COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Reference: Review of independent auditing

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CANBERRA

BY AUTHORITY OF THE PARLIAMENT

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Friday, 21 June 2002

Members: Mr Charles *(Chairman)*, Ms Plibersek *(Vice-Chairman)*, Senators Colbeck, Crowley, Hogg, Murray, Scullion and Watson and Mr Ciobo, Mr Cobb, Mr Georgiou, Ms Grierson, Mr Griffin, Ms C.F. King, Mr P.E. King and Mr Somlyay

Senators and members in attendance: Senators Murray and Watson and Mr Ciobo, Mr Charles and Ms Grierson

Terms of reference for the inquiry:

With the spate of recent noteworthy corporate collapses both within Australia and overseas, the Joint Committee on 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.

WITNESSES

Committee met at 10.03 a.m.

CHAIRMAN—Good morning. The Joint Committee of Public Accounts and Audit will now commence taking evidence as provided for by the Public Accounts and Audit Committee Act 1951 for its review of independent auditing by registered company auditors. I welcome everyone here this morning and I welcome those who are viewing proceedings via the Internet.

This is the first in a series of public hearings that will examine regulatory bodies, accounting and auditing professional bodies, the Commonwealth Auditor and an eminent academic in the field of accounting and auditing. Further hearings will be held in Canberra and Sydney in the ensuing weeks.

The committee has received a wide range of submissions from all sections of the accounting and audit industry and profession. The three key issues are audit independence, deficiencies in corporate governance and existing auditing and accounting standards. These will need to be considered in order to arrive at a coordinated and practical set of solutions.

The committee will begin by hearing from Professor Keith Houghton. Professor Houghton has a distinguished history in the field of accounting and auditing research and practice. We will explore with Professor Houghton ways in which greater accountability, competence and independence can be encouraged and the roles that government, the profession and company management may play in improving the financial reporting system.

The committee will then take evidence from two peak professional bodies, CPA Australia and the Institute of Chartered Accountants in Australia. The committee is interested in exploring issues such as the adequacy of Australia's accounting and auditing standards and whether self-regulation has been effective in properly protecting shareholders. In addition, CPA Australia has introduced into the debate an alternative model for the Australian financial reporting framework which the committee is interested in exploring further.

The committee will then take evidence from the Australian Stock Exchange. We are interested in discussing improvements to the ASX listing rules and how to improve monitoring and enforcement of those rules. The Australian National Audit Office will also be appearing. The committee is interested in any public sector processes and practices that may be adopted by the private sector to enhance transparency and accountability.

The hearing concludes with the Companies Auditors and Liquidators Disciplinary Board. The CALDB is responsible for determining whether a person should continue to be registered as an auditor or a liquidator. We are interested in exploring ways to streamline to give more teeth to the disciplinary process which is currently split between the CALDB and the professions.

Before swearing in the witnesses, I will refer members of the media who may be present at this hearing to a committee statement about the broadcasting of proceedings. In particular, I draw the media's attention to the need to fairly and accurately report the proceedings of the committee. Copies of the statement are available from the secretariat staff present at the meeting here today.

HOUGHTON, Professor Keith Allen (Private capacity)

CHAIRMAN—I welcome Professor Keith Houghton to today's hearing. Thank you for your submissions, for your extraneous article *On the trail of better auditing,* and for coming to talk to us today. Do you have a brief opening statement that you would like to make?

Prof. Houghton—Perhaps just a few words, if I may. My starting position is that we recognise that financial reports are an important part of the market for information. Financial reports of companies and other organisations are the representations of the management of those companies and the boards of directors, where appropriate.

Auditing plays a role because it provides validation of the financial reports; that is, the representations of management. An audit brings considerable value to the validation process if it is both competent and independent of management; that is to say, an audit is not worthy if it is not competently executed with the appropriate technologies and appropriate expertise. Similarly, it is not of value if it is not independent of management; that is to say, you need both competent and independent simultaneously for an audit to be of value; otherwise you may as well just have the representations of management in the original financial reports. Therefore, the issue of auditor independence is at the core of the value of auditing.

CHAIRMAN—Professor, you have written—I will read it for the benefit of everyone who is here listening because it is quite fascinating—as follows:

> Imagine a large listed company called XYZ and an audit market with only four large suppliers with the scale to undertake that audit.

that is not hard to imagine—

> Audit firm A is the incumbent auditor 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? The rational answer is that none of them would.

Could you explore that a bit with us?

Prof. Houghton—I think it is reasonably self-explanatory that, if you have competent suppliers of non-audit services that are doing a good job and are deriving profits from them, why would they rationally give up that relationship and that work to undertake an audit which might be less lucrative and might, in that sort of regulatory environment, be terminated at a prescribed period anyway?

CHAIRMAN—A number of players have said, I think I can reliably report, that company management does not generally consider audit to be a profit-making function. They have audit, I would hope, to satisfy the directors that the accounts are in order, but, perhaps more importantly, because it is a regulatory requirement.

Prof. Houghton—I think there is a problem if audit is just considered a compliance good, because then management will rationally try to drive down the cost because they do not see any value adding through an audit. I, amongst many, take a very different view that audit can be extraordinarily value adding. I will give a simple example. You have two companies—I will not call them XYZ on this occasion, just A and B—that have the same asset structure, the same incomes, the same cash flows, the same risk profiles—in all respects they are economically the same. Let us say in this hypothetical example that company A is audited by a competent and independent auditor and company B is not. Which would have the higher share price? The answer is company A every time, because the audit brings a validation process; it lowers information risk to the market. In that example, the audit brings integrity to the numbers that are produced in the market, it brings validation and, therefore, lowers information risk and, as a consequence, share price should be traded up in an economically rational market. That is the value of audit.

I am not sure that all boards of directors necessarily see that in that light. Since the independent spate has caught on—interestingly after I returned from the University of Texas—I have had the opportunity of talking with directors. In a sense when you make that statement, for some of them it is a revelation that there really is a very significant potential value adding component to audit. It should not just be a cost that is driven down and minimised because, in doing so, you might actually damage the value adding capacities.

CHAIRMAN—If every company saw that as a given and adopted it in practice, then we would unlikely be sitting here having these discussions today. I have had it said to me that, when Arthur Andersen was alive, when he put his name on the bottom of an audit he put his whole life on the line because that was who he was and he was demonstrating his character. He absolutely stood by his word and it was his bond. But that does not seem to be true anymore. Is it not true that we need some mechanism or mechanisms to replace that attitude within the profession?

Prof. Houghton—I think it is fair to say that there will be many members of the audit profession that would still hold that view that their whole reputation rests with their signature on an audit report. It is probably reasonable to say that not 100 per cent of all auditors fall into that category. The vast majority, I think, are honourable, diligent, hardworking individuals. However, there are some aspects of the system that are less than perfect and provide incentives that maybe do not drive to the sort of results that Arthur Andersen had. For example, it is the case that in Australia over approximately the last decade the amount of auditor provided non-audit services to listed companies has approximately doubled, whereas audit fees have barely moved in that same decade period.

There are incentives to try to increase revenue base because the fees from audit services have been relatively modest in growth. So there are economic incentives and profit incentives to do other things; hence, we do have the tension that exists.

CHAIRMAN—I would like to ask one more question and then I will let my colleagues loose. You said in this occasional piece:

> We need a creative and probably very unconventional solution that ensures high quality competence and independence in the audit process.

I read those words the night before last and I had this very unconventional thought. The situation we have today is that:

> The Corporations Act requires that registered company auditors be natural persons. That is, an audit cannot be performed by an incorporated body. This means that auditors cannot avail themselves of the protection of limited liability.

And on it goes. I am making you think on your feet which perhaps is not fair. You can always come back to us later if you would like to explore this in more detail. What might be the ramifications if we changed the Corporations Act to require that auditors of publicly listed companies be publicly listed companies?

Prof. Houghton—I am sure I cannot think of all the ramifications of that, but it is certainly an unconventional approach anyway. I think one of the issues that has arisen in the market is that the scale of audit firms has had to grow because the scale of the auditees has grown dramatically. So gone are the days where one individual could competently oversee the whole audit of a very large company. The historical background of why we had a natural person responsible has probably changed dramatically simply because of scale. That would suggest that maybe we should look at some alternative structure to do it. So I think there is that immediate attraction.

There is an advantage in the appropriate, if you like, unit of analysis—I use that term in research quite a lot—the appropriate level which you consider might better be a company because, frankly, the market is divided up not so much by individuals but by brand names and, as a consequence, it is the brand names that carry forward in the market. You look as if you want to respond.

CHAIRMAN—It seems to me that the market might act to judge competence. And that is what you said. You said that we need quality competence and independence in the audit process. We could somehow try to regulate independence—I doubt we will ever get there. We could try, but we cannot regulate competence. Wouldn't the market act to, in a sense, regulate competence because it would judge the value of audit firms by the quality of their audits and then we could also impose an external audit to audit the auditor.

Prof. Houghton—There are two things there. Yes, I think that market forces drive competence. I think there is a floor where regulators would regulate the floor of a level of competence. I am convinced that market processes have driven up competence in auditing in all sorts of interesting ways over the last few years. It has been in the last few years that we have seen industry specialisation. Particular firms have devoted enormous amounts of money in developing expertise, for example, in auditing insurance companies, which is a highly complex area, or banks. They have devoted enormous resources to drive up competence and that is because there are competitive processes out there which mean that level of competence is observable by the market and they react to that level of competence by buying sometimes at higher prices, sometimes just more of that level of competence.

We see a very competitive market in the audit process for competence and that has really driven up all sorts of interesting structures in competence—new technologies, new specialisations and what have you. We also see enormous amounts of competitiveness in respect of price. We see very competitive markets in respect of those. Until very recently we have seen

no observable competition for independence. The market cannot observe what quality control processes exist within the firms for independence and therein lies a major difficulty.

There may be very good quality control processes within these large and small accounting firms for controlling independence, but who gets to observe it? I think because you cannot observe it, you cannot compete with it.

Senator MURRAY—Professor, do you think that the investing public, both in the unsophisticated and the sophisticated sense, are more at risk of fraud and misleading conduct by management and directors than they were historically?

Prof. Houghton—I may be older than I once was, but I am not so old as to remember a large part of corporate history in Australia. The only observation I can make is essentially anecdotal. I once published a study which looked at corporate behaviour back in the 1950s and 1960s. At the end of the day there was a particularly controversial takeover that I analysed, in an environment where there really was not much regulation. At the end of the day I concluded that the directors and their wish to retain high reputation and their integrity, which are saleable on the market, drove what was a very honourable outcome without regulation, or with very little regulation.

That little anecdote suggests to me that honour was a very big part of business practice in the fifties. I still think it is today, but there are very substantial pressures and incentives. It is a different system than it was in the fifties, perhaps.

Senator MURRAY—I appreciate your reply because my own reading indicates to me that there has been no empirical research to evaluate the cultural values or behaviour over time, and yet there is a feeling that culture, values and behaviour have changed and that the investing public, both in the unsophisticated and the sophisticated sense, are at more risk of being misled by those who have fraud in mind.

If that was so, you would have to look at the origins of that change. It has been put to me and to other members of the committee that there are problems other than auditing to look to—I know we will be addressing those in our inquiry—such as accounting standards and their interpretation, principally as a result of a short termism; in other words, management and directors wish to realise their own value out of the company in the short term and neglect the long-term value which is what the shareholders body would be dedicated to.

Prof. Houghton—That is referred to in the research literature as a time horizon problem. The time horizon for management is different from the time horizon for the long-term investor. That difference between the two does give rise to different incentives for the different stakeholders.

Senator MURRAY—What I am going to do is to test from you the early proposition I have, which is that you cannot deal with the auditor issue in isolation of perhaps more prescriptive requirements over directors and management in isolation of accounting standards. The three are required to be addressed, not just the one area.

Prof. Houghton—I share your view in part, and in some part I am troubled about it. There are certainly interlinkages between the various areas you talk about. I for one am not a particu-

larly strong critic; indeed I am a supporter of the accounting standard setting process in Australia. I think it has much in favour of it. I am one of the people that believes the processes it is going through and even its current status is in very good shape. I have seen a lot of countries that are in much worse shape than Australia's accounting standard setting. I am something of a fan of the process that we currently have now. While it is not perfect, if you allow due processes, you do need time to debate things and argue things before you settle on something. We have a pretty good system, by and large.

What worries me is that if the scope of any inquiry becomes very large it may become so large as to become unmanageable and nothing very powerful gets put forward. So my concern about having a very wide scope with lots of interlinkages is that you may not be able to push forward a lot across the whole range.

My view is that in respect of the audit market there is significant evidence, largely anecdotal, that there are threats to independence out there that perhaps were not there 10 years ago. The mechanisms for dealing with those threats need to be dealt with reasonably quickly because the threats are there now and they are having an impact. So I think that in a sense while they interlink you can also define auditor independence and the threats that are pressing on it and at least have some specific recommendations and conclusions in respect of them.

Senator MURRAY—I would share your concern if it was to be too wide. I would also indicate that, from my experience in other committees and with the profession, I have been impressed by the people who are dedicated to the issue of accounting standards in Australia. But really the accounting standards issue, as I read it, revolves around two fairly narrow issues but with very wide ramifications, as is often the case. The one is the issue of return to management and directors—principally the options issue—and how the returns to those people are viewed. As you are aware, there are reports in America, for instance, that 13 per cent of the profit level reported has been overstated as a result of that. The other issue is perhaps a requirement specifically for auditors to determine a long-term prospective view resulting from the financial statements that are before them now. An analogy would be the coalition government's introduction of the budget's Intergenerational Report trying to be far more prospective than has been the case. That is an attempt in both cases, firstly, to ascertain real value and, secondly, to ascertain long-term value. That is where I would lay the interest in accounting standards. Would you comment on that? Do you have a view on that?

Prof. Houghton—In part it comes back to this issue of the time horizon I was talking about earlier. It also comes back to the issue of the right incentive structure. If you do 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 shareholders' interest is, in theory, an appropriate way of proceeding, but the actual practical implementation of that is extraordinarily hard. There is also information asymmetry. Management know an awful lot about the company that other stakeholders—the risk takers, the shareholders—do not know. That information asymmetry can sometimes be used not for the benefit of the shareholders.

So I think there are two things: the incentives problem, and that is linked to the time horizon issue, and information asymmetry. Both of those things suggest that the market is imperfect and that there is not a matching of the incentives for the management and the incentives for shareholders.

Senator MURRAY—If I turn to the second of the three fields I am dealing with, again there is a view being put to me that changes to the Corporations Law in the prescriptive sense would be relatively narrow. For instance, requirements that management and directors have to report certain categories of concerns or beliefs that they may have about impropriety—almost a whistleblowing decision. The confidentiality contracts which may or may not exist either under common law or are actually written down are overridden. People must say if they fear that a foreign exchange currency transaction has been manipulated for improper purposes and so on.

That is one side of it. On the other side is a requirement that companies lose their privacy—I suppose that is the best way to outline it—that regulators would have far more right of access and entry, and that the auditor would have far more right of access and entry than currently applies.

Prof. Houghton—The problem I have with those sorts of approaches is that they tend to be ex post—after the horse has bolted. The economic damage is done; people have already suffered socially and/or economically. As a general premise I prefer to set the incentives right and have more real-time transparency in the ongoing processes so that the problems never occur, rather than having a highly regulatory regime to try to deal with them. The regulatory process, while it is attractive in some ways, has the effect of not fixing the problem ex ante. It may give rise to disclosure of commercially sensitive information which might be very damaging to the firm—and hence all the stakeholders of the firm, including shareholders and employees, et cetera. So I would be troubled by a high regulatory regime that would do that. I would prefer to see some structure where the problem is dealt with in real time and by a transparent process so that the economic damage is never done in the first place.

Senator WATSON—I must declare a professional interest in this matter, being a member of a number of bodies whose representatives are sitting around this table today representing their interests. Many of those same people believe that I provide too many wish lists for regulators, whether it be in audit, tax or superannuation, so I suppose there is a balance there.

Professor, I am more encouraged by your oral presentation on the issue of professional competence than from your written submissions. I think your suggestion, for example, of testing competence could be taken, prima facie, as demeaning the acknowledged very high professional and academic standards which are required within the auditing profession. I am pushing for changes in the legislation to require any financial executive or company secretary of a listed company to be a member of a recognised professional body. This concept of regular testing of competencies and independence that you have suggested really worries me because when you look at the other professions—surgeons are a typical example—do we see that sort of regular testing? You indicate the marketplace—and I agree with that notion—but the written submission about that worries me because I think it would tend, in the public eye, to demean the high standing of the profession. Perhaps no other profession requires such continuous training, attendance at seminars and inputs et cetera, as does the accountancy profession. That is the first question I put to you because I think you will acknowledge that Australian standards around the world are very high.

Prof. Houghton—I am not quite sure what words you are reading. Clearly the interpretation you have made is not one that I intended.

Senator WATSON—I appreciate that. What about the words in brackets 'testing of competency'?

Prof. Houghton—The interpretation you have made is not the interpretation I intended when I dictated the words. I think I have already illustrated that the market forces accountants and auditors to continue to be extremely competent. My contract at the University of Melbourne allows me to engage in other activity as well as being a practising accountant and I see my fair share of problematic audit cases. Some of these issues involve competency but they are a tiny number compared to all of the audits that go on in the world.

In years past, I spent part of my sabbatical working within some of the large firms, and I am often extraordinarily impressed with the level of competence. I do not have a major problem with competency; the market takes care of that. You can have a very modest level of competency if you want a minimal sort of audit or you can have an extraordinarily high level of competency. You can have specialist competency; you can have combinations of different competencies.

One of the issues that worries me is in respect of the banning of joint supply with audit and non-audit services. Here I would like to draw the committee's attention to the fact that there is a little slippage with some of the terminology. There are audit services and non-audit services. But really the issue is not just audit services; it is auditor provided non-audit services. It is where they are joint. Non-audit services supplied by a large accounting firm or any accounting firm are not a problem. It is only when it is auditor provided where there is this matching of both audit and non-audit services.

Some of the competency may be lost if you ban joint supply. Imagine, for example, that you were auditing an insurance company. Realistically you are going to need actuarial expertise. If you have that in house and on tap, that is going to increase the competency and quality of an audit. If you are banned from the joint supply process, it is probable that you will not have enough work to keep that particular actuarial expertise within house, and therefore that competency will be lost.

Senator WATSON—So the real question concerns how far you take this notion of joint supply. I put it to you that, just in recent months, the big four in particular, certainly in Australia, have moved extraordinarily quickly in divesting their consulting arms from their audit arms. I put it to you that, if you were conducting an audit and there had been significant changes in tax law, it would be perfectly natural for the auditor to be asked questions on the impact of tax law on leverage type products or something like that. I put it to you that to take this joint supply to that level would be quite unnecessary. I can understand your consulting arms being quite separate, and they have moved in that area. But I cannot see anything wrong with inquiries and getting advice about taxation issues associated with the business from the auditor, and I hope that you are not taking it quite as far as that.

Prof. Houghton—I share your view.

Senator WATSON—That is why I am looking for some guidelines as to how far you take this notion of joint supply.

Prof. Houghton—I share your view. I am not one of the advocates of banning joint supply. I think it is a very crude attempt at trying to 'fix' the independence problem. Joint supply brings with it all sorts of efficiencies. Let us say you have a particular control problem. The auditor who already knows the firm can get in, identify the problem, deal with it, make a recommendation and move on quickly. So it is done more efficiently in terms of time and money. That is an example of where joint supply works really well.

The notion of banning joint supply would actually produce an economically inefficient result in many cases. There are other instances where the auditor may have a tax division that recommends or pushes extraordinarily aggressive tax planning. That is starting to get problematic. The difficulty is that there is no 'one size fits all' solution to this. There are instances where joint supply is problematic; there are instances where joint supply is economically rational and efficient and benefits the whole economy. The difficulty is that high regulation solutions just try to force a 'one size fits all' policy. That is why I think it needs to be dealt with case by case. 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. That is why the high regulation solution—whether it is banning it or saying that it is 25 per cent or some other arbitrary number—just will not work. It will not be economically rational and it will not be efficient; it will be disadvantageous to Australian companies—not to the audit firms per se, but to Australian companies. The model I have recommended is one that gets away from the 'one size fits all' approach.

Senator WATSON—My third question goes slightly outside the scope of your submission. I have concern that too high a focus has been put on this question of audit independence and that we have not looked further upstream to the issues which made life very difficult for so many auditors—connivance, fraud et cetera. The issue that I have been pursuing very strongly with the Australian National Audit Office is the issue of having very high standards and recognition for the role of internal audit. If you have a very strong internal audit, it does facilitate both the independence and the level of achievement, competency or outcomes of the external audit. I would like some comments from you. Should we be separating the responsibility or accountability of the internal audit function, which is essentially, at the present time, responsible to management?

Prof. Houghton—The external auditor can choose to use internal audit materials or not use them, as the case may be. It is really in the hands of the external auditor to make a judgment as to whether that internal audit is helpful or unhelpful to them. The internal audit is a useful mechanism for management, to whatever extent they want. Again, they are in the position of knowing the appropriate level of internal audit they want and what particular aspects they want dealt with in the internal audit. Then the external audit can use it or not use it as the case may be. There are some circumstances where the audit technology is such that making an adjustment because of internal outcomes might be inefficient because it changes the standardised audit program. It really is a situation where it depends on the case. In some instances it will be useful; in others it will not.

Senator WATSON—That has not been very helpful in respect of what I want to ask. What I am really looking for is whether we should be seeking to have the internal auditor primarily responsible not to the CEO but, say, to the audit committee. Or should there be some change in those sorts of lines of responsibility of internal audit? I believe that would also strengthen the

role and function of your audit committee. That is why I am trying to take the function a bit away from external audit and look at some of the issues as to how we can improve the whole universe.

Prof. Houghton—The whole regime.

Senator WATSON—Yes.

Prof. Houghton—It is not something that I have given any thought to. It could well be that you might restructure internal audits to report to the audit committee. Certainly the strengthening of the audit committee process should be on the agenda. As to whether that would be a component part, I have not thought at any length about that. One of the possible outcomes of that, though, is that management will devise some other process: they will call it something different but they will still get what we have traditionally called an internal audit done and reported to them. If management really want an internal audit, they will get an internal audit whether it is called that or not and whether or not the internal audit is then reported to the audit committee. I just think people will make the most rational decision they can. But I think strengthening the role and responsibility of the audit committee to take the primary role in respect of interacting with the external auditor is very much on the agenda. The strength of the relationship between the audit committee and the external auditor is one of the key issues.

Senator WATSON—But you have to equip that audit committee with some mechanisms to get the real inside information. I just see the audit committee as one very valuable channel of information.

Prof. Houghton—I agree.

Senator WATSON—Thank you.

Ms GRIERSON—Just expanding on your idea of independence boards, no-one seems to come up with a performance board. We have talked about compliance audits not being enough and therefore value adding to performance, but we really do not talk about performance audits that check the alignment between the corporate purpose and the corporate outcomes and activities.

Prof. Houghton—The performance audits, as described, are more the realm of the public sector than the private sector.

Ms GRIERSON—Is that good enough?

Prof. Houghton—The incentives and the structures within which the two sorts of organisations operate are different.

Ms GRIERSON—Do you suggest accountability is different for both and, if so, should it be different or should they have the same sort of accountability?

Prof. Houghton—As I have said, I think there are different sorts of accountability. Public sector organisations have many more different sorts of stakeholders than private sector organisations. We have a market economy where we have a group of private sector organisations that are essentially profit oriented, that have risk capital contributors called shareholders and that have management. Those processes do have pretty clear-cut performance indicators and commercial outcomes if things do not go right. It is called the share price going down. You do not have the same direct market processes in the public sector. As a consequence, you need to build in very elaborate, sophisticated, subtle performance type processes, because you do not have a share price. It is hard to do. As a director of Audit Victoria for a while, I know just how hard it is to craft relevant performance indicators and then set out measures that are valid measures of the performance you want to get. It is a very hard process. Because the incentives and the structures are different between public and private sectors, the notion of performance audits does differ quite dramatically.

Ms GRIERSON—The independence board that you have proposed in your submission involves a company establishing their own. So an audit firm—

Prof. Houghton—An audit firm, not a company?

Ms GRIERSON—Yes. What checks and balances would you place on that?

Prof. Houghton—I will explain the essential thrust of what you need, in my view. We have quality control processes for competence, we have market pressures to increase competence and we have market pressures over pricing of audits, but largely the independence decisions are made within the audit firms. The processes are very often very good but they are not transparent. One key difficulty is that there are instances with some firms where an independence decision will be taken by someone who will commercially benefit from the outcome of that very decision. Will they do this audit and auditor provided non-audit service? 'Well, I make a buck out of it.' It is very hard to be entirely objective when the economic incentives affect you. Even though in many firms there are good checks and balances, there is no transparency. No transparency means there is no market force to reward or punish you if you get it right or wrong. There is no window. What I am proposing with independence boards is essentially that we have a window into those processes. If they are good, that window really will not be terribly intrusive. What I am proposing is not so much an independence board across the whole profession, because I suspect they will be ex post, when it is too late, when the economic damage is done.

CHAIRMAN—Thank you.

Prof. Houghton—And real time. If you have it at the firm level, then you do not have the problem with client confidentiality, because it is still within the firm. To use an expression from a colleague of mine who is dean of medicine at Melbourne, that board can get its hands on the entrails. It can actually dig into the audit process to the extent that it needs to. It remains in house so there is client confidentiality, but you have high reputation, competent people on the independence boards who will assist in making those decisions. They do not have a commercial benefit from the outcome of their decisions, and as a consequence they can really add value to that firm in a transparent way.

Ms GRIERSON—I agree with you on that, but is there more required to deal with things not being quite so in house when irregularities have to be dealt with or reported?

Prof. Houghton—I also suggested—it was only a few lines—that these independence boards should report in an aggregated fashion threats that they come across, so that the client cannot be identified: you do not want to economically damage the market.

Ms GRIERSON—Trends—

Prof. Houghton—Yes, so that people are alerted to what threats are about. The fact that these things do have an independence board gives the audit firms more leverage over particularly aggressive clients. If you have a client really nudging you, you can say, 'I'm sorry, that won't pass the independence board.'

Ms GRIERSON—Thank you.

CHAIRMAN—Just to follow up on that, if our audit company that has its independence board was a publicly listed company, there is no reason why there could not be an external audit to audit the audit board.

Prof. Houghton—That is true, but I am not sure it is necessary. In a sense, an independence board would be like the external directors on a company board now.

CHAIRMAN—Fair enough.

Mr CIOBO—In the couple of minutes that are remaining, I am keen to get your comments on one particular aspect that I am interested in, and that is the business model and the actual structure of what I guess principally is the high profile end of audit—the 'big four'. I recognise the comments that you made with respect to there being market pressures on quality assurance and that being a good thing, and also on pricing, which is, I guess, a good thing from an efficiency point of view except when it leads to market failure. But I would be interested in getting from you comments pertaining to the extent to which that pricing pressure applies to the big four and there is a requirement therefore to have competent people who are brought in typically at a graduate level. The whole business model is built on having an army of graduates and then having things signed off by a partner. To what extent do you think that, if you are looking at running a successful and profitable practice in a tight market environment, there might be some compromise of quality given that a lot of the grunt work is done by people perhaps less experienced and able, and then a supervisory role played by a partner?

Prof. Houghton—I will resist the temptation to suggest that they should simply recruit Melbourne graduates and that therefore the quality and competence will be that much higher. I will stop the commercial at this point.

CHAIRMAN—Will Hansard please note that he was smiling!

Prof. Houghton—A partner will not make a compromise of quality to the point that they think that the quality falls below the level that is demanded by the client. If it does fall below that level and that shortfall is discovered, the reputational damage and the economic damage

done to the audit firm can be very significant indeed. Small mistakes can sometimes have dramatic economic consequences. I only need remind you of what I observed in Texas while I was visiting professor there. We have seen the decomposition of a major firm because of a series of events by what was, compared to the whole organisation, a small part of Arthur Andersen. I do not think that partners intentionally let it get away from them in terms of the quality and competence of what they do. They run different sorts of models. Some firms have a much larger number of very junior people; other firms might concentrate on audit with a smaller number of more experienced people. There are different models used, but in the end the engagement partner needs to be satisfied that the competence level is at least that which is paid for by the client.

Mr CIOBO—So you are of the view that the market provides an outcome that means that competency in that respect is always going to be covered off—it doesn't matter which model you choose?

Prof. Houghton—It is not going to be perfect. There is a phone ringing. I find it very distracting. Can someone turn it off. Where was I up to? Could you repeat the question?

Mr CIOBO—Sure. I was just inquiring whether you are saying that, given the variety of models that are adopted in the marketplace on the supply side of the services, basically there are enough checks and balances by virtue of the fact that the marketplace is operating to ensure that any signing off of any work done by a partner or under a partner—

Prof. Houghton—It is less than perfect. Through my work when I am engaged to assist where there has been a potential audit failure, I have seen competency that I do not regard as adequate, but I have seen many cases where an instructing solicitor has sent me things asking whether there is a problem with competency and I have found many reasons to find considerable competency in the work achieved. It is not perfect, but auditors are human too. By and large, I think the competency is pretty good. As I said, it is not perfect, but it is not bad. There can be improvements, but you do see market pressures driving improvements. Compared to 10 years ago, the level of specialist competency in certain industries has risen dramatically. Through my work in the public sector in Victoria and Western Australia, I have seen audit firms really build expertise to pick up contracts from auditors-general and they have developed very considerable expertise. So the market pressures on them are reasonably good. When the failures do occur, the economic consequences and the reputational consequences are very substantial. The engagement partner has to be pretty careful before signing off.

CHAIRMAN—We are almost out of time, but Senator Watson has an ultra quick question.

Senator WATSON—Some commentators have suggested that there should be a turnover not only of audit partners but also of audit firms. Given your comments on specialisation and so on leading to very high levels of competency, outcomes et cetera, what is your view on the turnover of audit firms in terms of an audit?

Prof. Houghton—Mandated?

Senator WATSON—Yes.

Prof. Houghton—I believe that mandated rotation would almost certainly, on average, give rise to lower quality.

Senator WATSON—Thank you.

Prof. Houghton—Do you want me to explain the rationale behind it?

Senator WATSON—Yes.

Prof. Houghton—There are several reasons. The most obvious are the following. If you were given a defined period of four or five years to get in, get to know the company, do a quality audit and then get kicked out, how much investment would you put into building the highest quality audit you could do? Some of my practising colleagues will not like the next statement, but the first year of an audit is not the best. You do not know that much about the company—

Senator WATSON—It is a bit like the first year in parliament.

Prof. Houghton—Or first-year university students. You do not know that much about the client, you do not know the systems that much, you do not necessarily know the people who might be more forthcoming. And then to be rotated out when you have really come to grips with the company is very damaging, I suggest. Superficially, it breaks the so-called cosy relationship. We know it costs more; we know it gives lower quality. It might assist independence. I think it is not a rational way to go.

Senator WATSON—You think there are better ways to do it. Thank you.

CHAIRMAN—You did say in the executive summary to your submission that the ultimate client of an audit is the stockholder or shareholder. Do you have a solution to that?

Prof. Houghton—I do not think that is a problem. That is a fact. One of the difficulties is, quite simply, that, in the modern day, audit firms are under pressure because they have audit processes and non-audit services. The client of the non-audit services is truly the management. They are hired to provide value adding services to the management. The client of the audit is the shareholder, who they never—or hardly ever—speak to. Having these different clients produces a tension that requires very tough management.

CHAIRMAN—Would you give some thought to my suggestion that perhaps we require audit firms to be publicly listed companies and therefore audited as well. And I assume that, if we have any further questions, we could correspond with you and you would be happy to answer any further inquiries.

Prof. Houghton—I would be happy to assist in any way I can.

CHAIRMAN—We thank you very much for your attendance. We will have a short break.

Proceedings suspended from 10.58 a.m. to 11.05 a.m.

BLOOD, Mr Brian Robert, President, CPA Australia

DIXON, Mr Arthur James, Director--Accounting and Audit, CPA Australia

CHAIRMAN—I welcome representatives from CPA Australia. We have received and read your submission, for which we thank you. Do you have a brief opening statement or may we proceed directly to questions?

Mr Blood—We do have a brief opening statement.

CHAIRMAN—How brief?

Mr Blood—Very brief.

CHAIRMAN—A couple of minutes?

Mr Blood—I will work towards that.

CHAIRMAN—Very good.

Mr Blood—Thank you for this opportunity to address the committee. In making the opening statement, I will table a one-page statement. As you know, CPA Australia represent 97,000 finance, accounting and business professionals. We have a wide range of membership throughout commerce, industry, the public sector and public practice. Recently, we have witnessed many corporate collapses and the focus has been on audit. CPA set about gaining an independent view of the position. We wanted to take a public interest view as well and to make sure that there was no form of knee-jerk reaction. The conclusion from the work we have done is that audit independence is only one part of the picture.

There are some issues that I would like to highlight from our paper. We have looked at the whole framework—I am talking about the organisations, the bodies and the players that are involved in the financial reporting framework. You will see that we have reached a conclusion that the current framework is somewhat complex and cumbersome and that there may be a more simple and transparent way of going forward with that framework.

We have also looked at all of the players involved in financial reporting. Some are very visible. The external auditor and the board are very visible but there are many other players in between: management, CFOs, CEOs, internal auditors, audit committees and other regulators and players. We think it is very important to keep that in mind and look at all the players involved in financial reporting if we are seeking to increase public confidence. I certainly agree with previous comments about audit matters: independence is one matter to look at but competence is also extremely important, and we should be very careful not to do anything which may undermine auditor competence.

Having said that, as the key messages, we can never prevent corporate collapses. The Australian financial reporting framework, in our view, is not broken. It is of a very high standard. It is regarded internationally as being of an extremely high standard. Of course we can seek to improve matters and raise public confidence—and our submission aims to do that.

CHAIRMAN—We have had quite a large number of submissions and some propose a principles based, self-regulatory system and others would have us move towards more prescriptive rules—as I believe the United States administration is doing at the moment. Do you have an opinion about the balance between external regulation and self-regulation?

Mr Blood—At the moment we have a co-regulatory system. As I said in the opening statement, we have a system which is working well—it is not broken—and is well regarded; therefore, we do not see a need to make substantial changes to that balance of co-regulation. In terms of any further emphasis towards a rules based system or legislation and regulation, we do not think that is required.

CHAIRMAN—How do we go about giving public shareholders—that is, me and, I assume, some of my colleagues—confidence that the auditing industry is doing a proper job? We went through a series of very dramatic corporate collapses in the late eighties and early nineties, and now we have just gone through this series of HIH, One.Tel, Harris Scarfe and a trucking company in South Australia, and I believe all of them had clean audits just prior to going belly up. How do we give the public confidence that the self-regulatory system is working?

Mr Blood—We have to look at all the aspects of that particular system, of which the auditing part is just that—it is part of it. In looking initially at that overall financial reporting framework and the bodies and organisations involved, we think there is a lot of benefit in having an overall framework that is simple and transparent, so the public can understand how standards are established and monitored and they can understand disciplinary matters. We think looking at the overall framework would go a long way to assisting public confidence. Clearly there are other matters to be looked at as well. There is a wide range that we can go into: for example, accounting standards, the auditors and audit independence, disclosures and disclosure regimes and regularity of reporting. There is a whole host of matters which we feel can be looked at to keep raising public confidence.

But, as I said in the opening statement, we are also trying to be careful not to have knee-jerk reactions. There are many thousands of companies audited every day and, clearly, many of those companies are reporting fairly and the auditors are doing a good job. We have to make sure that we have a system in place that will reduce the risk of something going wrong within the minority of companies or the minority of audits.

Mr Dixon—One of the important principles we have to be aware of is substance over form. That is one of the things that has driven us in terms of setting accounting standards, auditing and assurance standards and, indeed, our professional standards.

CHAIRMAN—You argue in your paper that auditor competence should be subject to ‘more rigorous and regular assessment’, but you did not tell us how. How do we go about that? Do we allow the market to do it, as you heard Professor Houghton say? Do we put words into the

Corporations Act? Do we require the securities commission to tell ASX to change the rules substantially? What do we do?

Mr Dixon—This was well covered in a 1997 ministerial inquiry, where agreement was reached that we would go forward with a competency approach. Unfortunately, that has not yet been implemented. The last communication that the accounting bodies got from government was on about 10 December 2000 when Minister Hockey communicated to presidents, acknowledging that the competency approach was the way forward but that, until other things were sorted out, the government was not going to implement that. There was agreement between the professional bodies, ASIC and the then government that the competency approach was the way forward. Since then, the professional bodies have done a lot of work in terms of establishing what these competency standards should be. In fact, we are proposing not only that there be a competency based approach to registration—which at the moment is 2,000 hours over five years—but also that, on a regular basis, our members report exactly what they are doing to meet those competency standards. So it would be a self-assessment regime.

CHAIRMAN—Some of your members, in their submissions to this inquiry and to other inquiries into auditing and accounting, have suggested that one of the difficulties they have is unlimited liability because the whole profession is partner based. Do you have a snap view on that, or would you like to go back to your members and see what they think about my suggestion that perhaps we should consider changing the Corporations Act to require public company auditors to be publicly listed companies?

Mr Blood—It is not something that we have specifically addressed, so we would quite like to take that one on board and have a look at that. Clearly it would address matters such as limitation of liability, which we believe is an extremely important matter to be dealt with at the moment if we are to look at improving the profession. I suspect there will be quite a wide range of issues and ramifications to deal with on that particular suggestion, so I think it is one we would like to consider quite carefully.

Mr Dixon—It could be seen to be in the self-interest of auditors to in fact support that proposal.

Senator MURRAY—Mr Blood, there are public companies both past and present where the board is corrupted by excessive self-interest and excessive management influence. Audit committees, which are a subcommittee of such boards, are just creatures of such boards. I do not imply that all audit committees are poor, but there are poor audit committees. I have long argued, almost campaigned, for a corporate governance board appointed by shareholders, not shareholding—which is what controls the main board—with a very limited remit by non-executive directors. That limited remit would include the appointment of auditors. My belief has been that that would be a better internal and very low cost mechanism for increasing the independence of the appointment process by the company and would be directly responsible to shareholders numerically rather than shareholding, which is dominated by financial interest. Are you acquainted with that idea, and how do you react to it?

Mr Blood—I think we see that as a potential option, but it is not one that we looked at in detail—largely because I do not think we wanted to think about adding in layers within the overall framework. I would agree with you and where you are perhaps coming from with the

question: how proactive are the shareholders? One would like to think they are so in both the appointment of boards and the performance of boards and, hence, the audit committees.

The position that we have taken is that, if the right mechanisms are in place to deal with board performance and audit committee performance, the board and the committee should be able to carry out the sorts of activities you are talking about: the oversight of the auditor and the appointment of the auditor. We do believe that there is a lot more that could be done in that area. For example, audit committees at the moment are not mandated for all listed companies, so there are those sorts of initiatives that could be taken. There is also this consideration: who will be members of the audit committee? We see the audit committee as an extremely vital part of this overall framework and as being necessary to improve public confidence. I think we focused in on that to deal with the corporate governance matters that you have alluded to.

Senator MURRAY—For the record, I should indicate that I have not advocated mandating my idea. I just believe it is one of the options companies should be required to consider, because there needs to be some mechanism. I think audit committees and/or corporate governance boards or other mechanisms that people can think of do increase the likelihood of independence. Having said that, I have never heard anyone say that they disagree that maximum independence of auditors is desirable. Everyone knows that to achieve that you need secure tenure, independence of appointment and fair severance mechanisms. I am of the belief that five years is far too short a spell for an auditor. Judging from my own business experience, you should never look at less than seven years. But what has not been discussed much in this area is the issue of remuneration. I think the only way auditors can achieve a level of remuneration that enables them to do a sufficient audit is by having a sufficient brief, either through legislation or regulation, as to the scope—the breadth and depth—of audit activity. That would result in an increase in audit fees across companies. My view is that in many cases the audit fee is too low, resulting in a weaker audit than is necessary. How do you react to that view?

Mr Blood—The matter of audit fees is one which we believe should be carefully discussed between the auditor and the audit committee or the board. In the process of going through that discussion, one would hope that they would talk about whether the fees and remuneration were adequate for the type of company and the risks and the issues being audited. If the audit committee were acting as we have suggested in the interests of the shareholders, hopefully that would work towards the correct result. We have heard how important it is to have strong corporate governance and strong audits and we have heard about the research 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.

Senator MURRAY—If I may say so, the weakness of your response is that that means a board and management who regarded audit as a cost and not a value adding mechanism would be inclined to argue for the lowest form of acceptable audit. My own view is that parliament is not competent to lay out in legislation all the levels of audit. I think it is far preferable for the regulators—and in this case I mean ASIC and the ASX—to agree on a mandated minimum. The consequence of that would be that there would be a floor level—I think that is a term the professor used earlier—which everyone would have to achieve. In my view, that would be greater than the present minimum and would have to deliver a sufficient fee to generate an audit

in which you could have comfort that it had sufficient breadth and depth. I say that in reaction to your existing model approach, which is tougher and more extensive.

Mr Blood—From an auditor's point of view, in terms of an audit of sufficient breadth and depth, you would find that that would always be the case. They would not compromise what they need to do in order to reach their conclusion. They would not let fees get in the way either to compromise, because, especially if we talk about issues of unlimited liability, the risks of being compromised in that way are too great for an auditor. If the fees were inadequate over time, one would expect that the auditor would be resigning.

Senator MURRAY—Except—and I would like to end with one last comment—that with the present mechanism auditors accept fees which are uneconomic because they make their profits elsewhere in the firm, often on non-audit services. If you accept the proposition of Professor Houghton, which is that there are instances where it is desirable to retain the integration of services from the same firm of both audit and non-audit services, then to get a decent audit you have to turn those audit fees into an economic level.

Mr Blood—I have not seen any research or evidence to support the proposition that audit is undertaken on a non-economical basis in order to secure the work on a more economical basis. I have not seen that research.

Senator MURRAY—Are you saying that what I have been told by some of the heads of the major auditing firms is wrong?

Mr Blood—I do not know what you have been told by them specifically.

CHAIRMAN—We have more than one submission that does contend exactly the point that my colleague has raised.

Mr Dixon—In most partnerships, it is a requirement that those who are in the audit area make a return. It may be a question of margins being lower within audit, as compared with other consulting activities, but I do not think there is any clear substantive evidence to suggest that audit is used as a loss leader.

CHAIRMAN—We have a role to play in this place in the appointment of the Auditor-General and the independent auditor who audits ANAO. I have formed a private view that the fees for the independent auditor, which were disclosed to us when we had a public hearing to approve the latest appointment, are very insubstantial.

Senator WATSON—It is a very competent audit, and all that sort of thing, but the question is how much value it adds to the already very high standards and good work of the Australian National Audit Office. That issue is still out there for further evaluation. That is not to demean that the role and expertise of the independent auditor: the fact that that is required, obviously, for some, might give a level of assurance. But I think that is about all—when you have two highly professional people looking at each other. Mr Blood, do you think that the concept of auditors having deep pockets has unduly focused corporate failure on the auditors rather than on the other recalcitrants?

Mr Blood—The focus is undoubtedly on auditors. That could well be one of the reasons. But I think the focus is clearly on audit and is to a degree which really means that we are not looking at all of the issues that are involved here. Through our submission, we have tried to make the point strongly that there are many other matters that need to be looked at as a result of the current business environment.

Senator WATSON—What about the concept of deep pockets? Obviously that is very attractive to the lawyers, isn't it?

Mr Blood—I think history will show that, whenever there has been a corporate collapse, the auditors are the ones that usually finds themselves in the headlines the next day.

Senator WATSON—Is it more so because they have got deep pockets—access to good insurance? Is that why they are in the headlines, rather than some of the other real recalcitrants?

Mr Blood—I think that is probably a fair comment.

Senator WATSON—You made a comment earlier about Australian accountancy standards. You might have been a little apologetic on those before our committee. Would you like to restate that for the benefit of the committee?

Mr Blood—On accounting standards?

Senator WATSON—Yes: the role of accounting professional standards, qualifications and competencies. You have been on the record as indicating that they are certainly the highest or are as high as any in the rest of the world.

Mr Blood—We believe we have a good system in Australia for the establishment of accounting standards. We are keen to move towards—and we would like to see other countries move towards—international accounting standards. We are looking to harmonise with the international accounting standards. We are very active internationally as a country on those accounting standards setting boards. One of the reasons is that they see the value of what this country is able to bring to the table in that respect. There are examples of standards and initiatives that have been taken here that have then been taken up internationally, so I think we can be proud of what we have. As we move towards international accounting standards, one thing we are going to be very careful of is that we do not actually reduce the high quality of the standards we have within Australia.

Senator WATSON—On the issue of standards, should the Auditing Standards Board be brought into line within the auspices of the Financial Reporting Council, thereby bringing it into line with the accounting standards boards? Also, what is your response to calls for auditing standards to be given the force of law, with a consequent strengthening of the powers to ensure that they are properly and adequately implemented?

Mr Blood—The model we have put forward in our submission is a conceptual model but it does bring together in one arm the standards setting bodies of both accounting and auditing. We think there would be benefits in doing that. Some would be efficiency benefits, through having one administration and one secretariat. Obviously you cannot totally keep separate issues of

accounting and audit—they clearly feed off each other. We do put standards setting into one of the three legs of our particular conceptual model. In terms of force of law on the auditing standards, we have not specifically considered that. The auditing standards are monitored through the profession; they are of a high standard—an international standard. We have not seen that as a priority, given all the other issues we feel are much more important and worthy to address first. I do not know if my colleague wants to add anything on that one.

Mr Dixon—In terms of world experience, there are only two other countries in the world that have in fact enshrined auditing standards and guidance releases within the law. If I am right, they are Brazil and Italy—I am just going off the top of my head there. If we did that, we would be going ahead of the rest of the world in that context.

Senator WATSON—In the recent paper I gave in Sydney I mentioned—I also raised this issue at the Senate estimates—that within the accounting standards there is still a lot of discretion which gives rise to what I might call creative accounting, and this has tended to be a reason for the expectations gap that so many people talk about. While the standards themselves are fine, would you agree that at times within those standards—and I know action is being taken in relation to ED 105 to rectify some problems—there is still a lot of discretion, which does not make it easy for auditors when you can have some widely held views as to when revenue should be brought to account, for example, and when it should not be brought to account?

Mr Blood—It is always difficult as to far how one goes with standards, but I will say again that we can be proud of the accounting standards we have in this country. We think they are of a high standard. One can always look to improve them. A more interesting area to go to would be that of financial reporting disclosure, which would perhaps link up to the type of matter you are raising. Again, in the submission we have suggested that there be increased disclosure regarding particular matters where, for example, estimates, assumptions or judgments may be involved. With increased disclosure, the ability is then there for the readers to better understand the underlying risks and to better understand the information in the annual reports. We feel that is a better area to be focusing on at the moment, as opposed to particular standards.

Mr Dixon—I think it is also important to note that at the international level, with which we are harmonising, one of the key focuses on standards is to in fact eliminate the alternatives. In the past decade of standards-setting by the International Accounting Standards Committee, now the International Accounting Standards Board, they have had the primary objective of reducing the alternatives within accounting standards. So that is being addressed at that level, and that is what we are attempting to harmonise with at this moment.

Ms GRIERSON—So you are saying now that there would be greater disclosure if that were to be done, that there would be greater information access.

Mr Dixon—I was responding to Senator Watson's contention that in fact there are too many alternatives. I am saying that there is a definite thrust to reduce the alternatives that are available when reporting. Remember that we are reporting according to the principles and we are trying to reflect the substance. That is one of the challenges: when you are trying to reflect the substance, you can have perceptions that can give rise to differences.

Ms GRIERSON—One of the points made by many people in their submissions is that the audit is only as good as the information given to the auditor. How do you increase that disclosure and the requirements for information? If the standards are not good enough or are not providing access to as much information as you would like, how do you improve that?

Mr Blood—Issues of disclosure can, of course, be dealt with in a formal sense in terms of the annual report and in terms of the types of information. We have in our submission put a preference to move towards quarterly reporting so that there is more information on a more regular basis. I will say that there are, potentially, some risks with that—because of the short-term emphasis of quarterly reporting. But, together with all the other initiatives on the table, we think quarterly reporting will assist in the provision of the information.

Ms GRIERSON—So if the focus is too high on the audit role and should perhaps be shifted to corporate governance itself, what would be your major recommendation in that area?

Mr Blood—I certainly do support, as we said before, audit independence. Audit is only one part of this picture, and we did look at all the other players involved. I think it is very significant that we do look at the roles of management, of CFOs. Very often they can come under pressure in terms of financial reporting, as well. One of the other recommendations in the submission is that there be a level of protection for those professionals within organisations. We have talked about whistleblower protection and about an industry ombudsmen. Many of these people are members of our organisation and they come under pressure because of what they may see and would like to say.

Going with that, of course, is that we need to make sure that we have disciplinary measures in place for those members who do transgress. Historically, one might always look at discipline as discipline of auditors. I think we need to start to looking at the discipline of the preparers of the information. A point that is often lost in many of the communications that I see is the fact that the information is prepared by the companies and put forward by the boards, and the auditor is working with that information. It is not the auditor who puts that information together.

Ms GRIERSON—If the auditor's role were widened to take into account more factors of business quality and wellbeing, how would that be done? Would you support that, and do you think there would then be extra need for auditors to be trained in different ways?

Mr Blood—I would certainly support it. The issue of education and training probably depends on how far it goes. I think most of the auditors would have the necessary competencies and skills to take it to the next level that is required. But, to the extent that you do broaden the gamut of what the auditor is reporting on, that quite quickly becomes a very complex issue as well. At the moment, the auditor is working to an audit report, which is fairly black and white. It is a tick or it is a cross, and there is little in between. As soon as you start going in between, then the job itself will get more difficult. However, in our view it would actually improve the financial reporting. In our view, what would have to go hand in hand with that would be a dealing with limitation of liability, because the risk would increase so significantly.

Ms GRIERSON—Do you think that just widening the role would have the effect of improving corporate governance, rather than having to put in place other sorts of regulations?

Mr Blood—I think it would improve the financial reporting, it would improve the information that is provided to users of the accounts; hence, it would improve public confidence in the whole system. That was where we started.

Mr CIOBO—You mentioned discipline before, and currently there is some discipline that is provided for. I wondered about your comments on liability, and how that serves as a disciplinary action in an indirect sort of way, versus the need to perhaps introduce more significant fines or even jail terms or something like that for serious breaches. Are you looking at pushing disciplinary action like that?

Mr Blood—We have disciplinary action now. Disciplinary action can be taken through the two professional bodies or through CALDB. What we have suggested within the submission is that it is very important to make that discipline extremely transparent to the public, again to increase the confidence—

Mr CIOBO—So it is transparency, more so than the significance of paying out a much larger sum or receiving a reprimand or a jail term?

Mr Blood—I think transparency will go a long way to dealing with the issues. One of those three legs in the model was to bring discipline under one of those columns again. We think that will make it more transparent. There is only one hearing dealing with a particular matter, be it with auditors or be it with the preparers of accounts as well. In terms of limitation of liabilities, I think the auditors would be the first to say that, if they had made an error of judgment, they should pay for that in some form. Whether that is done through limited liability or schemes such as a capping of proportional liability, we think that would go a long way to dealing with some of the issues.

Mr CIOBO—I want to tease out another issue that Senator Murray raised. There is the whole issue of cross-subsidisation between audit and non-audit services and the proposal of possibly having a fee floor. I wondered what your comments would be on how that might lead to potential market distortions, inefficiencies and those sorts of proposals. It seems to me that most business models are built around—and I have not been privy to the conversations that the chairman and Senator Murray have had—a non-commercial return from the audit wing of some of the big four, and other firms for that matter. So if you take the assumption that it is all built around a commercial return and you then sought to introduce fee floors and you then took the proposal that cross-subsidisation could occur, what might the market outcome of that be?

Mr Blood—I have not really considered fee floors before. I think with any particular audit there is a fee floor. As you are building up your estimate of fees to undertake an audit, clearly that will come into play. Fees for undertaking an audit are based on many facets: the complexity of the organisation, the risks of the organisation, diversity, international spread, geographic locations and different underlying forms of business. It is very hard to talk in generalities about fee floors across different types of organisations and businesses.

Mr CIOBO—Maybe I did not address the question properly. We heard comments before that the introduction of a fee floor might help to overcome some of the conflict that arises where a non-commercial audit has some pressure placed upon it because the company is trying to sell

other services. By raising the fee floor, you might reduce that conflict. That was a proposal. What is your view on the likely market distortions that might take place from doing that?

Mr Blood—I guess I do not really see the underlying question as an issue, in the first instance, to address what the ramifications of some of that might be.

Mr CIOBO—So you are saying you do not see a conflict between the two?

Mr Blood—There is also the idea of the uneconomical audit. Every audit can have different margins, but the market can take care of that. No auditor wants to perform work which is not making a sensible return. One would expect the market to work that out. Then it comes back to the company. I cannot see how it would look good in any way whatsoever if an auditor resigned because they had low fees. It would look as if they had been constrained in the undertaking of their audit work. They probably would not have been—because, as I said earlier, an auditor would fulfil their professional responsibilities and do what was required, but not over the longer term.

CHAIRMAN—Mr Blood, in answer to Steven's question, you indicated that you are big on discipline. I am advised that no auditor has been expelled from the profession in the last 10 years, despite a significant number of cases being heard by CALDB, including 25 cases of serious misconduct leading to penalties and sanctions. Why have you not expelled any of your members?

Mr Blood—We can certainly only deal with our own members—

CHAIRMAN—And you have had no instances of misconduct by any of your members?

Mr Dixon—I do not think you would read that into it. If the CALDB finds them guilty and they think that this is the end of the road, they can simply resign their membership; hence, they are outside the realms of what we can deal with. If they are not our members anymore then we cannot discipline them. We cannot remove them from the professional body; they have already resigned.

CHAIRMAN—My last question is: what did you think of Professor Houghton's suggestion about having an audit independence board within each audit firm's grouping?

Mr Blood—We are starting to see a range of ways of addressing the issues at hand at the moment. I do not think it is vital for that to be in place. In the submission we have put forward a whole range of issues which we think will address and improve public confidence in financial reporting. If that were to happen, I would say that that is not necessary or required in every one of the firms. If firms decide to do that and go that way then so be it, but I do not think it is necessary in every case.

Senator WATSON—Whistleblower protection is always interesting for politicians. Your submission indicates that improved whistleblower protection is needed. I understand there is some semblance of whistleblower protection in New South Wales. The question is: should the Commonwealth adopt such legislation? How effective, efficient and successful is the New South Wales legislation, that you have come to recommend it?

Mr Dixon—We are aware that we do have some members at the moment making representations to us that they have concerns about the organisations in which they are working. Of course, we want to do the best we can to protect our members. That is one of the things that has driven us to look at that situation. I think it is only equitable that, if someone thinks it is the right thing to do, they should be professionally protected. At the moment, there are very few models we can look at within Australia. We need to examine this, and it is an important thing going forward, so that, in the public interest, we find out the underlying situations.

Senator WATSON—So you are not necessarily saying the New South Wales model is the best one for us to follow?

Mr Dixon—No, we are not necessarily saying that.

Senator WATSON—It is a difficult issue.

CHAIRMAN—If we have further questions, you do not mind if we contact you?

Mr Blood—Not at all.

Mr Dixon—Please do.

CHAIRMAN—And you will try and get back to us on my question about whether we should consider making audit firms corporations.

Mr Blood—We will.

CHAIRMAN—Thank you very much for participating.

[11.52 a.m.]

FAULKNER, Mr Neil Thomas, Board Member, The Institute of Chartered Accountants in Australia

HARRISON, Mr Stephen Barry Morgan, Chief Executive Officer, The Institute of Chartered Accountants in Australia

REILLY, Mr Keith, Director-Technical Adviser, The Institute of Chartered Accountants in Australia

CHAIRMAN—I now welcome the Institute of Chartered Accountants to our hearing. Mr Faulkner, I am advised that you are a former student of Senator Watson and a distinguished example of what a good teacher he was.

Mr Faulkner—I can only endorse those comments, Mr Chairman.

CHAIRMAN—I do not know how well that goes down with the University of Melbourne. Do you have a very brief opening statement?

Mr Harrison—I will keep it as brief as I can.

CHAIRMAN—Very few words or we will run out of time.

Mr Harrison—I will try to keep it to three minutes. I have given a more detailed statement to the inquiry secretary. It is our opinion that auditing is cyclical. When companies fail, investors look for someone to blame and mistakenly direct most attention initially to the auditors. I say 'mistakenly' because company failures occur because of business decisions made by management and boards. What may properly be asked of auditors is whether the financial statements prepared before a collapse were drawn up in accordance with accounting standards and whether they showed a true and fair view.

Professor Ramsay's inquiry into auditor independence has canvassed the scene quite widely. This institute is in broad agreement with its recommendations. We particularly support independent audit committees; mandatory audit partner rotation, but not rotation of firms; the continued provision of non-audit services, not a wholesale ban.

On the issue of regulation and self-regulation, we are of the view that a co-regulatory model works best for business and the public. Full regulation is costly and does not prevent business mistakes and company collapses; it does not prevent fraud; it does not ensure all audits are conducted perfectly.

We believe there are three broad areas for regulation by government and/or the profession. In the area of standards, the government has taken control of accounting standards through the Financial Reporting Council. This is working well and forcing the pace to one set of acceptable

standards globally. The profession itself is responsible for the setting of auditing and ethical standards which are also set in a global context. Global harmonisation of auditing standards is more advanced in Australia than in the USA, the UK and Canada. Whilst auditing standards are not enshrined in company law, they are enforceable by the parliament through ASIC and the CALDB.

On monitoring, it is the institute's view that monitoring of compliance with accounting, auditing, ethical and quality review standards could be improved. ASIC appears to be underresourced in its performance of this task. We have discussed with ASIC the establishment of a financial reporting review panel or tribunal. Jointly established by ASIC and the profession, it would create a body responsible for monitoring compliance with accounting standards.

Public interest and perception is calling for a process to oversee the independence of auditors. The institute would support a public oversight board established by government and the profession. In assisting and maintaining the independence of auditors, such a board would oversee the effectiveness of the regulator and the profession in the setting and monitoring of professional standards, the conduct of quality reviews and the enforcement of compliance with accounting and auditing standards. Such functions could be attached to a reconstituted FRC to avoid setting up another entity.

On the subject of enforcement, the enforcement process in Australia we believe is not well understood. Many jurisdictions, including the USA, are moving to have enforcement under the regulator. In Australia we already have such a model in place. Through ASIC the parliament regulates registered company auditors and liquidators. Their compliance with the law and professional standards is enforced through the disciplinary powers of the government-established CALDB.

Much has been generated out of the debate surrounding the collapse of companies such as HIH. The issue of auditor independence has achieved some prominence. This, however, is only a small part of the picture challenging investors. Of much greater significance and need is to review the whole broad area of what companies disclose, the assumptions behind such disclosures and what assurance is given about the reliability of such disclosures in order to keep the marketplace fully informed. Such change would, however, impose even greater obligations and risks upon auditors and could not occur unless accompanied by change in the laws which assign liabilities. We need proportionate liability to replace the joint and several liability of defendants, Australia-wide application of the professional standards scheme, an ability for auditors to operate through limited liability partnerships or companies and be able to contractually limit their exposure to liabilities with their clients.

CHAIRMAN—Thank you, Mr Harrison. Professor Ramsay proposed a model of an oversight organisation, and CPA has proposed an even larger body to amalgamate all of the functions that are currently taking place. Do you really believe that an oversight function is ultimately going to work better than market-based solutions?

Mr Harrison—I believe an oversight function can provide a means of address on the issue of perception. I believe there is a strong place for market-based solutions. At the moment there is a perception that there needs to be a strengthening of independence. An oversight process that provides that independent scrutiny of the profession and corporate governance, that

provides an assurance to the investing community that those processes of audit are independent, does then provide some added value.

CHAIRMAN—What is your view of Professor Houghton's suggestion that each of the audit firms themselves have an independent board within their audit firm?

Mr Harrison—Keith provides a very effective market-based solution. The difficulty I have raised in my discussions with Professor Houghton is whether in fact the public would have sufficient confidence that independent boards set up by the companies, the audit firms themselves, would be sufficient to provide that level of confidence. If the market assumes that then it is a very efficient solution. If, however, the perception is that there needs to be a greater and more independent intervention through a public oversight board, then we see that as being another form of solving that problem.

CHAIRMAN—Perhaps you could try a bit of lateral thinking and think about my suggestion that I put on the table this morning, which was that we amend the Corporations Act and require audit firms to be corporations. Then within the audit firms we could adopt Professor Houghton's suggestion of an independent board. Because they would then be corporations, they would require to be audited. So the independent board itself would be externally audited. How does that turn you on?

Mr Harrison—I would prefer to be given a bit more time to think through the answer.

CHAIRMAN—We are looking for radical solutions.

Mr Harrison—That certainly, I believe, is radical and lateral. It is about how many stages you need of who audits the audit, who audits the audit, who audits the audit? We certainly accept the necessity for auditors to be able to operate within company structures and limited liability partnerships. Whether they should be publicly listed I would like to think more about. My initial reaction is that we were talking about some of the effects of short termism in listed entities, because the marketplace sets the price and people behave to try and ensure that there is a healthy market price. I am not sure that I would want to see that becoming a factor within accounting firms and audit partnerships. That is one reaction, but we would prefer to have time to think that through. A number of issues have been raised that have not been raised by anyone before, and we would like to think about them.

CHAIRMAN—Fair enough. One of the things that CPA talked about this morning was disciplinary powers. You probably heard me read a brief. I am advised that in the last 10 years neither of your organisations have required any members to become disassociated with your organisation. Do you really think that you have proved effective in disciplining accountants or auditors who are seen—maybe even by the general public—as being less than competent or less than honest?

Mr Harrison—I cannot go through each of the cases that have been mentioned in those statistics you raised. I can, however, give you an example of one case which I think refutes the proposition that no-one has been removed from the profession. There is a case where a registered company auditor was suspended for three years. All cases that go before the CALDB which involve our members and present an adverse finding are then taken through our

disciplinary process. In that particular case, the member was suspended from membership of the institute for the same period. We did not expel the person from membership, but the effect was that they were not a member for the same period for which their registration was suspended.

We have to be a little careful to assume that we will necessarily follow with further penalties in all instances where someone has been found wanting by the CALDB. I can think of one case where a member of ours was suspended from conducting further audits for a period of time. That member took no part in the process of audits but took on a managerial role in the company, which he was allowed to do by remaining a member of our profession. I think the punishment that the CALDB handed down was strong and severe. I am not sure that it was necessary or in the public interest for the institute to take further penalty steps against that particular individual. Each case has to be looked at carefully in its own right. I do not have before me a summary of every one of those cases that has been before the CALDB, other than to assure you that in every case it does go to our disciplinary committee, which is a committee of peers not influenced by management or the board.

CHAIRMAN—In your submission you mention that you recently commissioned an independent review of your disciplinary processes. Can you tell us where that is and when you expect to report?

Mr Harrison—I am hoping to get a report within the next couple of weeks. We have asked Mr Alan Cameron, former chairman of the Australian Securities and Investment Commission, to conduct that independent review and I am hoping that it will be with us by about the end of the month.

CHAIRMAN—Would you mind advising us of the findings, when you think you are able to release it publicly?

Mr Harrison—Yes. We have not asked Mr Cameron to prepare a report on the expectation that it be made public, but it will go to our board. The results of the board's determination certainly will be made public.

CHAIRMAN—You will advise us of that?

Mr Harrison—We will.

CHAIRMAN—We are trying to conduct a very fast inquiry, I might say, because time is marching on and I do not want worldwide events to overtake us. We would like to be able to make strong recommendations that hopefully involve a general consensus in the industry and get on with it.

Mr Harrison—Time may be a problem in that context in that our next board meeting is on 1 July. If we do not get the report by 1 July and deal with it at that board meeting, it will then be another six or seven weeks until the board next meets.

Senator WATSON—For the public record, I would like to indicate that earlier the Senate Select Committee on Superannuation conducted an audit in relation to superannuation. The findings of that committee—and I think they should be repeated here—are that the accounting

standards for audit of superannuation were more rigorous than those applying generally and that, generally, most auditors of superannuation entities in Australia were performing at a very high standard. I think that needs to be put on the public record, because the standards for auditors are certainly higher. But also the level of performance within that higher bar is being met, generally. Of course, there will always be the exceptions, but I do not think we should allow the exceptions to mar the image of the profession generally.

I now have a question for Mr Neil Faulkner from KPMG, which is one of the big four. Would you mind explaining the internal evaluation processes in audit within your firm—it being a major firm—to explain how you address this area of competency and independence et cetera? I understand that a lot has moved very quickly—there have been separations of consultancy functions and those sorts of things amongst the big four—but I would like us to focus on this issue of internal assessment. We have been talking about boards, but my belief is that the major four already have pretty high levels of internal competency assessment and quality control assessment. For the benefit of the committee, would you like to outline those?

Mr Faulkner—Before I answer that question, I would like to say that I am a board member of the Institute of Chartered Accountants, as well as being, as Senator Watson has said, an audit partner at KPMG, which is one of the four large international accounting firms. One of the issues—and I can only speak from my personal experience within KPMG, but I am sure it is mirrored amongst the others of the big four and also within other auditing practices—is that the quality control that we have is something that we pride ourselves on and something that is taken very seriously. I am based in Melbourne. As an audit practice, we are subject to a review twice a year from our peer group within Australia. In fact, one is going on at present. In that process, individual audit assignments are selected and subjected to reviews, the appropriate forms, questioning et cetera to ensure that the procedures required to be undertaken by KPMG in compliance with the auditing standards have been undertaken accordingly.

Our firm is also subject to a peer review by other members of KPMG on an annualised basis. The teams that come and do the individual reviews of the organisation are also supplemented by specialists and international partners to ensure that the processes are undertaken. In addition to that, we are subject to internal reviews by the Institute of Chartered Accountants. KPMG was subject to such a review and I personally was selected as one of the audit assignments that was subject to review of CPE hours et cetera during that process. Following from those, recommendations are made, reports given and actions taken to either fix up performance or congratulate people on it. Within our organisation, if a person as an individual audit partner does not receive appropriate levels, they are removed from the firm.

In addition, I think we should also look at the processes that are undertaken on individual audits. All listed companies in organisations such as ours have an audit team—which could be comprised of any number of partners and senior staff plus specialists—in addition to having a concurring partner who is not involved in that audit and who is required to look at the decisions made and the accounts prepared. In addition, they are supported by the technical resources of the firm in the event of dealing with accounting issues that may arise through the process.

Senator WATSON—The chairman has put forward the notion of setting up accounting firms as incorporated companies. As I see it—and I would like your view—while there may be some advantages, the disadvantages in commercialising something that is essentially a very highly

professional operation would far outweigh the advantages and could lead to some long-term undesirable outcomes: for example, share price exploitation and so on. I think it would be a dreadful thing if one company had a price earnings ratio of 40 and another had one of about five. What sort of message would that send to the rest of the world?

Mr Faulkner—I have not considered the proposal put forward by the chairman; however, as a partner in a major firm, the idea of floating does have a certain amount of appeal for immediate return.

Senator WATSON—For the short term.

Mr Faulkner—Whether I would continue within the practice after it was floated, I do not know—I would have to consider that. I think there are issues in terms of the limited liability that can flow through, and this has been discussed. Unfortunately, I would have to think far greater about that concept. It certainly would be setting precedents that I am not aware of elsewhere.

Mr Reilly—I guess there are certain elements, such as the limitation of liability, that Mr Charles's recommendation would be covered for in terms of an auditor being part of a listed group. There are other elements. As you heard in evidence earlier today, the market already assesses auditors, particularly audit firms and the value of the audit brand. Of course, in terms of quality review, as Neil has already explained, there is very detailed post-testing of the audit process to ensure that it has actually complied with the high aims and ethics that are required. So I think a number of the elements, Mr Charles, would be incorporated regardless of whether you have a listed entity or not. There are also perhaps some downsides in terms of having a listed structure, particularly when you are looking at only four global firms. We would like to take this on notice and come back to you.

Senator WATSON—Mr David Knott, the Chairman of the Australian Securities and Investments Commission claimed that accounting and auditing had failed to deliver acceptable outcomes and he said, 'amongst many complex factors is the content and style of accounting standards and the quality of the audit process'. That was said earlier this year. When he appeared before a Senate estimates committee recently he gave a completely different approach. He said:

I think there has been a sea change in sentiment in the last few months.

He then went on to say that one cannot underestimate the impact of the Enron collapse. Can you speak about the sea change that has taken place in terms of how Mr Knott has perceived it and how you perceive the change? I think a lot has happened in a short time.

Mr Harrison—A lot has happened. Where it is a sea change, I am not sure. I believe the profession has maintained a very constant approach to continuous improvement. To that extent, we have constantly been looking at our standards and the way they are practised and enforcement of compliance with those standards. I guess the issues have become more public. Therefore, the perception of a sea change may be there in the public because of the public emphasis that has been given to a number of these matters. But issues of improvement in accounting standards and their globalisation have been issues that we have been leading for a

long time. We were a founding member of the International Accounting Standards Committee and we were one of the first organisations to promote globalisation in Australia in the early nineties and, with the ASX, led in that regard. As I said in my earlier comments, in terms of auditing standards we are more advanced in globalisation around a set of high quality auditing standards than any of the other major Western countries and we are regarded as being one of the major contributors to those standards, and we have constantly fulfilled that task.

It is the same with ethical standards. We have recently adopted a new ethical standard for independence, which we believe has been necessary. It has come out since the debate about corporate collapses and Enron, but it has nothing to do with that. It was commenced well before those issues became public. So yes, there has probably been a lot more public discussion and public comment, both generally and by the profession, but I do not believe that the profession has done anything very different from what it has been doing constantly, which is looking for ways to strengthen that process, and examining now other ways in which that process can be approved and, in particular, the investing public can be better informed. In that context, we then would say that audit independence, whilst critical and important, is just a small component of the marketplace needs for investor confidence in companies, and that we need to go much further than just ensuring auditor independence and the quality of audits: we need to look at the whole corporate disclosure regime. I talk about corporate reporting rather than financial reporting, because the reporting needs to go beyond simply that which can be measured in financial terms.

Senator WATSON—My next question is on disclosure. Perhaps Mr Reilly and Mr Faulkner might like to comment. In terms of the Corporations Law, an auditor is required to report on whether a company has met these accounting standards. If he has any misgivings, he then is required to look at the question of failure to present a true and fair view, and that has to be accompanied by supplementary information. But there it seems to stop. Our supplementary information may not, in my view, be enough. Where do we go from there? Other than supplementary information, there must be a third step that appears to be lacking in corporate law at the present time.

Mr Reilly—Let me start in terms of what the Corporations Act requires. It requires directors to prepare financial statements that comply with Australian accounting standards and give a true and fair view. The requirement to comply with accounting standards—

Senator WATSON—No. That is the second step, the true and fair view. The standards are the first step, as I said.

Mr Reilly—That is correct. The auditor is then required to give an opinion as to whether those financial statements comply with Australian accounting standards and give a true and fair view. The Corporations Act envisages that there may be an instance where compliance with an accounting standard would not, by itself, give a true and fair view; and so the Corporations Act is very clear. It states that, if compliance with an accounting standard would not give a true and fair view, the director is required to provide additional information so that a true and fair view is given.

Senator WATSON—Correct.

Mr Reilly—An example of that would be that a board of directors may determine that a particular accounting standard gives, for whatever reasons, a result which they do not believe is the correct or appropriate treatment. In that case, there is a responsibility on the directors to say, 'Okay, we do not believe that that particular profit is the appropriate profit,'—for whatever reasons—'and we believe that the profit,'—or the loss, as it well may be—'should have been something else; and here are the reasons we believe that is the appropriate way to do it.' There is some arguments as to whether there should be a 'true and fair' override, which we did have, back in the early 1980s, whereby directors could produce a set of financial statements—ones that might not comply with a number of different accounting standards—because, in their view, a true and fair view was important.

The difficulty, of course, was that you then did not have a level playing field and so you could pick up any number of sets of financial statements and not know whether they had been drawn up on a common basis or framework. So the Corporations Law—the Corporations Act now—was then changed to say that you must comply with accounting standards but that you are also required to ensure that the financial statements as a whole give a true and fair view. If you have a strong disagreement—and it is pretty rare that you see that, these days—and if you do believe that the accounting standard gave the wrong answer, there is a legal requirement that you explain why.

The view that the profession has had when it supported those changes, along with the regulator ASIC and the accounting standards setters, was that the bar should be sufficiently high for it not to be very easy to say, 'I do not particularly like the result this year that the accounting standards are giving us. We will adopt a different basis that shows a different treatment.' I would like to emphasise that the requirement to give a true and fair view is there and is critical, but that we do have a level playing field or a framework in which we are required to produce those accounts.

Senator WATSON—But one of the reasons given for the need to issue ED 105 was the fact that, within those standards, under the prior standard it was impossible to compare entities across the spectrum, and that is why we had 105. We are locked into standards, but I think there is still room for a third tier, because where does the auditor stand in such situations, Mr Faulkner?

Mr Faulkner—Each case obviously has to be considered differently. Quite simply, with a number of our accounting standards there are a number of options. For example, if we look at dealing with intangible assets, there are a number of ways that they can be dealt with. We look for a disclosure to ensure that the users of the accounts can have a clear understanding of what is actually being taken. But if we took that example of intangibles, we could have three different companies, with exactly the same things, applying a different methodology and ending up with a different answer, and then, not looking at the bottom line result, only by going through the disclosures would you be able to determine the differences between them. My CPA colleagues spoke about disclosure, and Stephen and Keith have as well. It is the area where we see that the added benefit can be made by adding disclosures to the type of accounting that is being applied. That is where I see it at this stage.

Senator WATSON—What about the audit report on that disclosure?

Mr Faulkner—It is that overriding issue of truth and fairness.

Mr CIOBO—I was interested in your comments about the oversight model addressing the perception. Given the cost to the market, I am wondering whether it would be cost-effective to engage in a huge PR exercise rather than introduce an oversight model if its only real tangible benefit is an improvement in perception. On the point that Senator Watson was touching on with respect to auditor opinions, I am keen to get your comments on how the liability issue pertains to an unwillingness to provide a true and fair transaction analysis. Also, I would like your comments on how the relationship problem might be better overcome, so that we get a broader picture without perhaps losing the incentive that unlimited liability provides, if you make the assumption that it does provide incentive.

Mr Faulkner—Can I just clarify that question: is it in terms of the auditor and the opinion that they give or is it taking that opinion and making it a broader one?

Mr CIOBO—It is in terms of the auditor's opinion.

Mr Faulkner—An interesting discussion has been held in terms of fees and audit opinions. Talking from personal experience, the amount of fees has no bearing whatsoever on the audit opinion and the final result—none—and from our experience there is not an annexure between them. I probably do not quite get the thrust of your question.

Mr CIOBO—My question is: with respect to liability, does that have an impact on the willingness of an auditor to provide an opinion?

Mr Faulkner—I can assure you that I would get into far more strife if I made a mistake than lose a client. It was interesting in the discussion before about what Arthur Andersen thought when he signed an audit report. I never thought of it that way, but as a practising auditor that is very much the attitude and approach that is taken. We are professionals in what we do and that added burden of losing everything that we own by virtue of making a mistake certainly does bring it all home to you. At the same time, proportional liability, and as Senator Watson talked about before, the deep pockets matter are real issues in relation to an ongoing profession.

Mr CIOBO—What drives the demand side for auditors? What is your anecdotal experience as a company in selecting an auditor? You base it on market perception and a whole range of factors, but do you think that there is any reason why perhaps companies would look at selecting an auditor on the basis of more than a pre-existing relationship, with that relationship flowing across into perhaps having influence over the audit opinion?

Mr Faulkner—I cannot draw on any experience where that has been the case. There are an enormous number of factors that would go into choosing the auditor, especially their experience, industry expertise, global coverage and experience in those types of industries—knowledge of that individual entity could well play a part in determining that. If the suggestion is that, 'The audit firm will sign my audit report no matter what I do,' I certainly do not know of any instances or examples of that nature.

Mr CIOBO—Have members approached you as a body to say, 'Look, we are concerned, because we provide both audit services and non-audit services, that this client perhaps thinks they

have a high degree of influence over where we're looking at going than we would feel comfortable with'?

Mr Faulkner—That is a suggestion that the commerciality of the business transaction that you are involved in—that is, your appointment as auditors and others—has an influence on your audit opinion. I simply do not know of any cases where there is that influence.

Mr Reilly—If I could comment briefly, I think one of the inferences from your question could be: what influence should management have over the appointment of the auditor? Already we have seen today evidence that management does have an incentive to drive down costs. We have argued, in going back to the 'Expectation gap'—which was a document included as an appendix to our submission in 1993—that there should be an independent audit committee—independent being those directors who are not part of the management structure of the company—and it should be its role to effectively manage the audit mandate. In the setting of audit fees, rather than management being involved, it should be the audit committee that makes the recommendation to the board. I might get a smile out of Senator Murray by suggesting that some aspects of the independent audit committee are not dissimilar to some of the functions of the shareholder board that Senator Murray was looking—appointment is a bit different. That is important and, if you look at our submission, the evidence that has come out of Enron and that is coming out of the HIH royal commission and any one of a number of the other corporate collapses is that there has been a failure within corporate governance which really should have been picked up at the board level. If it is not picked up at the board level, it is somewhat of a hard ask to expect that the auditor will then be able to have a significant involvement in the process.

I go back to the comments made by Professor Berna Collier in her paper, which is an appendix to our submission, that there has been no systemic failure in the corporate governance framework, but clearly there have been individual cases where there has been what can only be described as management fraud. We need a way of inhibiting such fraud. The independent audit committee is one way of enhancing both the independence and role of the auditor, but it would also enhance the role of directors and ultimately shareholders. We think that would be a major innovation that probably is not in our Australian system at the moment. Yes, we have audit committees, but they are not necessarily independent.

Ms GRIERSON—I would like you to elaborate more on the independent audit committees, but first, from reading your submission, there seems to be acceptance of the standards and a view that the frameworks are fine, but you do suggest a tougher penalty regime for providing misleading information or withholding information. What would you suggest in that respect?

Mr Reilly—We have argued in our submission—again, we do not have in the financial reporting framework at the moment—for a system of management representation letters. Neil might be able to comment a little bit more about the way they have operated in terms of the auditor wanting to ensure that information that is being provided that goes into the financial statements is in fact correct. We are suggesting—at this stage it is purely a suggestion to be looked at—that you have sign-off from each manager within the company to say each year that the information they have provided, which has become part of the financial statements, is in fact correct.

Ms GRIERSON—So increasing their liability?

Mr Reilly—Not so much increasing their liability. If you have a finance director coming down to the accountant and saying, 'This is the result I want,' and there has been some evidence in one or two cases that that has been the case, the accountant now has a choice of either doing it or being fired. The case of the CPA whistleblower was probably a good example of that. If the accountant then had to say to the finance director 'Well, I can give you that result, but do you realise that the management representation letter that I give you and which also separately goes to the independent audit committee is going to draw attention to that fact? Do you want me to still engage in that fraudulent transaction?' that at least puts some barriers in place. At the end of the day you will not stop the crooks, but we have seen a number of examples where people who appear to have been honest and ethical have been caught up in some of these corporate collapses and have made really bad judgment decisions.

Mr Harrison—You might also think of whether it should be a felony to mislead an auditor either by providing false information or by withholding critical information which would be important to an auditor in reaching his or her conclusions.

Ms GRIERSON—The other thing is that if you mandate independent audit committees in some way would that be resisted? How do you ensure independence when it is internal to the organisation?

Mr Harrison—I suppose this is where we get into the discussion as to whether the better model is the corporate governance board. Most attempts up to today have been made to substantiate the independence through ensuring that those directors who serve on the audit committee are those directors who have no direct interest in the management or day-to-day activities of the company—that they are truly external directors. I have not heard a better case put. One needs to monitor that to make sure that that does provide the appropriate independent process that manages the audit. One of the things we are seeing is that the audit committees these days are moving away from seeing audit as being a commodity which needs to be driven down in price to audit as being a commodity which does add value. The more you enhance the role of the audit committee and the more they recognise that benefit, then the greater benefit we will get out of the whole process.

Mr Reilly—Professor Ramsay's report actually did contain a structure for having independent audit committees. In fact, he picked that up from the 1997 audit working party's report. We have also tabled in our submission, as an appendix, a best practice guide on audit committees that has been issued by the accounting profession, the Institute of Internal Auditors Australia and the Australian Institute of Company Directors. So we believe you will need some regulation to actually mandate audit committees at the listed company level, but what you would then do is leave the guidance, the fine detail, down to a group like the International Auditing and Assurance Standards Board or some other body that would then provide the mechanics for that.

CHAIRMAN—Something bothers me here, because I think all three of you are essentially saying, 'Gee, the auditors are doing such a fantastic, professional job.' I have not yet seen the video of the board meeting at Andersens in the United States on Enron but I am told it is quite

illuminating, with the partners freely talking about shredding every document that could even possibly lead to their incrimination.

Senator WATSON—We are talking about Australian practice, Mr Chairman.

CHAIRMAN—Then I am reminded that the HIH collapse has cost Australia dearly, not just people who held shares in HIH. A lot of community organisations out there are now bleeding or cannot even do their jobs because the insurance industry is in chaos following that huge collapse.

Mr Harrison—We have to be very careful though about treating Enron and HIH as being two similar situations. The Enron situation I refer to is the specifics of destroying documents, and I do not think you will find much debate that that was an incredibly foolish decision. The consequences are now very apparent. To suggest that those circumstances might be similar to the HIH demise and that the auditor—

CHAIRMAN—I made no such suggestion, none whatsoever. All I said was that we have had some big collapses in Australia that have hurt people.

Mr Harrison—My point there is that we acknowledge the shortcomings of the decision to destroy evidence in the way in which it occurred in Enron, but in the HIH case I think we have to wait until the royal commission finally determines the outcome as to where the blame lies for that failure. To date I have seen more problems about corporate management, corporate governance and fraud than anything else as being the cause of that collapse.

CHAIRMAN—I think we would probably accept that, Mr Harrison. But is it not also true, though, that the public says, 'Well, if there are going to be bad guys in the corporate sector—and there always will be; nothing is ever going to be perfect—can't we expect our auditors to let us know that there is a problem?'

Mr Harrison—I guess that goes back to the scope of the audit. It is not part of the scope of the audit for the auditors to be whistleblowers on all the activities of corporate management and governance. If it is of benefit to the investing public for the scope of the audit to be widened, that is something to be looked at, but it is not something that can be taken lightly. There are some quite significant issues attached to that. One of the things we have spoken about is that where there is a formal audit statement perhaps one needs to look at something a little less formal: a sort of DNA from auditors. If you are going to encourage auditors to become involved in that, you would have to look very carefully at the circumstances in which that is done, how they would get access to the appropriate information and, most particularly, the liability regime that they would face.

A question was asked earlier this morning about deep pockets. Insolvency practitioners almost invariably sue auditors when companies collapse because they have a duty to try to recover whatever funds they can for those who have lost their money. Auditors are well insured. Suing the auditor is a very tempting step to take—a necessary step to take, in the view of insolvency practitioners. They are pursuing that because of the deep pockets—not because the auditor has necessarily been at fault but because generally they gain a settlement out of that insurance process.

CHAIRMAN—Thank you very much for coming and participating in the inquiry. We look forward to the further information that you have advised that you will provide. I assume that if my secretariat puts further questions to you in writing, you would be happy to respond?

Mr Harrison—Certainly. Thank you for the opportunity to appear before you.

CHAIRMAN—We appreciate your contribution.

Proceedings suspended from 12.36 p.m. to 1.28 p.m.

[1.28 p.m.]

HUMPHRY, Mr Richard George, Managing Director and Chief Executive Officer, Australian Stock Exchange

JONES, Ms Christine Anne, General Counsel and Company Secretary, Australian Stock Exchange

SCULLY, Mr Colin Robert, Chief Operating Officer, Australian Stock Exchange

CHAIRMAN—I now welcome representatives of the Australian Stock Exchange to today's hearing. Thank you very much for coming and talking to us today, and thank you for your submission. Mr Humphry is an old friend of this committee, having briefed us on occasion and appeared as a witness on several occasions. Do you have a brief opening statement that you would like to make?

Mr Humphry—It might be a little long. We would be happy to have it tabled, if you wish.

CHAIRMAN—I would prefer that.

Mr Humphry—All right. The statement we have prepared deals, of course, with the issue of audit but, by way of background for the committee's information, it also deals with the issue of continuous disclosure and the way in which the markets function. In terms of audit committees, which may be the principal area of interest to the committee, perhaps I can just comment briefly. We have recently reviewed the extent to which the ASX listed entities have audit committees. We thought that might be useful to you. Of the 1,450 companies listed on the ASX, 93 per cent of the top 200 companies—which represent 94 per cent of market capitalisation—already have established audit committees. The bulk of the smallest thousand companies represent less than 4 per cent of total market capitalisation; a lot of these companies have only about $15 million in market cap. Notwithstanding this, 45 per cent of those have taken up audit committees.

The ASX is supportive of audit committees and agrees that an effective audit committee can play an important role in ensuring the quality of financial information. For that reason, the ASX does have a listing rule which requires that, if a listed entity does not establish an audit committee, that fact must be reported annually and the reasons for not establishing such a committee must be given. This requirement is backed by guidance notes on governance issues, which are distributed with the listed rules. We do, however, want to reiterate to the committee our concern about any proposal to mandate audit committees and to set minimum standards for them under ASX listing rules and guidance notes. Our reasons have been canvassed previously in our response to the Ramsay report but they are briefly set out by saying that mandating audit committees will not necessarily ensure auditor independence or audit quality. It is noteworthy that the high profile companies here in Australia that have failed in recent months—One.Tel, HIH and Harris Scarfe, for example—all had audit committees. In the cases of One.Tel and HIH, the committees had a majority of independent directors. Enron, in the United States, also had an audit committee.

A one size fits all prescriptive route does not take into account the size, the type or the variety of corporate entities which may expose investors and others to financial risk. ASX listed entities are bound by the listing rules but they are only a subset of the total number of companies in Australia and 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 sized companies. The ASX is not an arm of government; it is therefore not invested with the statutory powers of inspection and enforcement which are available to the Australian Securities and Investments Commission. As noted previously, the ASX's powers are limited and are based on a contract between the ASX and each listed entity. Because of these factors, the approach the ASX has adopted to date has been to require the disclosure of corporate governance practices to investors, including disclosure of whether the listed entity has an audit committee and, if it does not, the reasons for that. I will stop at that point and ask if I might table the rest of my opening statement.

CHAIRMAN—We would be happy to have your submission tabled as part of the documentation of our inquiry. We thank you for those words, Mr Humphry. These are important issues. One of the things the committee is trying to come to grips with is the question of independence across the whole broad spectrum of corporate governance, looking at accounting standards themselves, including auditing standards, in order to be able to provide the Australian public with a more reasonable assurance that when they invest on your exchange in one or more of your listed companies and they read the annual report they will get a true and fair view of the company itself.

The audit function is regulated—that is to say, there has to be an audit—but there is a lot of debate in the community about the quality of audit. It seemed to me the other night when I was thinking about this that the best mechanism I know of to assure quality is the marketplace. It seems to be about the best judge that there is, versus regulators and those who give exams, tests and so on. I wondered how the industry itself would react to a suggestion that auditors, instead of being natural persons, be required to be corporations. You do not have to answer that off the top of your head, because I suspect that you, like others, will need some time to think about the ramifications, but—

Mr Humphry—I am happy to give you a first reaction. I think that that would be a useful matter to explore. Then the audit corporation would be subject to the Corporations Law in the same way that any other listed company is. I see no reason why they cannot move into that type of structure.

CHAIRMAN—You certainly appreciate the independent audit function that operates in this place in respect of ANAO.

Mr Humphry—Correct.

CHAIRMAN—If auditing firms were corporations and they were required to be audited, would you not think that might give the public more assurance as to quality?

Mr Humphry—I think we are really talking here about the quality of audit. As long as the quality of the audit of that particular company was of an appropriate standard, yes, it is something that would then be required to be reported upon in the annual report. But what an

auditor normally does is certify on the accounts. I think what you might be driving at is a form of certification upon, for example, the processes and procedures that they adopt in order for there to be independence between, say, the audit function and other services that might be provided or to do with the quality of the audits that they supply.

CHAIRMAN—Professor Houghton has proposed that audit firms have an internal separate independence group, whatever you want to call it—a board or a group—within the firm itself which examines the independent issues for that firm itself and assures the partners that the operations are fair and reasonable.

Mr Humphry—I support that. The firm of PricewaterhouseCoopers has recently taken a step in that direction by appointing a panel to examine the procedures that they follow to ensure that there is an arms-length examination of the practice of independence. It might be useful for the committee just to note that, when the Australian Stock Exchange took the step of demutualising and moving across to be a listed entity, the issue of our regulatory role or supervision of the market had to be examined to see whether or not we were in conflicted positions. For example, if we entered into a joint venture arrangement with one of our listed companies, how could we also supervise that company's disclosures to the market? We have addressed that issue—and it itself has been subject to examination by a Senate committee—by establishing another arms-length body, the Australian Stock Exchange Supervisory Review Board, chaired by David Hoare. That group of people effectively review the ASX's practices and report independently not only to our board but to the Australian Securities and Investments Commission.

CHAIRMAN—As you will be well aware, US corporate law requires quarterly reports of listed companies and Australia requires only annual reports of listed companies. Would you be opposed to quarterly reports?

Mr Humphry—I would not recommend them. The reason I would not do so is that we have in this country a superior mechanism which we refer to as continuous disclosure. Under listing rule 3.1—and this is backed by the Corporations Law—every listed entity is required to bring material information immediately to the notice of the market so that investors may be made aware. I bring to the attention of the committee that, in the most recent filing with the SEC of quarterly reports by companies, there was a difference of over $100 billion between that and publicly released information by way of press releases. As a result of that, at a meeting with the United States Securities Exchange Commission chairman, Mr Harvey Pitt—and I have met with him—and the head of the Australian Securities and Investments Commission, David Knott, it was agreed that we in Australia would present a paper to him on our continuous disclosure regime. He is examining the question of whether to bring in current reporting, which is along similar lines.

CHAIRMAN—I hear what you say, but it did not seem to make a lot of difference in the case of HIH, Harris Scarfe or One.Tel.

Mr Humphry—There is no way that you can regulate against fraud. I would defy any regulatory system, no matter how many reports are produced, to stop people who are determined to mislead.

CHAIRMAN—Is there no way that you can enhance the independence of the audit function or improve on its quality to encourage better disclosure and encourage more honesty and fair dealing and less fraud in the market?

Mr Humphry—The Stock Exchange feels very strongly about this issue. Ultimately, we believe we are dependent upon the quality and the behaviour of directors to ensure that that transparency exists. There is absolutely no question in my mind that the most suitable mechanism to have is this continuous information flow to investors. We support audit committees, for example. What we do not think is that, by mandating an audit committee, you necessarily actually achieve the quality outcome that you want. You can write guidelines. I remember the Cadbury report produced in the United Kingdom on governance matters; when we matched it against the behaviour of Maxwell, who had absconded with all of the superannuation money, he got a perfect score. He ticked on every box. So the procedures or the 'tick a box' approach to mechanisms which are set up will not guarantee the outcome. In fact, they can, I believe, provide cover for people who want to mislead. Ultimately you are dependent upon a culture of disclosure, not a culture of compliance. I cannot give you an easy answer to this, but it comes through market transparency and education, and it has to be backed by severe sanctions.

CHAIRMAN—One of the issues we discussed this morning was the value a company management places on the audit function versus other functions that accounting firms supply to corporations. There seems to be a divergence of view. There are some in the Australian community who believe that there are instances—and perhaps lots of them—where audit firms undertake the audit as a loss leader in order to get the other business; there are others who say that does not happen and that there is no interrelationship between the two. And some argue that company management looks on audit as an expense, not a benefit. Would you share your views on this.

Mr Humphry—I certainly do not agree with any of those later points that you were making, Mr Chairman. To me it is not so much about whether or not you have other services provided in addition to audit, it is more a factor of whether the auditor is in fact dependent upon that company in some material sense. In other words, I am saying to you that, even if it was only an audit, if that audit was so important to that audit company that it needed to retain that business then, I think, there is an issue of conflict and a lack of independence. It seems to me that that is the criteria that has to be applied.

Having said that, I think there are a number of associated functions with audit that, legitimately, need to be still carried out by a single firm, just in terms of the sheer logistics and costs. But I am pleased to see that most of the accounting firms, if not all of them, are now moving to separate the arm that provides other services. I think that it is more than just a Chinese wall. There has to be a complete separation and that, really, in a sense, strengthens the point you made before about moving to a corporate structure, because that would place direct responsibility on the directors of those organisations. So the only point I am really trying to make is that it is do with the degree of leverage that the work means to the company rather than the mix of the work that they carry out.

Senator MURRAY—Mr Humphry, I appreciated your remarks about audit committees. In my experience, if there is a board dominated by managers and shareholders who are excessively

self-interested, that self-interest will flow down to the audit committee because they will be their creature; they will be part of the same group. So I think your remarks on audit committees are true and that sometimes audit committees are great beasts and sometimes they are not, and the lack of arms-length interaction is important. I want to address something else that is very important and which you remarked on—that is, the quality of directors, which we have not really heard that much about in the hearing today. Can you tell me whether the ASX and ASIC are getting along any further in developing a best practice guide for the election of directors?

Mr Humphry—I do not think we have any projects of that sort. I will ask Ms Jones if she will comment on corporate governance issues.

Ms Jones—Obviously there has been a lot of focus on corporate governance practices generally in recent times. ASIC and the ASX do work together pretty closely on this. In 2000, ASX and ASIC worked on a better disclosure process, in conjunction with listed companies. The results of that were incorporated into our practice note on corporate governance issues. There is nothing specifically of the nature that you have suggested that I am aware is happening at the moment but, certainly, corporate governance is on everybody's agenda at the moment.

Senator MURRAY—I should perhaps explain because it may assist you in your answer. I sit on the statutory committee that has oversight of ASIC. Over a period of three or four years now I have consistently asked them whether they were going to pay attention to—and they would need to do it in conjunction with you—the issue of the best practice election of directors. Some of the material we have had before us in that committee shows that certain listed companies have absolutely appalling processes which meet the requirements of their constitution but which, frankly, would allow anyone to rig the election as they see fit, compared with other companies that have exemplary systems. I feel it is in the interests of the market overseers, you, and the market regulators, ASIC, to go down that path. So that is the framework against which I put my question.

Mr Humphry—We do, of course, have a guidance statement on governance, and what we have been in the practice of doing is to make reference there to any of the publications, reports or materials that we are aware of which might aid a company. But I think the issue you are raising, Senator Murray, goes to the whole question of qualification to stand as a director and the issue of procedures that govern the actual election itself to ensure that suitable persons are appointed.

As you know, the Corporations Law governs the procedural aspects, terms of appointment and certain other requirements, but it all goes back ultimately to the quality and maturity of judgment these people are able to bring to bear in the conduct of discharging their duties. One of the factors in considering an audit committee that concerns me a little is that there is a tendency these days to overlook the fact that the Corporations Law requires every director to discharge, to the best of his or her ability, their duties with or without an audit committee. An audit committee in no way diminishes their responsibility as directors. I would not like a public debate of this sort to lead to some sort of conclusion that, if you have established an audit committee, you have somehow delegated that responsibility to another body. That responsibility remains with the directors, and the audit committee is only a committee—no matter how it is set up—and it must always report to the board.

Senator MURRAY—I will leave the issue of best practice election of directors there. In my mind is the fact that ASIC have developed some very good guidelines and guidance notes in other aspects and, if you are attending to a very important area of responsibility and execution of duties, this is an area which has not had the attention it should.

Mr Humphry—Certainly the Stock Exchange would be interested in doing anything it can to support that project.

Senator MURRAY—My third area of questioning is about performance audits. The parliament, and this committee in particular, are very alert to the difference between financial audits—or, as we call them, assurance audits—of the financial status of government entities and agencies, and performance audits which evaluate the outcomes and the achievement of the objectives of those agencies. To my knowledge, performance audits are almost non-existent as an audit function on companies, and the market is meant to do that job. In my opinion, there are very few financial journalists of the kind of expertise that can dissect a company from top to bottom based on the publicly available information.

This leaves three potential bodies: ASIC, who I do not think have the ability; yourselves, who might have the ability but might not want to do it; and the auditors, who would only ever do it if it were a statutory requirement because the company would probably not initiate it. Do you think one of the things we should look at is giving regulators—either you, ASIC or both—not a mandate to impose performance audits but a requirement that, in the event of you being concerned that a company's performance and presentation of its situation is less than it might be, you would be required to send out a market signal that a performance audit should be done over such a company?

Mr Humphry—I would like to answer that in various ways. Firstly, I am no stranger to the performance audit. I was the Auditor-General for the state of Victoria and I actually introduced performance audits, along with my predecessor in his last period.

Senator MURRAY—I apologise; I should have acknowledged that.

Mr Humphry—No, that is going back some years now. I agree entirely with the sentiment you give, because you are really making a value judgment on whether or not the organisation has achieved the objective as opposed to simply meeting the requirements of the statute. In the private sector, the issue that you are touching on may also be expressed in terms of a mechanism which identifies risk and has set in place the ability to manage that risk because a business may fail. An audit is essentially about ensuring that the business has been managed well and setting out what its financial position is so that the investor can make a decision. The other bits of information that really need to be there are whether necessary steps have been put in place to ensure that the business can continue and whether contingent arrangements have been put in place to meet all reasonable circumstances. I believe, therefore, that in audit committees—and this really comes to the heart of the arrangements that might guide the conduct of the audit committee—it should be a requirement that considerable focus be made on the risks that that organisation faces. I would like the audit to actually audit that risk assessment.

It is now practice—certainly with the senior audit firms—to do that. I also need to point out that not all companies are the same. The risks that may confront Qantas, or a mining company

in Western Australia will probably all be different. It requires different skills to assess whether or not those risks have been adequately addressed. One might argue that in the insurance industry actuarial skills might be more important than financial skills for that reason. In looking at the whole question of composition of audit committees and skills that need to be taken on board to conduct audits, I would like to put forward the view that risk assessment would be a big step towards improving the quality of the audit itself.

Senator MURRAY—As my last question, would you mind taking on notice giving a little more thought to this area of performance audit and ways it might be encouraged as a more formal and more common form of risk appraisal for companies?

Mr Humphry—I must point out that, as an Auditor-General when I brought down my value audits, they were the ones that actually created the most heat and dust. The value audit is really a subjective judgment on whether or not the right management decisions have been made. This is a very difficult area to address. To do it in the private sector will be an interesting experience. The exercise of our rule 3.1 on continuous disclosure on media reports has already generated a considerable amount of public debate by listed companies who feel affronted that we are insisting on disclosure.

Senator MURRAY—Would you mind giving a bit of thought to that and dropping us a note?

Mr Humphry—I will.

Senator MURRAY—My assumption is that the media does not do the job, and I do not know anyone else who is doing the job. Therefore the market, I think, likes that kind of assistance.

CHAIRMAN—Perhaps Senator Murray is envisaging another role for this committee, or perhaps a new committee that can oversight all of those internal performance audit reports, because we have plenty to do.

Ms GRIERSON—I want to follow up on that point because I think it is fairly essential. I represent the layman and the public here, and I think there is a need for a performance audit function. Is it possible to consider something like the taxation commissioner does? They choose an area of what you might call risk and signal to all companies that this year they are looking closely at an area of risk in terms of performance and management. Is it possible to use a model like that, that introduces annually, or on a progressive cycle, areas that are identified that are impinging on performance?

Mr Humphry—I certainly think that one could encourage this to occur. I should explain also that many of our large firms have risk management committees. There is a debate going on at the moment as to whether or not you should integrate these with an audit committee. My view is that for medium-sized companies and smaller companies having a proliferation of committees is not necessarily productive. Many of the functions of risk assessment and financial reporting have a great deal of synergy. That is why I am advocating a stronger reference to risk. In a sense, annual reports should be doing these things now. Annual reports are really about explaining what the company is about and what its strategic direction or plans might be. It is in

that context that one would write it against the risks and the opportunities that might exist. I think that would add a great deal more value to the investors' information.

I think many companies already do that. If one wants to encourage it, perhaps the best way to do that is by guidance, because it comes back to the question of the quality of the directors and their desire to impart to their investors this sort of information. The difficulty is always that, for those who do not wish to convey the information, it is very hard to find a mechanism which will force it. I reiterate that what you do need is the importance of quite severe sanctions. It is for that reason that the Stock Exchange has supported the Australian Securities Investment Commission's call to extend fines as a means of further sanctions against companies which do not adequately disclose.

Senator WATSON—In the public mind, Mr Humphry, there is a false notion that corporate failure is often associated with audit failure. Would you care to comment?

Mr Humphry—In the public mind, I think there is a view that somehow the auditors duplicate all of the decisions of management and check everything that has been done, whereas an audit is essentially a qualitative assessment, normally based on some form of sampling, as to whether or not the records have been maintained at an appropriate level and against a series of accounting standards which, by their nature, are not absolutely precise, that the financial accounts have been drawn up and are representative of the true state of affairs. I have to tell you that, as a person who is getting on in years, I used to prefer the true and fair certification by auditors, but you might note that it has long since been taken away. I think it was taken away because the auditors did not feel that they could guarantee that it was true and fair.

Senator WATSON—It comes back as a secondary consideration, doesn't it?

Mr Humphry—Yes. When I was the Auditor-General of Victoria, I took a fairly critical view of that. It seemed to me that what was being presented was fairly true or truly fair, and that was not, to me, satisfactory. But the nature of audit is, by definition, something which will always be a judgment, an assessment. It is no guarantee that a corporation cannot fail. The responsibility for management of the corporation and for failure or success rests squarely with the directors. The Corporations Law is quite clear on that point. It probably highlights the point that Senator Murray raised about not only the selection process but also the ongoing education and information that they must have. Perhaps the Instititute of Company Directors might have a view on this—on how they might go about enhancing their members' capabilities.

Senator WATSON—If you look at companies like Barings and perhaps One.Tel and those sorts of operations, a lot of the problems occurred as a result of the quick sequence of events after the audit report had been prepared. How do we overcome this problem?

Mr Humphry—Do you mean the destruction of material?

Senator WATSON—No, the significant events. In the Barings case, the way he carried on in relation to his IT operations, which resulted almost in the bankruptcy of Barings. In One.Tel, the very significant events really came to fruition after the audit report had been prepared. How do you prepare for those things? In an IT environment, a lot can happen in 24 hours. How do we guard against those sorts of telco type failures?

Mr Humphry—I suppose this comes back to the whole question of transparency and the view that we have that it must be on a continuous disclosure basis. An audit report will probably be signed around August or September, but the annual report may not be issued until towards the end of the calendar year, so there is going to be an elapsed period of time in which things may be occurring, if I understand Senator Watson's point.

CHAIRMAN—Can't you fix that?

Mr Humphry—No. The Australian Stock Exchange is often called upon to fix all these sorts of things, but the best we can offer—and I still think it is the best practice in the world—is the continuous disclosure regime. So, if material events occur, it is incumbent on the directors to immediately inform the market.

CHAIRMAN—But can't you mandate when the annual report is produced by?

Mr Humphry—Yes, we can require that. Is that Corporations Law?

Ms Jones—It is in the Corporations Act.

Mr Humphry—So it is the parliament that actually determines that?

Ms Jones—Yes.

CHAIRMAN—So we do that—we will have to write that one down!

Senator WATSON—A criticism of the ASX that we have heard is that your listing rules are not sufficiently rigorous to prevent companies with low prospects of success being listed in the first place. While I do not expect you to agree with that, I will take you one step further: once they are listed, what processes do you have with regard to looking over and re-evaluating their prospects for success? I would have thought that would be one of your responsibilities in ensuring confidence in the exchange.

Mr Humphry—On a statement of principle, we do agree that the confidence in the market essentially rests upon the perception by the community that the exchange manages a market of integrity. In fact, it is a critical issue that is occurring right now in the United States—fortunately, I think, not to the same extent here. I will ask Christine Jones to comment on the admission requirements for a company. It was in fact in the first part of our statement, so you will get material on that when that is read into the *Hansard*. I would also point out that we use provisions of escrow of promoters of companies to ensure that they cannot realise any gains within a certain period, and a couple of years ago we introduced quarterly reporting on cash flow for start-up companies and for some companies where we believed we needed to take extra steps.

Ms Jones—With respect to the first part of your question in terms of setting appropriate admission standards, I think ASX, in line with every other market in the world, uses the basic principles of establishing that minimum standards going to size and quality are in place and also that there is likely to be sufficient investor interest when the securities come to market. They are generally based on either net tangible assets or a profit history. There is obviously some distinc-

tion between markets depending on local factors. The Wallis inquiry pointed to the fact that Australia was not doing enough for its small to medium sized enterprises to foster growth in new business and development. I think it is important to bear in mind that there is this balancing between providing fostering for innovative new companies and protecting investors. So setting admission standards is really a bit of a balancing act. Our standards are set consistently with other markets in the world and, as I said, after going through the usual consultation process with our companies and with ASIC and going through the usual disallowance process by the minister.

For start-up companies we do have—as Mr Humphry referred to—additional protections in place. We not only require the financial statements on a half-yearly as well as a yearly basis but also require them to provide a cash flow statement on a quarterly basis. That allows the market to assess whether the kinds of projections that have been made in the prospectus material are actually being met. That should provide a tool for investors to make a better assessment about how the start-up company is travelling. For companies without a profit record, we frequently require the promoters of that company to hold any securities in escrow. That means that they cannot deal in those securities. If the securities do not come to market, suddenly there is a spike and the people who brought the company to market get out at the top and let the investors deal with the aftermath. What this is designed to do is to share that business risk between the people who are bringing those companies to the market and the investors. It allows a period of between 12 and 24 months—depending on the circumstances. It allows the market a period of time to value those securities before the promoters of those companies are allowed to sell their securities. So there are additional protections in place for some of those start-up companies. I guess that is a fairly longwinded way of saying that we believe our admission standards are appropriate for Australia in its position of scale, and monitoring and enforcement of those standards is constant—it is what we do.

Mr Humphry—On that aspect of it, we might place on the record—and it will be in our other paper—that we run a continual electronic surveillance of the market. The statistics of the alerts that are generated from that, which in turn are referred for investigation and possible referral across to the Australian Securities Investment Commission, are all set out in our annual report. The surveillance operations I would say are at the most sophisticated level you will find of any market in the world.

Senator WATSON—What about the need to report substantial director selling-down of their shareholding, say, as occurred with Anaconda? Who do you expect to carry the baby there for small shareholders?

Mr Humphry—There is a requirement that that be notified to the market.

Senator WATSON—What would you do about it?

Mr Humphry—What would we do about it? This is the whole point here. Would you suggest, Senator, that we would be restricting directors from selling their shares? I do not think that that is an appropriate step. We have to ensure transparency, which means that the market must be informed of these events, and then the investors must make their decisions. Otherwise what we are starting to take over is the management of the organisation.

CHAIRMAN—You do not agree with Ramsay that audit committees be mandated.

Mr Humphry—Yes.

CHAIRMAN—What is your view of the appropriateness or otherwise of company management purchasing the audit?

Mr Humphry—I must make the point here that we are very supportive of audit committees. We are not in any sense trying to downgrade their importance. Our only problem is really one of the practical issues that would be faced. If you have a $15 million company which has perhaps three directors on it and you suddenly require an audit committee to be formed, frankly, that could be done easily by the whole of the board becoming an audit committee. But if the requirement is that they would have to practise—that is, the majority of independent directors—and they would have financial or other expertise. Quite often these companies would be faced with having to put on two or three or even double the number of directors. Audit committees are, I think, very important; I think they need to be encouraged in every possible way—but I just caution that one size does not fit all. On the issue of management of the manager's purchasing audit, I am not quite clear on what you are referring to there, but, to me, the managing director and the staff should have no part in the appointment of that director or the decision on the levels of remuneration of the auditor from outside.

CHAIRMAN—That is what happens now. Doesn't management hire the auditor?

Mr Humphry—No, certainly not. The audit committee—if we take the Stock Exchange as an example—

CHAIRMAN—Are you telling me there is no company in Australia where management hires the auditor?

Mr Humphry—The internal auditor would be, but not the external auditor. If that is the practice, it is an inappropriate practice. The whole concept—

CHAIRMAN—I am not aware it is mandated. I am not aware it is in the Corporations Law.

Mr Humphry—I do not think that best practices have to necessarily be in the Corporations Law, but it is an inappropriate practice and can lead to the perception of lack of independence. So if you are putting the question to me whether or not I believe that that is an appropriate practice, the answer is no.

Senator MURRAY—Would you accept the alternative proposition that the proper thing for the parliament to do would be to mandate that the constitution of a company must have a mechanism for ensuring that the appointment and management of the external auditor was independent?

Mr Humphry—I would be happy to support that.

Senator MURRAY—Because then they can choose the mechanism that suits them.

Mr Humphry—Yes, but if what we are talking about there is that the acquiring of the auditor is by the board and the reporting by that auditor is to the board, the answer is yes: that is how it should be.

Senator MURRAY—Yes.

Mr Humphry—It is meant to audit the activities of everybody in the management, including the managing director.

Senator MURRAY—I would say especially.

Mr Humphry—Okay.

CHAIRMAN—Thank you once again for your submission. Thank you for coming today and for the additional information, which we will authorise to be published. If we have further questions I am sure you will not mind if we direct them to you in writing.

Mr Humphry—Certainly not. It is our pleasure to be here. Thank you for inviting us.

CHAIRMAN—It is our intention to conduct a quick inquiry. These issues have been hanging around long enough. We think they need to be aired publicly and we would like to come to our conclusions as quickly as possible in order that they can be fairly considered.

[2.18 p.m.]

McPHEE, Mr Ian, Deputy Auditor-General, Australian National Audit Office

WATSON, Mr Michael, Group Executive Officer, Australian National Audit Office

CHAIRMAN—I welcome representatives of the Australian National Audit Office appearing at today's hearings. Do you have a brief opening statement? You know what I mean by brief, Mr McPhee.

Mr McPhee—Exactly; that is why I decline to provide an opening statement. We are happy to go with the submission.

CHAIRMAN—God bless you, Mr McPhee. In a paper which I believe is to be published shortly, Professor Houghton said:

> We need a creative and probably very unconventional solution that ensures high quality competence and independence in the audit process.

I thought about those words and it appeared to me—rightly or wrongly—that when it comes to the issue of competence the best judge of competence is the market. In that context I read, in the papers we have in front of us today, that the Corporations Act requires that an auditor be a natural person, not a company. And it appeared to me that if we were looking to better guarantee independence of audit forms and to better guarantee quality of audit outcomes the market mechanism would work better if, instead of requiring auditors to be natural persons, we required auditors to be corporations and trading. I wonder if you have any views?

Mr McPhee—I think there is a range of issues which go to the question of independence and quality of audit. I probably know least about the issue of incorporation versus the partnership arrangements, and I would not profess to be an expert there. There seem to me to be a range of legal issues and liability management issues that go to that question. But I think there are some fundamental issues—and no doubt the committee is dealing with those as well—which go to the issue of auditing standards and how the profession self-regulates and how the profession itself ensures the quality of audits. So I think there is a whole range of issues.

I am not persuaded that the issue of incorporation or partnership is central. I certainly agree there are issues about how to restrict or contain the liabilities that auditors bear in their profession. For instance, when I am making these comments I am thinking of the Auditor-General's own position, which you are well aware of. He is an individual. His position is mandated. His independence is guaranteed by statute. There is a range of other provisions, which this committee is very well aware of, which ensures the independence and integrity of the Auditor-General. So I think there is more than one way to skin a cat.

CHAIRMAN—Is there anything about both financial and performance audit functions in the Commonwealth's jurisdiction—in which you and we have a vital role to play—that gives you

any insight as to what changes might be possible in the private sector to encourage more independence and more quality?

Mr McPhee—I think the public sector environment has traditionally been different because, as you are aware, our Auditor-General has the ability to do the financial statement audit as well as performance audits, which allows him or her the discretion of wider coverage where he or she deems that necessary. That is a very important difference in the private sector where the engagement, at least in respect of the financial statements, is about giving an opinion on the financial statements.

The other thing that is particularly clear in our legislation is the independence of the Auditor-General, and that has been made very clear in a declaratory type statement about the independence of the Auditor-General. From our point of view, the other thing that I think is very important is that the parliament itself provides us with the appropriation funds for the operations of our office. While we do charge fees for statutory bodies, including GBEs, we do not rely on the fee revenue from that. Our total budget comes from the parliament. So while I am not suggesting we nationalise all the audit firms to get to that position—

CHAIRMAN—It would certainly please the Audit Office, Mr McPhee!

Mr McPhee—I am pointing out that, as you know, we are in a special and indeed privileged position, and we recognise that. To come to the point, I know in the submissions that the issue about whether the independence of auditors should be in the Corporations Law or not is a relevant issue, and I certainly could see some merit in that. It is a symbolic provision, but I think in our legislation it is a very clear signal not only to the Auditor-General but also to the community at large that the auditor is indeed independent and has the statutory support to be so.

CHAIRMAN—By the same token, Mr McPhee, you will have to admit that you are audited, are you not? As natural persons, as partnerships, public auditors of private companies are not audited. There is no audit of the auditor. But if we made incorporations, they would be required to be audited. Wouldn't you think that would add another level of assurance to the public that the auditors are going to do the best job they can of being as responsible, honest and fraud risk-free as possible?

Mr McPhee—I certainly think that is one avenue. I guess I am not persuaded that it is the only approach and I am not persuaded about whether it should apply to all companies or whether there should be certain exclusions, as there are now.

CHAIRMAN—In his submission to us, Professor Houghton proposed that for every audit company there be an internal board called an independence board or whatever you want to call it. That board would deal with independent issues for that firm on a day-to-day basis. They really are very large firms and not single person operations anymore. There are only four big ones and they are very large companies with very large turnovers. I understand that at least one of the big four has adopted those procedures, and some others are saying no. Do you have a view on his proposal?

Mr McPhee—There are a couple of things, I think. The profession certainly seeks to act in the public interest. That is its charter, and that is what it is there to do. The other message these

days, I think, is that it is important to get external perspectives into the profession, so that it is not seen as a club and there is no perception that accountants and auditors are running this profession for themselves. Therefore, I am attracted to the idea of getting more input into the profession from different sources. Certainly, I am on the Australian Auditing and Assurance Standards Board and recently we have been fortunate to have a member who is not an auditor or an accountant but someone from the Australian Institute of Company Directors—he is a former chairman of the Stock Exchange in Melbourne, I think. He has brought a different but very valuable perspective to the auditing standards board. Firstly, I think the profession is to be congratulated for taking that step. I think it could herald a wider opportunity for other parties to become involved in the profession. Whether each firm needs one of these oversight boards is a matter for them. I think it probably demonstrates an acceptance that the firms and the profession would benefit from a wider perspective in grappling with the issues that each is required to deal with.

CHAIRMAN—CPA Australia has proposed a huge oversight model with a standard setting board for auditing and accounting and for the regulatory function; they are all put together. Does that attract you?

Mr McPhee—Certainly presentationally it looks pretty good and it has a nice symmetry about it. I guess my personal position is that at least from the point of view of the auditing side the auditing standards we have in Australia are very good. We have strong links with the international arrangements, and my point would be that the pluses and minuses really need to be carefully considered before making such a significant change. The other thing I would consider is whether the auditing side would get a reasonable crack of the whip in terms of the accounting side. It is a bit like the debate we currently have with the FRC about whether the public sector gets a fair crack of the whip compared to the private sector. If you lumped the auditing side into the current arrangements, the issue I would have would relate to whether sufficient priority were being given to the auditing. At the moment the arrangements are very clear and streamlined as far as the auditing standard setting processes are concerned. I am not anti the idea. I like the idea it has of allowing external views to come into the profession, but I am not necessarily convinced that it is the right model, because I do not think the existing model is that broken. I think it actually works quite well. It would be different if we had failures in terms of auditing standards or some systemic problem but I am not seeing that. Therefore, I say: show me the arguments as to why we should change the approach.

Senator MURRAY—As you know, because we have had this discourse before, you are entitled to audit the 12 government business enterprises, if you are requested to do so by this committee or by the minister.

Mr McPhee—In terms of performance auditing.

Senator MURRAY—That is right, and you have not been asked to do so. All those government business enterprises are audited by external auditors. That is true, isn't it?

Mr McPhee—Let me just clarify that. They are audited by the Auditor-General but we use the firms under contract to assist us with that audit. We are still involved in the management and the planning for those audits to allow the Auditor-General to discharge his responsibility. In terms of the day-to-day auditing, you are correct, we do outsource those.

Senator MURRAY—I would be interested to know whether you have ever been told as an audit office by those auditors whether the nature, breadth, depth and scope of their audit, their access, their remit, if you like, is materially different to what they encounter in a private sector audit.

Mr Watson—No, not to my knowledge. We have not been told that. In fact, when we do the audit of Telstra we use Ernst and Young. When we do the audit of the Reserve Bank of Australian we use Pricewaterhouse. The audit we are getting from them meets our standards, meets their standards and is consistent with an industry standard. They have not come forward and said it is any different sort of an audit that they are doing for us than if they were doing it privately or separately.

Senator MURRAY—You may not have asked the specific questions in the specific environment, of course—

Mr Watson—If I can interrupt you there, they have to do the audit in accordance with the Australian auditing standards, which are gazetted under the Australian National Audit Office standards, which are one and the same thing.

Senator MURRAY—One of the assumptions I certainly have is that there are private sector companies which comply with statute and no more and there are other private sector companies that say, 'That may be statute, but we really want you to check out this, this and this in addition to make absolutely sure our systems are producing what we want and that our assets are at real value and actually exist in the place they are said to exist in et cetera.' That really lies behind my question, because I assume that when you give a brief to a subcontractor you do not just look for the minimum; that in addition to the statutory minimum you look for those areas where you think there may be an issue or a problem. Let us take a huge company like Telstra. I would expect you would never—perhaps you can answer me whether you do or do not—say: 'Just comply with the minimum.' You would look for the areas of risk.

Mr McPhee—Our focus is to give that opinion that the accounts are materially correct. That is our focus. We work closely, say, in Telstra's case with the audit committee, which is extremely strong. We tune in to some of the issues which are concerning the company itself. Modern-day audit practice is very much designed to take a risk based approach. You start off saying: what are the risks to this particular corporation and how is the management managing those risks? So the auditor considers the risks and considers the system of internal controls to see what reliance can be placed on those sorts of management arrangements and then decides what sort of testing is required to cover off those risks to get assurance about the accounts. But the focus is very much still on the financial statements.

There have been occasions where, because of particular matters of interest to the Auditor-General, we have given particular emphasis to that during the course of our audits, and we have spoken to the firms working with us on those audits to make that point clear. I think what Mr Watson is saying is that, in terms of the straight financial audit, it is not very dissimilar to what a firm would do in its own right. The only distinction is that we do write to the minister on the results of our audits as well and draw any significant matters to the minister's attention and then subsequently to the parliament's attention. So we have, I guess, the opportunity for greater

disclosure than a private sector auditor would vis-a-vis our role with the parliament compared with their role with the shareholders.

Senator MURRAY—The value of this evidence is that it indicates that the ANAO cannot be considered as just having public sector expertise. That is useful in terms of your own views from our perspective. Moving to the issue of the auditor independence, I am attracted to the idea that it does not mandate specific mechanisms but mandates specific outcomes, namely, in the case of audit independence, I would like to see the Corporations Law say that the appointment and the practice of external audit in a listed company and, frankly, in any company of size, should be at arm's length and genuinely independent. And they must have processes to ensure that. That would mean to me that, if a company wanted to choose my particular model of the corporate governance board, they could. If they wanted to choose an audit committee model, they could. If they wish to select an audit firm, which had an independent board of management, they could. There are many mechanisms which would mean that you could get horses for courses. How do you react to that proposition?

Mr McPhee—I agree in principle. The only area I would perhaps query would be the arms-length approach because often you will need management to sift through to develop proposals, so an audit committee or a subcommittee of the board could consider the selection of the auditor. It just depends on what you mean by arm's length. All I am saying is that you need to allow for the company officers to do some preliminary work.

Senator MURRAY—That is an area we should explore. Both the chair and I come from a business background, and perhaps other members of the committee as well. Both of us know that, as directors, managers and owners—including in publicly listed companies—we determine who the auditor would be and then the shareholders tick it off. That is not always as arm's length as it should be, because if you get an owner or a manger or a controlling shareholder who has an improper interest in steering things along in the way they might like to, they may try and pick somebody who they think they can pressure a little more than somebody who otherwise might be a little tougher to deal with.

Mr McPhee—I accept your point. Knowing that directors can be very busy people as well, all I am saying is that you do not regulate for the process, which is your point. But you make it clear what the outcome is that you are expecting. I do not have any problems with that. I was really just picking up on the completely arms-length comment that I think you made. It was just really to say sometimes you may need a bit of assistance.

Senator MURRAY—My last question is a request on notice. Could you perhaps give us some assistance in indicating what frame of words would help us determine in our report mandating a process?

Mr McPhee—Mandating a process or an outcome?

Senator MURRAY—Yes, mandating an outcome. That is what I meant.

Mr McPhee—Senator Murray, we would be happy to provide our view along with others that you may receive.

Senator MURRAY—Thank you very much.

Senator WATSON—Mr McPhee, do you think we should have penalties in legislation—if the auditor is misled by any corporate official or if the ASX is misled—to treat it as a felony? Mr Stephen Harrison earlier today suggested that in terms of the auditor, but I have added the ASX. What do you think of that idea? Would that help you in the public sector as well?

Mr McPhee—We actually have some quite powerful legislation, as you would appreciate. We have very wide access powers. Officials are required to tell us the information that we seek if we approach them in a formal way, and there are some fairly severe penalties for leading us astray. So we actually have that regime. However, we rarely use it. We generally operate on a very informal basis because of the standing of the office and because public servants, knowing the legislative backing we have, generally will not play games with us.

The difficulty with the formal approach, and the reason we avoid it most of the time, is that it tends to generate a formal response. People are very careful. If you ask a question, they will give you the barest minimum, a narrow response. You really have to drag information out of them. Sometimes they will even appear with lawyers to make sure their position is protected. So, while I am sympathetic to the point that you are making, operationally it may have some downsides.

Senator WATSON—In relation to internal risk assessment, obviously that is necessary, but in relation to the profile of that, I see a need for an independent auditor review. Do you agree? If so, who should do it?

Mr McPhee—Independent auditor review of—

Senator WATSON—Risk assessment.

Mr McPhee—Certainly auditors generally will look at assessments of risks by organisations as a starting point for their own consideration of the audit coverage required. We certainly see it as good practice, and certainly the profession and its standard setting processes are heading down that way. In fact, there is a project very much being treated as a priority by the International Auditing and Assurance Standards Board which is dealing with the auditors' assessment of risk and the response to that risk assessment. It very much starts off with what risks the company or the organisation itself has assessed and what responses it has made to those risks. What you are saying is good practice and will become part of the auditing standards regime going forward.

Senator WATSON—The auditing standards going forward?

Mr McPhee—Going forward.

Senator WATSON—Can you spell that out a bit more?

Mr McPhee—At the moment, there is a priority project on the international board's agenda and the expectation is that in September three new exposure drafts of new standards will be released for public comment internationally. Then the due process requires comments to come

back. No doubt in the new year the new standard would be made available. I would be happy to provide the committee with the draft material at this stage. I believe it is a public document on the international web site. Certainly it will give you an indication of the updated approach of auditors to risk assessment.

Senator WATSON—From the outside, I ask you for an opinion as to whether you believe that on too many occasions, in terms of listed companies, the directors have too many other board responsibilities or too many outside interests. What is the optimum number if you are going to perform your duties as a corporate director—how many boards should you be sitting on?

Mr McPhee—I am not in an authoritative position to comment on that. It seems to me that it depends on the support the director has: whether the director is operating alone or with support staff to help him or her work through the papers. I do not think there is a definitive answer to that question.

Ms GRIERSON—Your support for strengthening the integrity of audit committees is appealing, and that submission has been put forward in many of the submissions we have had. We have also heard the ASX say they like the continuous disclosure provisions, and they think they are a powerful tool. We have also heard opposition to more frequent reporting. Is there a way of having a more continuous audit function that links the external auditor with an ongoing internal audit committee in a monitoring role?

Mr McPhee—Clearly that is possible. The question is that, at this stage, I am not aware of any mechanism for public reporting in that arena. Even if you are doing a continuous audit, the question becomes: how do you report publicly?

Ms GRIERSON—I would like to take up the point that you have made in your submission that you also like the use of the management letters that give some guidance et cetera. Is that a way, perhaps, of having a more continuous model or should they be separate in terms of them having a higher status? Should there be management letters that guide performance and perhaps respond, and management letters that really have an alerting or stronger function?

Mr McPhee—Certainly, the management letters play an important part in the process, and they are a necessary part. That is confidential, if you like, between the company and the auditor.

Ms GRIERSON—Yes. You have suggested that that might be a way of making things more transparent or making that more a tool that is used more widely?

Mr McPhee—Certainly, it is available and, as I say, in the Audit Office we are in a fortunate position where we basically convey the contents of our management letters—the significant issues—to the minister, in the first place, and then to the parliament. I have read some of the submissions and some of the other parties are suggesting that this is certainly a way forward and worth exploring, but they also raise the point about liability issues. They are basically saying sort those out and then we can go along with the management letters. It is a bit of a chicken and egg situation.

It is certainly different in the private sector where the company could conceivably ignore management letter issues, and the auditor, at the end of the day, can only disqualify or give a clear opinion. The benefit we have in the public sector is that, if we actually report this information to the minister and then the parliament, it is conceivable that, if it is significant enough, a parliamentary committee will pick it up, ask the entity to appear before it and, one would hope, get some resolution of the issue. Again, it is a benefit we have in the public sector where there is no equivalent arrangement in the private sector.

CHAIRMAN—This committee has had 39 or 40 submissions to date, and we have some conflict between the Australian accounting standards and a true and fair view of the balance sheet and the profit and loss statements of the company. We have heard today that, in earlier times, a true and fair view was really all that was needed, but it then got a bit out of kilter as people started applying rules differently—for instance, whether they were operating leases or finance leases.

Mr McPhee—Yes.

CHAIRMAN—I do not want to put too fine a point on the issue. Do you have a view on that?

Mr McPhee—As an aside, I found it very interesting the number of times the leasing standard got a mention as an area where perhaps a more principle based approach might be adopted; I found that quite interesting amongst all the papers. My personal view is that people have fond memories looking back at the old true and fair override. I think it brought some problems of its own back then. The attempt was to get the standards comprehensive and principles based, with a fairly clear objective, so that the public was aware just exactly how the auditor was framing his or her opinion—that is, against the body of approved endorsed standards.

I think we need to get the standards right. I like the idea that others have raised of principles based or making a clear message of what this standard is seeking to achieve and what it is seeking to stop—making that very clear in each standard—and then you could continue with the existing approach. It would not worry me about having a true and fair override, but I do remember some of the abuses at the time that that allowed to creep in. We have visited that issue and moved on, but obviously some people want to raise it again.

CHAIRMAN—You will probably blame me, because I raised it at the Australian Accounting Standards Board consultative group meeting and heads were nodding everywhere.

Senator WATSON—But don't we have that now—that if it is not true and fair you have to provide supplementary information?

Mr Watson—Yes, we do that.

Senator WATSON—This is a little bit ambiguous.

Mr Watson—There are 45 accounting standards. The language in the report says that, when you are applying, you say they are fairly stated in true and fair. When you have an issue, the

standard has to stand on its own. Two or three years ago I think you were allowed the option to say that if they did not adhere to the standard they were still true and fair. Now we say that you have to adhere to the standard and you can have what we call an emphasis of matter just to highlight something or get the financial controllers to put something in their accounts and then you can move on.

Mr McPhee—I think the issue, Senator Watson, is that you cannot ignore the standard. You can provide additional information—

Mr Watson—And then disclose that. The standard has primacy over the true and fair.

Senator WATSON—And then you can provide some additional information?

Mr Watson—Yes.

Senator WATSON—Does the auditor check and express an opinion on that additional information?

Mr Watson—For completeness, we have to assure ourselves about the veracity of that additional information to make sure it is consistent with what we are being advised and we would then report accordingly.

CHAIRMAN—Section 296 of the Corporations Act says that you have to comply with the accounting standards but section 297 talks about the financial statement and notes that you must give a true and fair view. Section 297 goes on to say that it does not affect the obligations under 296. So you have to do both. I simply raise the point, which I think you have agreed with, that those two sometimes are not complementary. I have one other question. Professor Ramsay suggests that we mandate the audit committee as part of the board structure of a large public company. The Australian Stock Exchange is very strongly against mandating. Can you tell us your view?

Mr McPhee—If I can come from the point of view of the Commonwealth public sector, as you would be aware both under the FMA Act and the CAC Act audit committees are mandated. Because I have a rosy view of the world, I would like to think that, even if they were not mandated now, people would see the great benefits of audit committees and continue to do that. However, I do not think you can always be assured of that. I do not have a problem with mandating, because that is the environment we work in. But I do think we need to hear the messages from some other submissions. It seems to me that it is probably unnecessary to mandate audit committees where companies have only one or two directors. Then the question becomes: do you just do it for listed and disclosing companies or entities; where do you draw the line? For me that is the only issue.

Mr CIOBO—I am just seeking a quick commentary. Mr McPhee, it seems to me that the ANAO is in a unique position with regard to two aspects. The first aspect is the compliance side of ANAO and how that might reflect in the private sector in terms of that conflict between compliance and value adding. A number of the submissions deal with that, and there is some argument to say: we need to add more value and that will help close that expectation gap. I wonder if an argument can be made—and I will be interested in your comments on this—from

the alternative position, which is if it is purely a compliance vehicle there might be less cause for concern and conflict. The second aspect is with regard to the scope of audits. It would seem to me that there is some attraction in increasing the scope of audits, and that can still be done without breaching the compliance vehicle mechanism. I would be interested in your comments in terms of how ANAO finds a broader scope of audit and how that might apply in the private sector.

Mr McPhee—In terms of the first question, there is no doubt the opinion is very much an assurance product. The firms, and even we, endeavour to make sure it adds value. If you were an outsider looking in you would pretty well see the opinion as an assurance opinion. We try to bring to the attention of, say, Telstra what some telcos might be doing internationally to handle these particular issues or problems that Telstra might be facing, so we seek to add value in that context. But, fundamentally, it is an assurance product.

I would not write down the value of that. A number of GBEs have asked us to do mid-year audits, which are not mandatory, because they want assurance that the mid-year position is as management is telling the board. They certainly have value, but it is not like, say, our performance audits where we have the mandate to look at the performance of systems, processes, procedures and governance arrangements. They are constrained because, fundamentally, the entity is only willing to pay for the assurance opinion. That is basically what the company wants. In those circumstances, if it wants further assistance, it will look to separate engagements for that with the auditor.

In terms of whether there are opportunities for enhancing the scope of audits within the private sector, as you say we are fortunate in that we have a wide scope from the assurance products—which are the opinions—right through to performance audits, and we cover all the territory in between. We have got a very wide range of products. I think certainly the opportunity exists within the assurance product to provide a little more coverage.

As I recall, Paul Coleman's submission talked about the liability issue once you start to take a wider position on that. Under the current convention, if entities themselves or directors want further work they would tend to see that as a separate engagement, and that then brings into play the question of other services and that whole debate. So I think there is a strong convention or tradition around the opinion and, while there may be some movement, I would not hold my breath for significant change in that. I think it will take a lot of time to get acceptance—both from the entity's point of view but also in relation to the audit firm's issue about liabilities—before that matter can be pursued.

CHAIRMAN—Thank you very much for coming and talking with us, as well as for your excellent submission. As is our usual practice, you will not mind responding to any further questions the secretariat may put to you?

Mr McPhee—Not at all, Chairman. We wish you all the best. This is a very significant issue.

CHAIRMAN—Mr McPhee, I am personally finding this more intellectually challenging than any issue I have addressed in the last several years.

Mr McPhee—I can understand that, Chairman. It is a tough one.

[3.01 p.m.]

COLEMAN, Mr Paul John, Registrar, Companies Auditors and Liquidators Disciplinary Board (CALDB)

CHAIRMAN—I welcome the representative from the Companies Auditors and Liquidators Disciplinary Board. We have not received a submission from you. Do you have a brief opening statement to make, or do we ask you our penetrating questions straight up?

Mr Coleman—Aside from offering you the apologies of the chairman, who is overseas at present, I have no opening statement.

CHAIRMAN—There are only so many things that we can talk to you about since you are a disciplinary board, but there is one thing that does concern the committee. I am advised, with the exception of perhaps one, that no auditor has been expelled from the profession in the last 10 years despite a significant number of cases being heard by your board, including 25 cases—and it is a mouthful to try and say—of serious misconduct leading to penalties and sanctions. Is the system working? Are we weeding out those who should not be in the profession?

Mr Coleman—Let me say that the board's jurisdiction is only enlivened on receipt of an application from ASIC. If ASIC is detecting auditors which it believes should be dealt with by the board, then it brings those matters to the board. To the extent that the board's work or those matters have come to the board, I would say that the system is working. We are talking about the livelihood of professional people who, in many cases, spend a significant portion of their working life, if not all, in that profession. To deprive people of that registration is basically an execution in criminal law. So that is a kind of sanction that you would only impose in the most extreme circumstances, I would imagine.

CHAIRMAN—Is your funding enough?

Mr Coleman—We do not have a problem with funding. ASIC provides for us quite sufficiently.

CHAIRMAN—We have had submissions that your funding be increased and that you be allowed to hear more than one matter at a time.

Mr Coleman—At present the workload is not such that the board needs to sit in more than one division simultaneously. We are aware that the audit committee in 1997 and also Ramsay took up the recommendation that the board be allowed to do so. That would be beneficial if the workload demanded it, but the workload is not there presently.

CHAIRMAN—Does there need to be a mechanism other than ASIC referring issues to you?

Mr Coleman—There may well be other avenues that can be explored. As the board has no investigatory powers of its own—nor does it want any for that matter; that would compromise

its role as an independent disciplinary board—it could be possible for other bodies such as APRA, or even the accounting bodies, to refer matters to the board but, given the compulsory powers that ASIC possesses which the other bodies do not, one has to question what sort of an investigation the accounting bodies could do, even if they had the funding.

CHAIRMAN—You would not want to hear cases based on rumour would you?

Mr Coleman—The board has a statutory obligation to afford respondents before the board natural justice and procedural fairness. The board must be satisfied that the evidence that has been led by ASIC is sufficient to warrant a sanction.

CHAIRMAN—You would be well aware that there have been some suggestions of a merger, with your board and your disciplinary powers and the professions brought together under the auspices of one new body. Have you formed a view on those suggestions?

Mr Coleman—No, the board does not have a view. I can only restate the case I stated before. There are some parties that have greater investigatory powers than others. Whether or not the board could adequately deal with or be satisfied by something or indeed whether some body like the institute could get the evidence necessary to bring a case before the board, it has not got compulsory powers. If it were given those powers, one has to ask whether the institute would want to use them.

CHAIRMAN—Fair enough. What about the Stock Exchange?

Mr Coleman—The stock exchange does not have any investigatory powers other than those that are spelt out in its contractual arrangements with its listed corporations. In fact in matters relating to the market in such things as insider trading, where it gets beyond ASX's mandate, they refer the matter to ASIC.

Senator MURRAY—Although ASX does not have investigative powers, does it have reference powers and can it refer matters to you?

Mr Coleman—It refers matters for investigation to ASIC. For it to refer matters to the board for investigation comes back to this issue of whether the board needs investigatory powers. It is set up presently as an independent disciplinary authority or board and it is a quasi-judicial authority. ASIC does the investigation and the prosecution of matters, much as before the creation of the DPP the police did the investigation and the prosecution of criminal matters before the court. The respondent is given an opportunity to appear and adduce evidence in his or her defence. Based on the evidence before it, the board makes a decision on whether to exercise its discretion or not.

Senator WATSON—This morning we heard from the accountancy bodies that a number of whistleblowers from within their profession pass on their concerns. Do you have many concerns passed on by various people in terms of being unhappy with the performance of some auditors and expecting some disciplinary action to be taken? If so, how do you handle those? Do you just refer them straight off to ASIC for evaluation?

Mr Coleman—The short answer to the last part of your question is yes. In line with the board's role and its jurisdiction, we have no option but to refer them to ASIC in the first instance. I instruct those people to lodge a complaint with ASIC for it to deal with under its complaints processing.

Senator WATSON—So you do not pass them on to ASIC?

Mr Coleman—I refer them to ASIC.

Senator WATSON—You refer them to ASIC?

Mr Coleman—Correct.

Senator WATSON—But also, at the same time, tell them to refer them to ASIC? You have given me two answers. You told me you refer them to ASIC, and in your qualification you said that you asked them to refer it to ASIC.

Mr Coleman—If I receive a communication from a member of the public or a member of the profession—I have never had one from the profession, but I do get, on the odd occasion, calls from members of the public complaining about an auditor or, more commonly, insolvency practitioners—I cannot deal with those complaints, and I suggest to them that the people they should be talking to first are ASIC. In doing so, I recommend they contact ASIC and lodge a complaint with ASIC.

Senator WATSON—So you do not lodge the complaint with ASIC?

Mr Coleman—No, I do not lodge the complaint.

Senator WATSON—So you do not make ASIC aware that there are a number of whistleblowers out there who are expressing concerns to you about the operations of certain companies?

Mr Coleman—I do not have the facility to do that. I am a one-man operation, apart from my board, who are part-time members. ASIC has a well-documented and well-established complaints processing set-up where any person who lodges a complaint with the commission has their complaint assessed against a number of criteria. I do not know those criteria. If ASIC decides that a complaint meets those criteria, it will instigate an investigation.

Senator WATSON—But what if I am, say, an uninitiated person who is concerned and has some inside information. I get the rebuff from you by referring it to you in first place. You say, 'Refer it to somebody else.' If the person feels that he is on a merry-go-round, he may well then drop it. I just feel that there should be some sort of mechanism, particularly if there are a series of complaints in relation to a particular operation. You should have the mechanism to refer them on to ASIC.

Mr Coleman—I would like to answer this by way of an analogy. If a person wishes to blow the whistle on some criminal conduct by coming to the CALDB in the first instance and ex-

pecting the CALDB to do something with that information, it would be like a person with information on criminal conduct going to the district court with that information. The district court is only going to refer them to the police. There is nothing I can do to investigate or to make an assessment. I am not even an accountant. The statute is quite clear that the jurisdiction of the board members is only enlivened on receipt of an application from ASIC.

Senator WATSON—I thought it might be handy if you also had a post office function of forwarding them on to ASIC if people did express concerns.

Mr Coleman—For members of the general public who are not familiar with the way this system operates, the CALDB has only in the last two or three years had any sort of a profile whatsoever. Prior to two or three years ago, nobody knew we existed. For a member of the general public, who does not know the system, to come to the board and for the board to then take on that information and help them through the system—

Senator WATSON—No, I am not suggesting that.

Mr Coleman—Even for the board to take the information from them and give that information to ASIC on the person's behalf may have the effect of compromising any evidence the person has.

CHAIRMAN—I have one last question. I am asking you your private view, not the view of your board: do you think that your findings should be made public, and would that give a higher profile not only to what you do but to the fact that there is a watchdog?

Mr Coleman—Definitely. Daylight is the best disinfectant.

CHAIRMAN—Thank you very much. We will take that on board, Mr Coleman. Is it the wish of the committee that the submissions from the Institute Chartered Accountants, No. 42, and the Australian Stock Exchange, No. 43, dated 21 June 2002 be accepted as evidence in the review of independent auditing by registered company auditors and authorised for publication? There being no objection, it is so ordered. I thank Hansard, all our respondents and participants, those that have come to view the proceedings, my colleagues and the secretariat.

Resolved (on motion by **Senator Murray**):

That this committee authorises publication, including publication on the parliamentary database of the proof transcript of the evidence given before it at public hearing this day.

Committee adjourned at 3.16 p.m.