers a further relevant amendment to section 297 (true and fair view) would be to replace the current footnote which says:

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).

With the following words:

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.

Recommendation 6

- 3.81 That Section 297 of the *Corporations Act 2001* be amended as follows:
- add the requirements 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.

- delete the current 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).

- add the following new sub-sections:

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.

- 3.82 As discussed in Chapter 4, the auditor (separately from the directors) is required to form an opinion and report on whether the financial report presents a true and fair view. To further support the expansion of the true and fair view assessment, the Committee considers it appropriate that the *Corporations Act 2001* be amended to require auditors to also form an opinion and report on any additional disclosure made by directors pursuant to Section 297 (true and fair view).

Recommendation 7

- 3.83 It is recommended that Sections 307 and 308 of the *Corporations Act 2001* be amended to require the auditor to form an opinion and report on any additional disclosure made pursuant to Section 297.

Continuous disclosure

- 3.84 Shareholders and investors are demanding more frequent and informative reporting because it increases their ability to better understand the impact of the information being presented, and in particular the risks underlying that information.
- 3.85 The ASX administers a regime requiring the continuous disclosure of certain information (Chapter 3 of the ASX Listing Rules). Continuous

disclosure is defined in those Listing Rules as the timely provision of certain information to keep the market informed of events and developments as they occur.

- 3.86 Chapter 3 of the Listing Rules has general provisions which require the disclosure of any information (with certain exceptions) that a reasonable person would expect to have a material effect on the price or value of the entity's securities and specific provisions, which require the disclosure of information concerning a series of prescribed events.
- 3.87 In the United States, Mr Harvey Pitt, Chairman of the SEC, recently announced an intention to seek public comment on a proposal to significantly expand the list of items which require intra-period (or current) disclosure by public companies.⁴⁵
- 3.88 It was suggested to the Committee that the current continuous disclosure regime should be reviewed to ensure it captures timely and relevant information because a robust regime of continuous disclosure, supported by proportionate and timely sanctions, remains the best means of sustaining a well informed market.⁴⁶
- 3.89 In July the ASX, which considers the promotion of a culture of disclosure plays an important role in enhancing the quality of Australian companies, released a discussion paper titled '*Enhanced Disclosure*.'⁴⁷ This paper contained a series of proposed amendments to enhance the effectiveness of continuous disclosure listing rule (3.1). For example, amongst other things, the reforms are designed to:
- ...emphasise the responsibility of companies to make the disclosure necessary to avoid an uninformed market.
- 3.90 Ms Jillian Segal, Deputy Chair of ASIC recently suggested that many companies regard the continuous disclosure obligations as an impediment and that the corporate culture and attitudes towards disclosure and compliance need to be enhanced. She also indicated that a system of sanctions, including fines and penalties should be introduced for offences such as late or inadequate disclosure.⁴⁸
- 3.91 Mr Rodney Bennett also suggested to the Committee that in order to ensure the integrity of the market is maintained and to add discipline to the continuous disclosure process the regulators need to get tougher in

45 '*Accounting and Investor Protection Issues*', Testimony to US Senate Committee on Banking, Housing and Urban Affairs, March 2002

46 Australian Securities and Investments Commission, *Submission* No. 39, p.S375

47 available from <http://www.asx.com.au>

48 '*Current areas of concern to ASIC regarding corporate disclosure*', Jillian Segal, Deputy Chair, ASIC, 20 March 2002

relation to disclosure and financial reporting. He told the Committee this would encourage better compliance with the financial disclosure requirements and the lodgement of documents.⁴⁹

Conclusion

3.92 The continuous disclosure rules are a powerful tool to ensure the maintenance of a well-informed and therefore efficient market. The Committee supports the recent reforms proposed by the ASX to further improve the effectiveness of these rules and to clarify the disclosure obligations of companies.

Statutory oversight of financial reporting

3.93 Among the measures designed to enhance the integrity of corporate financial reporting has been the recent public announcements by the corporate regulators in Australia and the United States that they are adopting more robust mechanisms to monitor compliance with the financial reporting rules.

3.94 In Australia, Mr David Knott, the Chairman of ASIC announced on 12 July, that the Commission was developing a more rigorous accounting surveillance practice to apply to selected listed companies for the financial year ended 30 June 2002. The primary focus of the project will be to review compliance with a series of nominated accounting standards.⁵⁰

3.95 In the US, the SEC has proposed to significantly expand its review of financial and non-financial disclosures to focus on disclosure that is important to understanding the companies financial position and results and which, at least at face value, seems to conflict with accounting standards or be materially deficient in explanation or clarity.⁵¹

Conclusion

3.96 The Committee considers that a program of financial reporting surveillance, with appropriate levels of sanctions and penalties, is critical in the enforcement of accounting standards and compliance with the *Corporations Act 2001* and is pleased with ASIC's stated intention to increase its level of activity in the area of financial surveillance.

49 Mr Rodney Bennett, *Submission* Nos. 4 and 24, pp.S47 & S199

50 ASIC Media Release, 12 July 2002

51 Testimony by Mr Harvey Pitt, Chairman of the SEC, concerning *The Corporate and Auditing Accountability, Responsibility and Transparency Act*, before the US House of Representatives Committee on Financial Services, March 2002

3.97 The Committee hopes that this increase in the level of activity is not a unique event, and suggests ASIC develop a systematic process that occurs each year and in which every listed company has an equal chance of being selected for review. As well as ensuring compliance with the accounting standards, it is considered ASIC might also evaluate whether the information contained in the financial statements is sufficient to provide a true and fair view.

Further reforms in the area of disclosure

3.98 Many submissions to the Committee have highlighted the need for further 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. By way of example, the following is a selection of the views expressed to the Committee in regards to financial reporting reforms:

- The Institute of Chartered Accountants in Australia told the Committee:
...we see that the added benefit can be made by adding disclosures to the type of accounting that is being applied.⁵²
- The Auditor-General for Victoria suggested the financial reporting framework would be enhanced by a requirement for management to provide a written representation as to the effectiveness of the company's internal control structure and also provide a commentary on the main factors affecting the financial performance, financial position and financing and investing activities of a company.⁵³
- Ernst & Young advised that there was a need for a greater level of transparency in the reporting of accounting policies and suggested companies could be required to report upon:
...the quality of accounting practices where judgement has been exercised.⁵⁴
- PricewaterhouseCoopers told the Committee:
The Audit Committee and potentially the board...should comment in the annual report on the adequacy of their corporate risk management policies and procedures.⁵⁵

52 Mr Neil Faulkner, *Transcript*, pa.33

53 Auditor General Victoria, *Submission* No 25, p.S212

54 Mr Brian Long, *Transcript*, pa.95

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

- CPA Australia proposed there ought to be increased disclosure regarding matters involving estimates, assumptions or judgement.⁵⁶
- Mr John Hammond suggested to the Committee that listed companies should be required to report against a series of key performance ratios.⁵⁷

3.99 The following is a summary of recent activity in the areas in which the Committee considers reform is required in Australia.

Internal controls

3.100 The reliability of financial information is heavily dependent on the maintenance of a system of internal controls. The internal control system can be defined as:

The policies, processes, tasks, behaviours ...designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- effectiveness and efficiency of operations;
- reliability of financial reporting; and
- compliance with applicable laws and regulations.⁵⁸

3.101 There have been numerous calls for greater levels of public reporting on internal control arrangements. In Australia, for example, a research study commissioned by the accounting professional bodies in 1993, recommended, amongst other things, that management should be required to report on the effectiveness of their company's internal control processes.⁵⁹

3.102 More recently, in 1997 the Organisation for Economic Cooperation and Development recommended, amongst other things, that management should be encouraged to make statements concerning their internal control mechanisms,⁶⁰ and in 1999, the Institute of Chartered Accountants in England & Wales, provided guidance on appropriate levels of disclosure about processes to assess the effectiveness of the risk management practices and internal control systems.⁶¹

56 Mr Brian Blood, *Transcript*, pa.21

57 Mr John Hammond, *Submission*, No.19, p.S143

58 '*Report of the Committee of Sponsoring Organisations of the Treadway Commission*', Committee of Sponsoring Organisations (COSO), 1992

59 ICCA, *Exhibit* No. 5,

60 '*Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*', Organisations for Economic Cooperation and Development, 1997, <http://www.oecd.org>.

61 '*Internal Control – Guidance for Directors on the Combined Code*', Institute of Chartered Accountants in England and Wales, September 1999

- 3.103 A key part of an effective internal control system is a risk management process. The Institute of Chartered Accountants in England & Wales has recently suggested that companies should provide more disclosure on their major business risks and detail those strategies in place to deal with them. In a paper titled '*Working for better risk reporting*'⁶² the Institute claims that investors need a proper understanding of the risks affecting the business and that there would be benefits to companies disclosing more information on their risk management processes, including whether there is an on-going process for identifying, evaluating and managing the significant risks faced by the company; and what action the company takes to manage those risks.
- 3.104 Section 404 of the *Public Company Accounting Reform and Investor Protection Act, 2002* in the US requires management to provide an assessment of the effectiveness of their internal control structure in the annual report. The same section also requires the auditor to attest to, and report on that assessment.

Management Discussion and Analysis

- 3.105 Another area where there have been calls for greater disclosure is in relation to information to assist users in the assessment of a company's performance. This is commonly termed as *Management Discussion and Analysis* disclosure.
- 3.106 For example, the 'Expectation Gap' research study mentioned previously, recommended companies provide in their annual reports an outline of the entity's objectives and strategic plans and comment on the impact of material changes in accounting policies.
- 3.107 In their submission, CPA Australia told the committee that:
- ...listed public companies and other disclosing entities be required to prepare a *Management Discussion and Analysis* report to be included in the financial report...⁶³
- 3.108 Professor Ramsay was recently reported as saying:
- Perhaps management or directors should be required to address the three or four most critical accounting issues and make some prominent disclosure in the annual report – in other words, discuss whether the financial statements would be different if other assumptions were made.⁶⁴

62 Available from <http://www.icaew.co.uk/index.cfm>.

63 CPA Australia, *Submission* No. 33, p.S298

64 '*Running an audit of the Auditors*', Sydney Morning Herald, 20 April 2002

- 3.109 Mr Harvey Pitt, the Chairman of the US Securities and Exchange Commission recently highlighted that informative and timely disclosure by public companies was one of the key areas for reform. In particular, he proposed a series of reviews of the SEC's disclosure rules to require companies to provide the following information in their annual reports:
- critical accounting policies – require companies to identify and provide more precise disclosures about the application of their most critical accounting policies, including an analysis of the sensitivity of estimates derived from those policies;
 - off-balance sheet obligations and contingencies – disclosure of transactions and the nature of relationships with unconsolidated entities, including description of their business purpose and economic substances and disclosure of the factors impacting on off-balance-sheet financing arrangements; and
 - trend information – inclusion of information about trends and forward-looking information.⁶⁵

Conclusion

- 3.110 There was clear evidence provided to the Committee 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. As discussed in other sections of this report, the traditional model of corporate reporting and auditing is no longer tenable as shareholders and other stakeholders seek more comprehensive information. Stakeholders are also demanding assurances on aspects of a company's performance outside the narrow scope of the financial reports. In recognition of these changes, the Committee considers that enhancements to the level of disclosure, particularly in the areas identified (although this list is by no means exhaustive), is critical to improving the usefulness of financial reporting.
- 3.111 This recommendation is made in the context of Recommendation 3, which calls for corporate governance standards in the *Corporations Act 2001* and Recommendation 10, relating to an expansion in the scope of the audit. It also picks up the Committee's view, in paragraph 2.41, that information on performance management or appraisal arrangements for directors and executives should be disclosed.

65 'Testimony Concerning Accounting and Investor Protection Issues', Harvey Pitt, Chairman SEC, United States Senate Committee on Banking, Housing and Urban Affairs

Recommendation 8

3.112 It is recommended that the Australian Stock Exchange amend the Listing Rules to require additional reporting by companies in the following areas:

- **commentary on internal control systems, including risk management processes;**
- **management discussion and analysis;**
- **commentary on the main factors affecting reported financial performance and financial position;**
- **commentary on the key judgements made in the application of accounting policies;**
- **results for a set of key performance indicators pointing to the health of the organisation; and**
- **details of directors' and executives' performance appraisal or management systems .**

THE AUDITING FRAMEWORK

Introduction

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

What is an audit

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

¹ PricewaterhouseCoopers, *Exhibit* No. 11

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

Auditing and professional (ethical) standards

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

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

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

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

The qualities of an audit

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

3 Mr Graeme Macmillan, *Exhibit No.2*

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

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

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

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

Audit independence

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

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

Ramsay Report

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

Independence of the Public Sector auditor

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

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

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

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

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

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

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

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

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

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

Conclusion

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

Recommendation 9

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

- **the following statement**

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

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

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

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

The provision of non-audit services

- 4.30 The extent of the risk to an auditor's independence posed by the simultaneous provision of audit and non-audit services to the same client, has generated a wide range of views amongst respondents to this inquiry and amongst other commentators generally.
- 4.31 A number of submissions have asserted that there is no evidence to support claims that the provision of both audit and non-audit services by the same firm compromises auditor independence by creating conflicts of interest. In his report, Professor Ramsay highlighted the arguments for and against the provision of non-audit service by auditors to their audit clients and concluded:
- The mixed results found in the literature makes it difficult to draw firm conclusions...regarding the provision of non-audit services to audit clients...Audit independence studies examined during the course of this review have reached different conclusions concerning whether the provision of non-audit services impairs audit independence.¹³
- 4.32 Several submissions have contended that the provision of both audit and non-audit services allows a firm to develop valuable knowledge of a company's operations that assists in the audit process. For example, the AuASB told the Committee:
- The greater the knowledge the auditor has of an entity, the more improved the quality of the audit will be. We would encourage doing other work to improve the quality of the audit.¹⁴
- 4.33 As indicated in Chapter 2 of this report, in May 2002, the professional accountancy bodies in Australia formally adopted *Professional Statement F1 – Professional Independence* as part of the professional code of conduct. This statement establishes a framework for the identification and evaluation of threats to audit independence, including through the provision of non-audit services and requires the application of safeguards to eliminate or reduce those threats.
- 4.34 In particular, the Statement provides guidance on the risks and possible actions to address those risks for a range of non-audit services and also recognises a number of activities that create risks that are so significant that the external auditor should not provide them, including:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

You need some process that identifies where this joint supply is a threat and where, in other instances, it is not a threat but is actually beneficial.²¹
- 4.42 Consistent with the view expressed in chapter 2 regarding the influence of US reforms, the Committee believes that the provision of non-audit services by Australian audit firms to the operations of US companies in Australia, or to the Australian subsidiaries of US companies, may potentially be affected by the recent prohibition of a range of non-audit services in the US.
- 4.43 Recently a number of corporations have publicly announced their reaction to the risks inherent in the provision of non-audit services by their auditors.²² The following recent examples are considered to be indicative of the fact that the risks are being recognised and of the practices being employed in response.
- 4.44 Westpac publicly stated it was their policy not to use their external auditor to provide non-audit work if their independence would be impaired, or seen to be impaired. Further, Westpac's Audit and Compliance committee is responsible for monitoring and assessing the independence of their external auditors and approving all non-audit engagements by the external auditors.²³
- 4.45 BHP Billiton told the Committee that it excludes its auditors from performing certain types of non-audit work, including work that has the
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19 Australian Institute of Company Directors, *Submission* No. 26, p.S220

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

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

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

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

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

The auditors' tenure

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

24 Correspondence from Karen Wood, Company Secretary, BHP Billiton, 24 July 2002

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

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

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

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

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

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

- 4.56 To support the contention that mandatory rotation of audit firms would be detrimental to the quality of audits, Deloitte Touche Tohmatsu provided the Committee with a copy of research recently completed in the United States which, based on its analysis, concluded there was:
- ...significantly more audit reporting failures in the earlier years of the auditor/client relationship than when auditors had served these clients for longer tenures. The results do not support the arguments of those who propose mandatory auditor rotation...³⁰
- 4.57 Professional Statement F1 highlights the risks of long associations of senior personnel with the same clients and recommends safeguards be put in place to reduce these risks, and in particular, for audits of listed companies, recommends the rotation of the lead engagement partner after periods no longer than seven years.
- 4.58 KPMG told the Committee that the major audit firms already have policies of partner rotation in place and said that by rotating the partner rather than the whole firm:
- ...you achieve the dual objective of keeping some understanding of the corporate history between the auditor and the business being audited, as well as providing a fresh set of eyes...³¹
- 4.59 Taking this issue further, the Committee received evidence which indicated the rotation of the lead partner was likely, on its own, to be insufficient to address the risks involved. For example, Mr J W Cameron and Mr R J Sendt, the Auditors-General for Victoria and NSW respectively, suggested to the Committee that rotation policies should also be applied to the detailed operational level of the audit process and include, for example, the audit manager.³²
- 4.60 The Australian Chamber of Commerce and Industry (ACCI) suggested rotation of the entire audit team, including managers and functional staff was also preferable.³³ Subsequently the ACCI explained the reason for this view when it told the Committee:

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

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

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

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

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

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

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

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

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

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

Recent overseas experience

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

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

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

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

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

Risk management

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

Conclusion

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

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

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

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

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

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

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

Expectation gap

- 4.72 As indicated in chapter 2 there is a strong sense that much of the public disquiet regarding apparent audit failures in cases of corporate collapses stems from an 'audit expectation gap'.
- 4.73 The expectation gap might be described as the misalignment between what auditors understand should, or can be delivered and what stakeholders, including the general public, expect auditors to deliver. For example, Mr John Hammond told the Committee:
- I believe the public at large has the perception that an external auditor should be attesting to the accuracy of the financial statements of a company...it would be an impossible task for an external auditor or a team of external auditors to examine every record and transaction entered into by a company during the year.⁴²
- 4.74 The Auditing and Assurance Standards Board (AuASB) told the Committee:
- Too often, more is expected of the auditor than can be reasonably be expected...too often, misunderstanding and unrealistic expectations of the auditor's role within the corporate reporting framework occurs.⁴³
- 4.75 Australian Auditing Standard AUS 202 explains that audits are not, and cannot be designed to provide an absolute level of assurance given the existence of several inherent limitations, including:

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

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

- need for judgement regarding the accumulation of evidence, the timing and extent of audit procedure and in the drawing of conclusions;
- use of testing procedures;
- the existence of collusion or intentional misrepresentations to conceal irregularities from the auditor;
- limitations on the operation of any internal control structures⁴⁴; and
- the existence of factors and circumstances which affect the nature of the available evidence and go to the balance between persuasive rather than conclusive evidence.

4.76 CPA Australia told the Committee that the expectation gap has three components:

- performance gap – audit performance falling below the required professional and legal standards;
- standards gap – although audit performance meets required standards, it still falls short of ‘reasonable’ expectations; and
- unreasonable expectations gap – auditing not meeting all of the expectations placed on it.⁴⁵

4.77 The Committee agrees with CPA Australia when it suggested in its submission that the profession, government, regulators and business all have an obligation to address the first two areas. Reforms in these areas will help ensure the delivery of effective audits, which reflect the reasonable expectations of stakeholders and also comply with relevant standards to improve the confidence of investors in the capital market.

4.78 The third component is more problematic and requires a mix of responses including, continued reinforcement with the investing public about what the audit process can reasonably be expected to deliver. Continued monitoring of public expectations is also important so that public confidence in the audit process is not further weakened.

Enhancing the scope of audits

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Continuous auditing

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

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

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

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

Performance audits

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

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

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

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

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

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

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

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

4.100 Similarly, Professor Ramsay told the Committee:

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

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

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

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

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

The audit report

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

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

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

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

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

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

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

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

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

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

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

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

Conclusion

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

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

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

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

Recommendation 10

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

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

Recommendation 11

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

Auditors' liability

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

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

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

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

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

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

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

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

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

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

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

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

Table 3 Risk reduction

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

Source Deloitte Touche Tohmatsu

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

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

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

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

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

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

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

4.134 KPMG explained to the Committee:

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

Conclusion

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

Recommendation 12

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

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

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

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

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

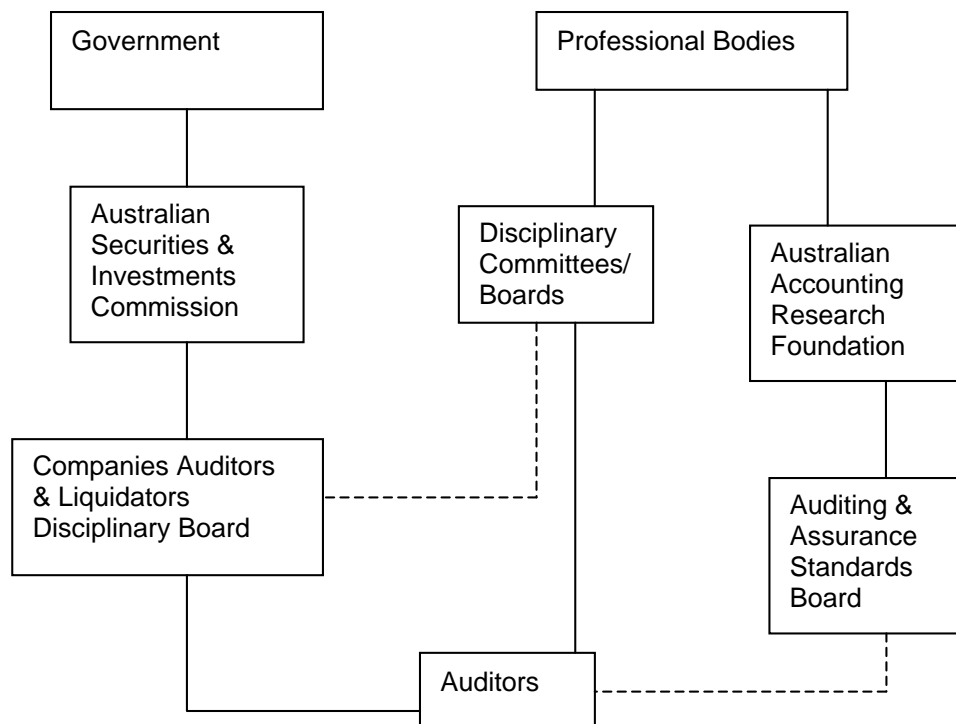
Oversight of the accounting profession

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

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

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

Figure 1 Oversight arrangements in Australia for Registered Company Auditors



Source JCPAA

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

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

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

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

4.144 Similarly, in its submission, the ACCA said:

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

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

CPA Australia

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

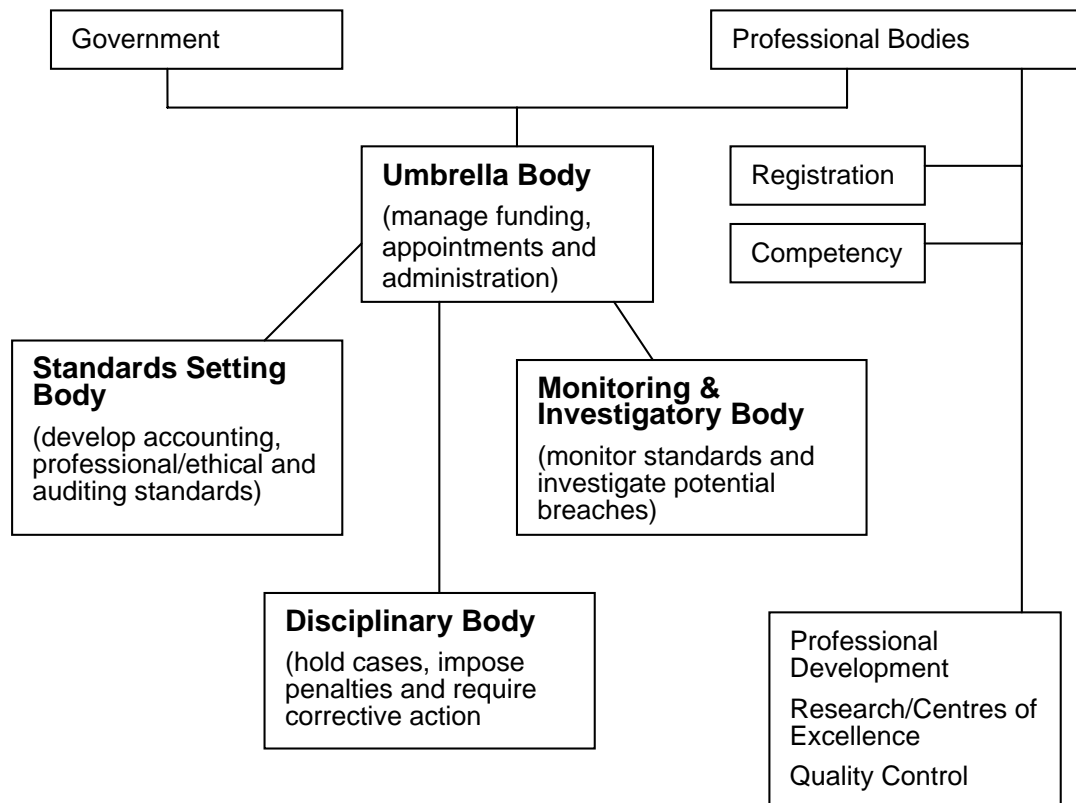
- functions are required to support an efficient reporting framework;
- degree to which these functions should be integrated or separated; and
- the strengths of regulation by the government and the profession can be best incorporated.

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

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

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

Figure 2 CPA Australia's model



Source CPA Australia

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

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

Institute of Chartered Accountants in Australia

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

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

Audit firms

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

United Kingdom

4.151 Reforms overseas are far more expansive than those proposed to the Committee, for example, the United Kingdom has recently introduced a system of non-statutory, independent regulation of the accounting profession, commonly known as the Accounting Foundation. More details on this model, which involves the creation of five new bodies, can be found at pages 65 and 66 of Professor Ramsay's report.

4.152 In its submission, the ACCA described the UK model as:

...demonstrably more effective and independent than the widely used and much criticised system of peer review. The overall aims of the new system are to ensure that the (accounting) profession operates in the public interest and to secure public confidence in the impartiality and effectiveness of the accountancy bodies' systems of regulation and discipline....⁸⁹

United States

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

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

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

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

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

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

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

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

Conclusion

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

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

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

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

Development of auditing standards

- 4.159 An issue integral to reform to the auditing framework is the question of the process for the development of the auditing standards. As indicated at paragraph 4.9, the auditing standards provide guidance and prescribe the minimum standards for the conduct of audit services.

- 4.160 Several submissions have canvassed issues associated with the development of auditing standards. For example, Mr Graeme Macmillan told the Committee:

...the auditing framework suffers from total confusion of responsibilities and roles mostly caused by the government not adopting the same model for auditing as they have for accounting standards.⁹¹

- 4.161 CPA Australia suggested there were efficiency benefits and synergies to be gained by bringing the auditing and accounting standards setting processes together (as described in their model shown at Figure 2) and told the Committee:

...you cannot keep totally separate issues of accounting and audit – they clearly feed off each other.⁹²

- 4.162 Professor Keith Houghton suggested to the Committee that the AuASB should be brought under the auspices of the FRC, similar to the arrangement for the AASB.⁹³ In addition, the NIA, while noting that there may be little to gain by developing the accounting and auditing standards together, told the Committee:

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

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

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

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

- 4.163 The AuASB when asked for their views on these suggestions indicated they doubted there were significant benefits from harmonising the accounting and auditing standards setting processes, although it acknowledged there may be some benefits in administration and in the research process.⁹⁵
- 4.164 A number of submissions have highlighted to the Committee the fact that, in contrast to the accounting standards, there is no support for the auditing standards in legislation and have suggested that the Corporations Law should contain the requirement that compliance with the auditing standards is mandatory.
- 4.165 For example, ASIC told the Committee the auditing standards should have the force of law and they (ASIC) should have the power to police them.⁹⁶ John Shanahan told the Committee:

I believe that similar legislative authority should be given to Australian Auditing Standards...this would mean that non-compliance with the auditing standards would become an offence – which may make issues easier to prove in CALDB proceedings – and that the process of developing and drafting auditing standards would become more rigorous.⁹⁷

- 4.166 However, there is not total agreement that this would be an effective reform. CPA Australia advised the Committee there were only two other countries that have enshrined auditing standards in legislation⁹⁸ and Mr Tom Ravlic told the Committee that any reform to give the auditing standards legislative backing would be wasteful and cosmetic saying:

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

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

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

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

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

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

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

Conclusion

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

Disciplinary processes

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

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

- 4.172 Professor Ramsay explained to the Committee that:

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

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

101 Mr David Knott, *Transcript*, e206

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

- 4.173 The professional bodies have acknowledged this criticism. As indicated above, CPA Australia proposes a new body to replace the current disciplinary processes. Further, the ICAA, in its submission acknowledged its support for the role of the CALDB and for the recommendations in the Ramsay report for strengthening it. They also advised that, in recognition of its responsibility to ensure its policies and processes reflect the public interest and the division of responsibility between the statutory process and the profession, it has arranged a review of its disciplinary processes by an external consultant.¹⁰³
- 4.174 ASIC told the Committee that it had referred 251 matters to the CALDB in the ten years to 30 June 2001 ¹⁰⁴ (this figure was subsequently revised to 249).¹⁰⁵ This total was comprised of:
- 167 matters relating to a failure to lodge a triennial statement;
 - 45 matters relating to a failure to adequately perform duties; and
 - 37 matters relating to working while disqualified.
- 4.175 A summary of the results of these matters is shown in Table 4.

Table 4 Outcome of disciplinary matters provided by ASIC to CALDB

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

Source ASIC ¹⁰⁶

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

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

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

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

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

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

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

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

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

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

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

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

Conclusion

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

Whistleblowers

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

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

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

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

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

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

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

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

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

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

Conclusion

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

Recommendation 13

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

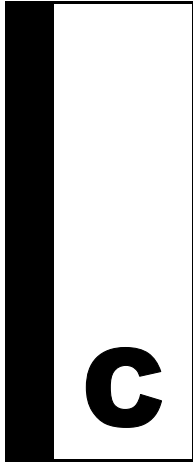
**Bob Charles MP
Chairman
August 2002**



Appendix B—List of Exhibits

1. Mr Tom Ravlic
'Submission to Ramsay Report'
2. Mr Graeme Macmillan, Managing Director, Ciptanet International Pty Ltd
'Submission on the Ramsay Report'
3. Mr Steve Gibbs, Chief Executive Officer, PSS and CSS Boards of Trustees
'Position Paper – Audit governance'
4. Dr Shann Turnbull
'Submission into the Collapse of HIH Insurance LTD and Media Article'
5. Mr Geoff Brayshaw, President, The Institute of Chartered Accountants in Australia
'Documents from the ICAA'
6. Mr Brian Schwarz, Chief Executive Officer, Ernst & Young
'Corporate Information'
7. Mr Greg Larsen, Chief Executive, CPA Australia
'Financial Reporting Framework – The Way Forward'
8. Mr Rob Elliott, Policy Manager/Company Secretary/Legal Counsel,
Australian Institute of Company Directors
'Best Practice Guide'
9. Mr Michael Coleman, National Managing Partner, Assurance and Advisory,
KPMG
'Response to the Ramsay Report & Policy Material'
10. Mr Reece Agland, General Counsel, National Institute of Accountants
'Submissions on the Ramsay Report'
11. Mr Tony Harrington, Chief Executive Officer, PricewaterhouseCoopers
'Accounting for the World & Maintaining Confidence in Australian Capital Markets'

12. Professor Keith Houghton
'On the Trail of Better Auditing'
13. Australian Institute of Company Directors
'50 Matters to be Considered Before Signing a Company's Financial Statements'
14. The Institute of Internal Auditors
'Position of Internal Auditing and Corporate Governance Processes'
15. Ernst & Young
'Internal Risk Management'
16. Mr Terry Benfold, Partner, Pitcher Partners
'Adoption of International Accounting Standards by 2005'



Appendix C – Witnesses appearing at public hearings

Canberra, Friday 21 June 2002

CPA Australia

Mr Brian Blood, President

Mr Arthur Dixon, Director, Accounting and Audit

The Institute of Chartered Accountants in Australia

Mr Stephen Harrison, Chief Executive Officer

Mr Neil Faulkner, Board Member

Mr Keith Reilly, Director, Technical Adviser

Australian Stock Exchange

Mr Richard Humphry, Managing Director and Chief Executive Officer

Ms Christine Jones, General Counsel and Company Secretary

Mr Colin Scully, Chief Operating Officer

Australian National Audit Office

Mr Ian McPhee, Deputy Auditor-General

Mr Michael Watson, Group Executive Director

Companies Auditors and Liquidators Disciplinary Board

Mr Paul Coleman, Registrar

Individual

Professor Keith Houghton

Canberra, Friday 28 June 2002

Australian Chamber of Commerce and Industry

Mr Brent Davis, Trade and International Affairs

Auditing and Assurance Standards Board

Mr William Edge, Chairman

Dr Christine Jubb, Acting Executive Director

Ernst & Young

Mr Brian Long, Chairman, Board of Partners

Ms Ruth Picker, Business Unit Director, National Audit and Accounting Services

Pitcher Partners

Ms Dianne Azoor-Hughes, Technical Director

Association of Chartered Certified Accountants

Mr Richard Francis, Head of Australian and New Zealand Centre

National Institute of Accountants

Mr Reece Agland, General Counsel

Mr Gavan Ord, Technical Policy Manager

Individuals

Professor Graeme Dean

Emeritus Professor Frank Clarke

Professor Peter Wolnizer

Sydney, Monday 8 July 2002

PricewaterhouseCoopers

Mr Anthony Harrington, Chief Executive

Ms Jan McCahey, Partner, Professional Standards

Australian Consumers' Association

Ms Catherine Wolthuizen, Senior Policy Officer

Australian Institute of Company Directors

Mr Rob Elliot, National Policy Manager

Mr Gavin Campbell, Member, Accounting and Financial Advisory Committee

Mr Stuart Grant, Member, Accounting and Financial Advisory Committee

Deloitte Touche Tohmatsu

Mr Robert Wylie, Partner

Mr Nick Hullah, Partner, Professional Standards

Institute of Internal Auditors

Mr William Middleton, National President

Mr Christopher McRostie, Executive Director

Mr Robert McDonald, Senior Vice-Chair, International Board (IIA)

KPMG

Mr Lindsay Maxsted, Chief Executive Officer

Mr Michael Coleman, National Managing Partner, Risk and Regulation

Individual

Mr John Shanahan

Melbourne, Friday 26 July 2002

Australian Securities and Investments Commission

Mr Malcolm Rodgers, Executive Director, Policy and Markets Regulation

Mr Douglas Niven, Deputy Chief Accountant

Australian Accounting Standards Board

Mr Keith Alfredson, Chairman

Ciptanet International

Mr Graeme Macmillian, Managing Director

Individuals

Professor Ian Ramsay

Professor Keith Houghton

Mr Mark Leibler