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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.*

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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: Pasminco 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;

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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 case[10] 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.

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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, therefor, 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.

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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.

17 Ernst & Young, *Exhibit* No. 15

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.

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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]

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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]

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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: • 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: • 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.

Source *JCPAA*

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/commttee/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.