

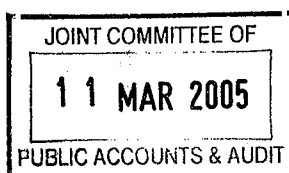
**Supplied with Compliments
by the Senate Table Office**

GOVERNMENT RESPONSE

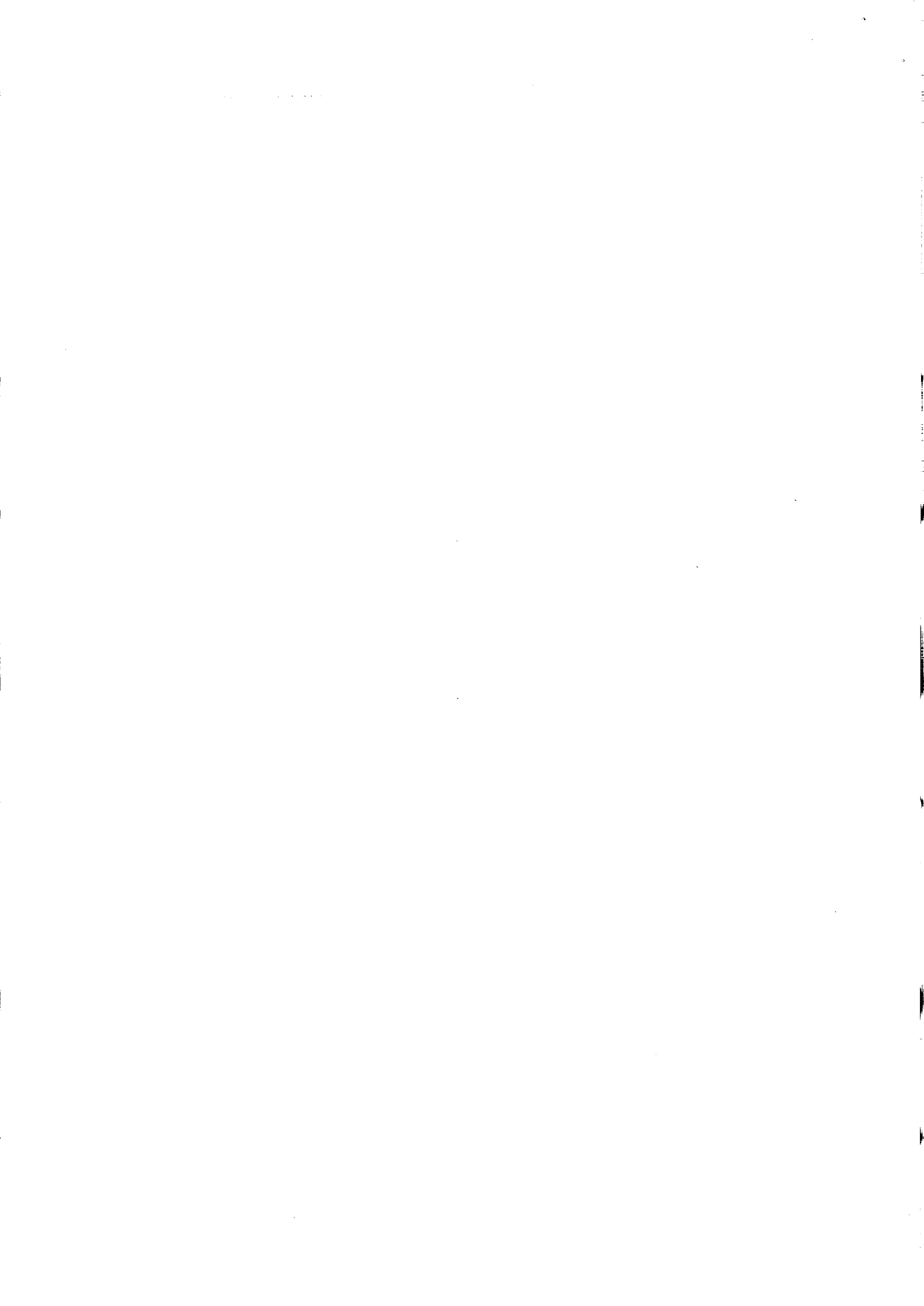
TO

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

***REVIEW OF INDEPENDENT AUDITING BY REGISTERED COMPANY
AUDITORS***



MARCH 2005



GOVERNMENT RESPONSE TO THE JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT – REPORT 391 – REVIEW OF INDEPENDENT AUDITING BY REGISTERED COMPANY AUDITORS

BACKGROUND

On 4 April 2002, the Joint Committee of Public Accounts and Audit (JCPAA) resolved to conduct a review of independent auditing by registered company auditors. The Committee tabled its report in the Parliament on 18 September 2002.

The Government notes that many of the recommendations contained in the JCPAA report traverse proposals contained in the ninth discussion paper of the Corporate Law Economic Reform Program *Corporate Disclosure: strengthening the financial reporting framework* (CLERP 9). The Government consulted widely on the CLERP 9 policy proposals receiving over 60 submissions from interested parties. The submissions were taken into consideration throughout the drafting of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003* (the Bill). The Bill was released for consultation in October 2003 and approximately 50 submissions were received and taken into account while finalising the Bill. The Bill passed through the Parliament on 25 June 2004.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* received the Royal Assent on 30 June 2004 (the CLERP Act). Most of the provisions of the CLERP Act commenced on 1 July 2004. Schedule 3 to the CLERP Act (containing the proportionate liability reforms) commenced by Proclamation on 26 July 2004. The regulations relating to the CLERP Act commenced on 9 July 2004.

During the development of the CLERP 9 policy paper and the CLERP Act, the Government considered the recommendations of the JCPAA. A number of the recommendations have been taken up in the CLERP Act including Chief Executive Officer and Chief Financial Officer (CEO/CFO) sign off of financial reports, true and fair view requirements, a general requirement for auditor independence as well as proportionate liability and incorporation of auditors. The Government considered that some of the recommendations could be better implemented through other channels such as the Australian Stock Exchange (ASX) listing rules and by the Australian Accounting Standards Board (AASB).

The Government's response to the Committee's recommendations is as follows.

CORPORATE GOVERNANCE

Committee Recommendation 1

That the *Corporations Act 2001* (the Corporations Act) 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 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 the Corporations Act.

Response

The CLERP Act amends the Corporations Act to require CEO's/CFO's to certify to the directors of a listed entity that the annual financial statements are in accordance with the Corporations Act and accounting standards and that the statements present a true and fair view.

Committee Recommendation 2

That the Corporations Act 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.

Response

The Government supports strengthening the role of audit committees but does not agree that audit committees should be mandated in the Corporations Act. The Government's CLERP 9 policy paper proposed audit committees be mandated only for the top 500 listed companies, not all listed companies. This requirement was implemented through ASX listing rules.

The Government notes that more than 85 per cent of listed companies already have audit committees. At the smaller end of the market, flexibility is required as not all companies will be large enough to warrant the establishment of an audit committee.

ASX Listing Rule 12.7 provides that an entity which was included in the S&P All Ordinaries Index (the top 500 listed companies by market capitalisation) at the beginning of its financial year must have an audit committee during that year. If the entity was in the top 300 of that Index at the beginning of its financial year, it must also comply with the ASX *Principles of Good Corporate Governance and Best Practice Recommendations* (ASX Principles) on the composition, operation and responsibility of audit committees. Under the ASX Principles, the audit committee should:

- have at least three members;
- consist of only non-executive directors;
- have a majority of independent directors; and
- have an independent chairperson, who is not the chairperson of the board.

The role of the audit committee is to review the integrity of the company's financial reporting and oversee the independence of the external auditors.

Companies outside the top 300 who do not have an audit committee in the form set out in the best practice recommendations should disclose how their alternative approach assures the integrity of the financial statements of the company and the independence of the external auditor. This approach recognises the significant range in size and diversity of Australian listed companies and the difficulties smaller companies may face in applying all the ASX principles.

The Government supports the specification of standards for audit committees — including in relation to their charter, structure, membership, and the nature and scope of their duties and responsibilities — but as a matter of best practice rather than legislative requirement. In this way the standards respond flexibly to changing market circumstances.

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, as either pursuant to or mirroring section 334.

Response

Not accepted. The Government supports a co-regulatory approach and considers that some matters are better left to industry bodies to pursue. Best practice corporate governance standards have been developed by the ASX's Corporate Governance Council and ASX listing rules continue to require listed companies to report on their performance against these standards. These include recommendations that systems be developed to identify, assess, monitor and manage risk. The standards encourage companies to have an internal audit function.

The Government does not favour giving corporate governance standards legislative backing. The co-regulatory approach will allow standards to respond flexibly to changing market circumstances and require disclosure to the market, with the market able to apply sanctions where appropriate.

The Government also notes that the Financial Reporting Council (the FRC) is not a standard setting body but rather oversees the standard setting process relating to accounting and auditing standards.

Committee Recommendation 4

That section 1288 of the Corporations Act be amended to incorporate the following principles:

- require audit firms undertaking assurance audits of publicly listed companies to submit a report to 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.

Response

Not accepted. The Government notes, however, that the CLERP Act has introduced a comprehensive regime on auditor independence which incorporates the recommendations of the Ramsay Report (*Independence of Australian Company Auditors*) and that many of the proposals in the Ramsay Report have been endorsed by the JCPAA.

The CLERP Act has expanded the role of the FRC to monitor the effectiveness of auditor independence requirements in Australia. One of the FRC's specific auditor independence functions in the CLERP Act is to monitor and assess the nature and overall adequacy of the systems and processes used by audit firms to ensure compliance with auditor independence requirements. The

FRC is required to report annually to the Minister on its audit independence functions, including findings and conclusions that it reached in performing those functions and any action taken.

The CLERP Act includes a requirement that auditors make an annual declaration to the directors of an audit client that they have not contravened the auditor independence requirements of the Corporations Act or of any applicable code of professional conduct in relation to the audit or review.

ASIC is responsible for surveillance, investigation and enforcement of the responsibilities of companies and auditors in relation to financial reporting, including the enforcement of auditor independence requirements and Australian accounting and auditing standards.

FINANCIAL REPORTING

Committee Recommendation 5

In the process of adopting the international accounting standards by 1 January, 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.

Response

The AASB made Australian equivalents to International Financial Reporting Standards (IFRS) on 15 July 2004. The development of IFRS is based on the *Framework for the Preparation and Presentation of Financial Statements* (Framework). The Framework, which is issued by the International Accounting Standards Board, underlies the principles based approach to drafting taken in the development of IFRS.

The 40 international equivalent standards made by the AASB include standards specifically addressing:

- 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.

Committee Recommendation 6

That section 297 of the Corporations Act 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.

Response

The Government considered that the JCPAA's recommendations in relation to the true and fair requirements have merit and they have been implemented in the CLERP Act. The CLERP Act provides that, where compliance with accounting standards would result in the financial statements and notes together not giving a true and fair view, the directors report should set out:

- the directors' reasons why compliance with accounting standards would not result in the financial statements giving a true and fair view; and
- the additional information and explanations needed to give a true and fair view.

Sections 298 (annual directors' report) and 306 (half-year directors' report) of the Corporations Act have been amended by the CLERP Act for the purpose of giving effect to the JCPAA's recommendations.

Where an entity's directors consider that compliance with the accounting standards would result in an entity's financial statements not giving a true and fair view, and they include additional information in the notes to the financial statements in accordance with paragraphs 295(3)(c) (financial year) or 303(3)(c) (half-year) in order to give such a view, the directors will be required to include in their directors' report:

- their reasons for forming the view that the additional information was needed for the purpose of giving a true and fair view in accordance with sections 297 or 305; and
- the location of the additional information in the financial report.

The Government has not accepted the JCPAA recommendation that the directors, in undertaking the assessment of a true and fair view, must consider the objectives contained in section 224(a) of the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). Section 224(a) of the ASIC Act relates to the framework for the development of accounting and auditing standards in Australia and has no relevance to the assessment required to be made by directors in relation to the true and fair view.

Committee Recommendation 7

It is recommended that sections 307 and 308 of the Corporations Act be amended to require the auditor to form an opinion and report on any additional disclosures made pursuant to section 297.

Response

The CLERP 9 Act adopts this recommendation.

Committee Recommendation 8

It is recommended that the ASX 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 judgments 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

Response

The Government considers that many of these issues are best addressed by the ASX in the first instance or, where appropriate, the accounting standards.

The Government notes however that the CLERP Act requires listed companies to include in their directors' report an operating and financial review.

THE AUDITING FRAMEWORK

Committee Recommendation 9

That section 324 of the Corporations Act 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.

Response

Agree in principle. The CLERP Act puts in place a general requirement for auditor independence, breach of which is a criminal offence.

The CLERP Act also requires an auditor to provide to the directors of the audit client an annual declaration that there have been no contraventions of the auditor independence requirements of the Corporations Act or of any applicable code of professional conduct in relation to the audit or review.

Committee Recommendation 10

That the following sections of the Corporations Act 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.

Response

Not accepted. As indicated in the response to recommendation 3, the Government does not support giving legislative backing to corporate governance standards. Corporate governance standards contain a range of matters outside of auditors' expertise. Auditors are not necessarily equipped to form opinions and report on compliance with such standards. The proposal could add significantly to audit costs.

The Corporations Act already contains provisions requiring the audit report to describe any defect or irregularity in the financial report, and any shortcoming relating to whether the auditor has been given all information, explanation and assistance necessary for the conduct of the audit, or relating to the keeping of financial and other records by the company. The Corporations Act also requires the auditor to notify ASIC of a suspected contravention of the Act if it cannot be adequately dealt with in the audit report or by bringing it to the attention of the directors. The CLERP Act expands the matters which auditors must report to ASIC to include any attempt to influence, coerce, manipulate or mislead persons involved in the conduct of the audit.

Committee Recommendation 11

That ASIC explore the costs 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.

Response

Not accepted. While performance audits perform a valuable role within the public sector, difficult questions arise in relation to their application in the private sector. The Government believes that the market should determine the need for private sector performance audits, including in response to any demand from shareholders.

Performance audits are designed to evaluate outcomes and the achievement of objectives. Evidence presented to the JCPAA on this issue was mixed. For example, the ASX advised the JCPAA 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 for companies could not be readily developed, measured

and kept current. Professor Ramsay told the JCPAA that in certain circumstances it may enhance confidence in information to have the auditor do performance audits, but he did not think that they should be mandated.

The Government believes that audit assurance of the requirements of the Corporations Act and ASX listing rules relating to continuous disclosure is unnecessary. The enforcement capacities of ASIC and ASX in this regard are considered appropriate, taking into account the Government's strengthening of the penalty regime for continuous disclosure contraventions in the CLERP Act, including a power for ASIC to issue infringement notices, and to encourage the ASX and other market operators to provide listed entities with education and guidance to promote compliance. The Government considers that the continuous disclosure regime has its own checks and balances.

Committee 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 proportionate liability, so as to provide a more equitable basis for allocating damages;
- amend the Corporations Act 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.

Response

Proportionate liability: Agree. The CLERP Act has introduced a proportionate liability regime in respect of claims for economic loss or damage to property arising from misleading or deceptive conduct. The introduction of proportionate liability is one of the key measures on which all governments in Australia have agreed in order to improve the availability and affordability of professional indemnity insurance.

Incorporation of audit firms: Agree. The CLERP Act has established a framework for incorporation of audit firms, which was not previously allowed under the Corporations Act. Allowing auditors to incorporate addresses the concerns relating to the professional liability of auditors arising from the joint and several liability of partners of a firm. Incorporation also provides accounting firms with an additional option in terms of how they structure their operations.

Capping of professional liability: The Government has agreed to support State and Territory professional standards legislation based on the NSW legislation. The *Treasury Legislation Amendment (Professional Standards) Act 2004* amends the ASIC Act, the Corporations Act and the *Trade Practices Act 1974* to give effect to the Australian Government's commitment to support the State and Territory professional standards legislation. This Act was passed by the Parliament on 25 June 2004 and received the Royal Assent on 13 July 2004.

Committee Recommendation 13

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

Response

Agree. The CLERP Act contains provisions to amend the Corporations Act to provide qualified privilege and protection against retaliation in employment for any company employee reporting internally within a company or to ASIC, in good faith and on reasonable grounds, a suspected breach of the Corporations Act and associated legislation.

