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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Friday, 28 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 King, Mr King, Ms Plibersek and Mr Somlyay

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

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 9.39 a.m.

CHAIRMAN—The Joint Committee of Public Accounts and Audit will now commence taking evidence for its review of independent auditing by registered company auditors as provided for by the Public Accounts and Audit Committee Act 1951. I welcome everyone here this morning. This is the second in a series of public hearings that will examine audit firms, regulatory bodies, accounting and auditing professional bodies and eminent academics in the field of accountancy and auditing. Further hearings will be held in Sydney and Melbourne in July. The committee has received a wide range of submissions from all sectors of the accounting and auditing industry and profession. It is worth restating that three key issues have emerged in this debate: audit independence, deficiencies and corporate governance, and existing auditing and accounting standards. These will need to be considered in a holistic way in order to arrive at a coordinated and practical set of solutions.

The committee will begin by hearing from the Australian Chamber of Commerce and Industry. We will explore with ACCI ways in which corporate governance can be improved and what role the corporate sector should be playing to ensure audit independence. The committee will then hear from the Auditing and Assurance Standards Board. We are interested in investigating whether our accounting and auditing standards are meeting the public's expectations. The committee will then take evidence from two audit firms, Ernst and Young and Pitcher Partners. The committee wants to explore what audit practitioners can do to assure audit independence.

The committee will then take evidence from three prominent academics who have undertaken a wealth of research in this area. This will provide the opportunity to discuss ways in which greater accountability, competence and independence can be encouraged. The hearing concludes with evidence from the Association of Chartered Certified Accountants, which was involved in reforming the UK financial reporting system, and the National Institute of Accountants. We will examine their role in approving accounting and auditing standards and how both government and the professions may go forward together in finding practical solutions and rebuilding public confidence and trust in Australia's financial reporting system.

Before swearing in witnesses, I 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 report the proceedings of the committee fairly and accurately. Copies of the statement are available from secretariat staff present at this meeting. I might also add that the WorldCom fiasco, together with the Treasurer's announcement that the CLERP 9 discussion paper will be available sometime around August, has made this inquiry even more important, not just for Australia but on the world stage as well. I welcome the Australian Chamber of Commerce and Industry to today's meeting.

[9.43 a.m.]

DAVIS, Mr Brent, Director, Trade and International Affairs, Australian Chamber of Commerce and Industry

CHAIRMAN—Mr Davis, thank you very much for coming. We have, of course, received your submission which was quite comprehensive. Do you have a very brief opening statement?

Mr Davis—Just to reiterate some of your earlier remarks, CHAIRMAN, that I think the work of this committee plus other work under way elsewhere in this country, including the new CLERP 9 initiative announced by the Treasurer and the HIH Royal Commission, are quite valuable with regard to investigating some shortcomings in our corporate governance system. We hope that the recommendations of these various processes help rebuild that confidence in corporate governance which we believe is essential to investor confidence in our corporate community.

CHAIRMAN—I have said over and over again that we are looking at three things. We are looking at corporate governance, so-called auditor independence or competence or whatever, and we are also looking at accounting standards and it is to those three issues that we address ourselves. The Treasurer has said that our report will be right up there with everything else in terms of the decisions the government finally makes on the direction that Australia goes so this public inquiry is very important. There is always a balance between formal regulation and self-regulation and self-governance. One of the things we are exploring is where that balance lies—where the focal point is. Do you think we need tougher regulations regarding corporate governance?

Mr Davis—You have to work back from an outcome. You have to work out what your deficiencies are and what problems you are seeking to resolve. A blanket statement like that really does not help us focus on particular problems. To say there is a generic problem in corporate governance in Australia may be too broad a brush. To say there are some shortcomings in some areas, identify those and work through those as particular instances I think is a more productive approach. We could also say that, by and large, the quality of people coming forward to lead our corporations, whether it is people on boards or in senior management, is generally quite good. I will not sit here and say there are not some people whom we might call bad apples but, if it therefore becomes a question of whether the Corporations Law and some of the criminal laws are adequate to pick up those processes, prosecute them and impose suitable remedies and penalties where appropriate then I suggest that if the committee wishes to deal with particular elements that might be appropriate.

The balance between official regulation and self-regulation is always a delicate one. I guess the ultimate point is that no self-regulation model ever takes place totally in the absence of, or without a background to, regulation or law, so it is not really an either/or, it is just a stratified approach. There are any number of cases where official regulation is seen to be not the best practice, and they will trial self-regulation. Many self-regulation models such as trade practices law end up going under an authorisation or an official approval process anyway. Again, it is a

stratified approach. You have to look at a problem and deal with a problem—of course, not in isolation from each other—and focus on each issue per se.

CHAIRMAN—It has been said to me, anyway, that, when Arthur Andersen was alive, when he signed an audit report he would put his honour on the line with his signature. I am certain that there are many in the audit profession today who still live by that creed but there are those who do not, and that is obvious from a number of the corporate collapses in the early 2000s, the early 1900s or the early 1990s. How do we replace that personal guarantee with regulation, best practice guidelines or whatever to get us back to that position?

Mr Davis—The world was a lot different in 1915. The corporate world was much smaller, the professional world was much smaller and the regulatory framework was probably a lot simpler. I do not know that we could ever back to the arrangement where, in effect, the audit partner knew most of the people in that business community. The business community is much larger now, the laws are more complex and the nature of transactions is much more complex. And there is a material difference: in 1915 the audit partner or the auditor probably did the audit. They probably turned up on day one and marched their way through processing the books and actually did the work. That tends to be the exception these days. An audit is generally done by an audit team of a senior manager, a middle manager and a crew of rising talent, if you will, within an accounting firm. It would be unusual, I would suggest, that the auditor partner conducts per se the whole process. So in effect an audit partner just checks over what is done by his staff. I have heard it argued that the audit partner should be the person with their sleeves rolled up and a pencil in hand in the room doing it, not leaving it to a 28-year-old with an MBA or a master's degree in accounting. We do not have a view on whether that should be the process but again it is a question of complying with the laws. The laws are more complicated in some respects but equally they are not as precise as some may wish them to be. The Corporations Law does not set out the tests per se; it only sets out a requirement for a true and fair view. That is different issue again.

CHAIRMAN—Professor Ramsey has recommended that the sorts of companies that the ACCI represents, when they are public corporations, should be required to have an audit committee on the board made up of independent auditors some of whom are independent directors who are not employees or management of the company. Dick Humphry says that is a good idea but it should not be mandated. What is the ACCI's view?

Mr Davis—We have generally regarded that as a matter for the individual enterprise. I should have prefaced my remarks by saying that we are an umbrella for 350,000 firms but you would probably regard only about 200 of those as the big end of town. The great majority are what we would call the small end of town or are in country towns. We regard that as a matter for the individual company. We believe that most firms are going in the direction of setting up audit committees anyway. We have never had a view on the balance between independent directors and what might be called executive directors. We have followed the literature on that. There does not seem to be a best practice rule or any a priori view to say that one works better than the other. An executive director brings some talents to a board, and there can be some downsides to having independent directors. It goes to the question of balancing their talents, their abilities and the number of boards that an independent director can responsibly serve on. It is a very complicated issue.

As a matter of policy we would encourage our members to take the independent audit committee approach, but that again begets the question: what function does it serve? One could say that what you are in fact bringing in is a two-stage audit process. You have an audit group within a large enterprise where the in-house auditors do an audit to report to an audit committee that reports to the board. Then outside auditors come in, and what do they do? Do they check over the work of the in-house auditors, do they redo the whole thing a second time or do they just take assurances? It can be very expensive for large firms with complicated business operations to effectively undergo two audits, one with the in-house auditors and one with the out-of-house auditors. Insofar as you go down that track, it would be undesirable for the out-of-house auditors to lessen their rigour. But for a firm like a Fairfax, a BHP Billiton or a Telstra two audits can be exceptionally expensive. Of course you have to be mindful that we still have continuous disclosure too, so information—which is effectively what this is about—is continuously made available.

CHAIRMAN—We could end up recommending that we do nothing. We could say, 'Australia is pretty good.' In fact we have had some submissions in which people say that we are probably world class—world's best practice—at the moment. I think that is probably unrealistic. It is also unrealistic to think that the public would expect us to make no recommendations and say that we will leave things as they are, because the public, rightly, is very concerned. This is dinner table conversation now, and that is highly unusual.

Professor Houghton in Melbourne wrote in a recent article that we need a creative and probably very unconventional solution that ensures high-quality competence and independence in the audit process, and those two things are not necessarily mutually exclusive. In thinking about the competence end of it more than the independence end, it came to me that we require auditors to be natural persons; they are not allowed to be corporations. What if we turned that on its head and amended the Corporations Act to say, 'We require auditors to be corporations and therefore judged by the market as to their competence'? What would be your view of that?

Mr Davis—That would virtually mean changing the corporate structure of the profession from an association or a partnership into a corporation. Would it solve it? If one perceives that there is a problem in auditing, would corporate form redress that? To go back to the jurisprudence, would it turn a watchdog into a bloodhound? No, it would not.

Senator MURRAY—That is not jurisprudence; that is animal husbandry.

Mr Davis—I can give you the citation of a case we picked up on: the Kingston Cotton Mill. It is jurisprudence from 1896 which is the foundation of the Corporations Law. We can give the citation to the committee secretariat if you want it. Lord Justice Lopez said:

> It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution ... He is a watchdog, but not a bloodhound.

That is the foundation of the audit law. I do not think changing the corporate structure of an entity like Ernst and Young or Pricewaterhouse would make one iota of difference in their diligence. If one wishes to improve the diligence or change the functions of an auditor, that is the prerogative of the parliament—through, we hope, a very intensive consultation process, because such activities would not be costless.

Ms PLIBERSEK—Some of the evidence before us is that companies see the audit process as an inconvenience and an expense. There is, of course, potential to see it as a good way of adding value to a business. Do you have any views on how you would get companies to change their views of the auditing process?

Mr Davis—If you are running a medium-sized business and you get a Bureau of Statistics form—or your BAS statement or another piece of paper—it is another day that you are not out there building your enterprise. I think most enterprises would realise that, in fact, an audit is an essential part of their compliance with the Corporations Law. The Corporations Law is simply a trade-off: we get limited liability in return for these requirements which we comply with. So, if you like, it is a package deal between society and business. Business will comply with those regulations, and we hope we will be consulted on which ones are best practice. I would suggest, however, a good audit is a good marketing tool. It does not say that you are squeaky clean, it does not say that you are beyond reproach, but it says that you are compliant with the law and you are meeting your obligations. A lot of firms would treat it like that. I think most firms would regard it as just part of their business affairs.

Ms PLIBERSEK—It does also give the opportunity to discover areas of the business that are not particularly efficient, doesn't it? They may be compliant, but they are not—

Mr Davis—No; an audit is not an efficiency evaluation.

Ms PLIBERSEK—You do not ever pick those things up?

Mr Davis—An audit has nothing to do with how well the enterprise is spending money or whether the money could be spent better or otherwise. It does not make any business judgment rule type decisions at all. It is simply a review of financial statements. That is what the law prescribes. The law does not say that it is an efficiency or an evaluation of business judgment at all.

Ms PLIBERSEK—I am not suggesting that it is a legal requirement. I think that a lot of auditors would say that their work has the potential to add value in a way that you are saying it does not.

Mr Davis—It is an aside. Some auditors may say, 'Comparing your enterprise to another enterprise, have you thought of doing it this way?' Most auditors will come back and say, 'Yes, you can improve your systems by doing this, this and this.' But that tends to be what you might call a secondary function of the audit. The primary function of the audit is to meet the requirements of the law. If there were any secondary benefits, it would be an unwise business leader who would ignore those.

Ms PLIBERSEK—In fact, it has been suggested to the committee that that is one of the problems, essentially: the role of the auditor should be changed so that it is not just about attesting to compliance but goes more to those issues. Do you have a view on that?

Mr Davis—I think that would be adding to the obligations of an auditor and would bring subjectivity into an audit process. What constitutes a good business judgment has been well established in jurisprudence over many years. It is subjective, and the courts do not interfere to

say what a good decision was. An auditor, I would suggest, would have superior accounting skills. If they wanted to participate in a business judgment type function, they would probably perform a different role in an organisation. For example, if it was an accounting firm, and a person felt that they had better strategic skills, they might move out of auditing into the business advisory area. If we went down the track you are suggesting, we would end up with the situation where there would be a clouding of the role of an auditor. This comes back to, I think, the question that the CHAIRMAN touched on earlier: the division between auditing and advisory. If you put your two concepts together, you blend an auditor as an adviser and an auditor. As I understand the public debate, the drift is to go the other way: to stop them advising and have a very clear separation of functions.

Ms PLIBERSEK—In your submission, you indicate your support for the mandatory rotation of audit firms at least every five years.

Mr Davis—That is right.

Ms PLIBERSEK—An alternative proposal that was on the radio again this morning—I do not know whether you caught it—

Mr Davis—Yes.

Ms PLIBERSEK—was not rotating firms, but rotating partners within firms so that the corporate knowledge that the firm develops of a particular business is not lost. Do you have a view about that?

Mr Davis—Corporate knowledge tends to reside with individuals rather than with an audit firm. It would probably be the audit team rather than the partner that has the knowledge; it would not be the firm. Our view is that rotation of firms is probably to be preferred to bring more contestability into the area. Competition, we believe, has great dividends and great rigours. The advantage to us of mandatory rotation of firms is that the checkers check the checkers. So firm B would check firm A—that is a great incentive. Because of the nature of contributory negligence and liability, there would be great rigour in that checking process—and then B would check C, or A might come back. The only qualification we put on that is that, in some instances, firms are very large and very complex and it does take some time. I think the more challenging question—this thought has arisen from questions put to me by the CHAIRMAN—goes to balance: who does the audit? Is it done by the audit partner and audit managers, officers, graduate trainees and the like? Who actually does the audit in the great majority of cases? From our observation it is done by subpartner personnel, not by the partner himself or herself sitting out there with their sleeves rolled up. That is an issue that the committee may wish to examine: the balance of who does it physically.

Senator MURRAY—Following on from that, I think auditing is sometimes like police work: it is the people on the beat who do the police work, not the sergeants and the people in the office. I think your observation is a good one. The ACCI has quite an extensive breadth and depth of members. Most of the discussion about this issue relates to publicly listed companies with large numbers of shareholders and considerable market capitalisation. However, there was an instance recently where a number of shareholders of a family-owned company were ripped off—not to put too fine a point on it—of many millions by one of their executives. Do you think

that the same sorts of problems apply to non-public listed, but quite large corporations, of which there are a substantial number in that middle tier in Australia? I would hate for us to pass them by without gaining a perception of their view.

Mr Davis—I think the inherent proposition behind your question is: are the audit standards different for publicly listed and non-listed companies?

Senator MURRAY—In practice, yes; not in law.

Mr Davis—In law they are not. In practice—I am afraid I cannot answer that. I have no information that there is any difference there. I guess you would have to ask whether the processes are any less rigorous, and I think that they are not. Are the penalties for any wrongdoing any less rigorous? I should not think so. Is ASIC any less rigorous in dealing with private companies as distinct from public companies? I should not think so. I guess the question is: could someone in a private company, or a non-public company, get away with something that someone in a public company could not get away with? I should not think there would be that case through the auditing process. One might say that the annual general meeting process might bring to the fore some issues in a publicly listed company that may not happen otherwise. But then one gets into the debate between the role of institutional shareholders versus mum and dad type shareholders. Then there is the question of how rigorous an annual general meeting is as a mechanism for transparency, and the literature shows there is a huge debate on that. Some say that they work; some say that they are just glossy PR events. We hear, and the committee will probably hear, that better outcomes would be had if large institutional investors were more active. I know that is an issue that will probably come up in a CLERP 9 review.

Senator MURRAY—I share your assumptions. I would expect that the same difficulties of influence with a dominant family member, a dominant shareholder or a dominant executive member in the non-listed company would apply if there were people who wished to try and subvert the full independence of the auditor. I would have thought it is the same phenomenon.

Mr Davis—In any enterprise, whether a voluntary association, labour union or corporation, if there is a conspiracy amongst the board, it is very hard to break unless there is a whistleblower or a trail. In that case, you are reliant on the effectiveness of the remedies, the enforcement and the enforcement agency. Again, if there are wrongdoings out there, we can only hope that they come to the fore and are prosecuted effectively.

Senator MURRAY—You know where I am going with this. Obviously, in conclusion, you would say that there are no grounds for having different standards or recommendations for different tiers in the corporate world.

Mr Davis—We are not aware of any good reason for it. There would be great administrative and compliance difficulties about where one draws the line. We know that the parliament has wrestled many times over this with small business: where does one draw the line? The Australian statistician has three or four definitions, I understand, so having a stratified approach would be terribly difficult. We would probably not be in favour of stratification of obligations by size. At the moment, the Corporations Law says that you are incorporated or you are not, and that is about it. There are some special treatments for small firms that give them a lighter handed approach, but that tends to be proportional to the size of their activities. A firm may

operate in one location, have one product line and service a small area, and a light-handed model of corporate regulation would probably be all they need. But I think a stratified approach may be unnecessarily complicated, unless good cause can be shown for why it is necessary—and we are not aware of any need.

Ms GRIERSON—In your submission you recognise the need for, perhaps, increasing disciplinary measures and you suggest that should be the province of professional organisations.

Mr Davis—Yes.

Ms GRIERSON—To me, that suggests you already have some influence and power in that regard. I am not sure that is so. What do you think is working at the moment and what changes would you recommend to make that more rigorous?

Mr Davis—It mainly falls into the area of conflict of interest. This is a question where we would like to see the continuance of a fairly light-handed self-regulation model. Our recommendation is largely to leave it as it is but with one improvement, and that is—as the chairman observed—mandatory rotation. The question then arises of how you deal with the offering of auditing services and advisory services within the one professional service firm. We are aware that in the larger end of town the view is that there are efficiency benefits in having them come from the one firm. Rather than having eight or nine services contracted out to eight or nine players, it can be most efficient to have them with perhaps one or two. Therefore, our mind turned to: okay, how do you manage that? We think it is a conflict of interest. One can say that Chinese walls work, and generally they do. But, if we are to maintain that model—and we should—our view is that, where there is a breach, more effective penalties are probably needed. What would those penalties include? One could lower the threshold on what constitutes a conflict of interest so one would move into a breach of the law earlier.

Ms GRIERSON—So you would rely on the Corporations Law?

Mr Davis—You could. The other option is to go down the track of where the professional associations would have a lower threshold, so the conduct would be breached more easily. Penalties can then range from a financial penalty, a black mark on your reputation, limitations on your right to practise in a certain area to suspension for a period. Those penalties could be administered by professional associations and could go through to the ultimate sanction within a professional association of being struck from the roll of practitioners in that area. For the most egregious—for example, conspiracy to defraud—they may trip off into the Corporations Law and then be subject to criminal penalties by ASIC. We will not stand here and look for any professional who conspires with a wrongdoer on the board or amongst management to defraud anyone. They should be subject to the law. If the law finds them guilty, then the law, as set down, should punish them.

Ms GRIERSON—Do you think an organisation like yours plays a role in disciplining or advising?

Mr Davis—We do not have those provisions amongst our members. Our members tend to be business people, as distinct from members of a professional association. We do not have mandatory requirements to belong to a chamber, and malfeasance is not a ground for being

struck off. If you are struck off you are not allowed to practise. We know that exists in some other jurisdictions around the world; for membership of a chamber of commerce it is mandatory. If you are, so to speak, struck off, you are not disbarred from practising in business, but the professionals are quite different and they are regulated differently.

Ms GRIERSON—Although you show some reluctance to suggestions that have come to us, such as widening the scope of audits so that they include things like performance audits, some continuous auditing, some continuous disclosure and some risk management—

Mr Davis—We are quite relaxed about continuous disclosure. We have no problem with that.

Ms GRIERSON—If that scope were to be widened, what would be the impact of that on industry and what should be some of the cautions or some of the absolutes?

Mr Davis—As we remarked—I think it was to Ms Plibersek—quite simply, if you go down the track of efficiency auditing with financial auditing you are going to end up with all sorts of conflict of interest problems. You have to separate the two out. We are not keen on auditors being charged with efficiency auditing, other than as possibly a discrete commission via the firm.

Ms GRIERSON—So sometimes, in order to provide those services, anyway, separate to the audit function—

Mr Davis—As a secondary—

Ms GRIERSON—you do not see any way that we should perhaps require that both those functions be performed?

Mr Davis—If you have the two functions performed together—a financial audit and an efficiency audit—you are going to end up with conflict of interest type problems. You are melding two functions into one. Whether a financial accountant feels capable of making what amounts to business judgment rules is another matter. If an audit firm wishes to offer an audit as a discrete product and service and then another part of that firm wishes to offer what amount to advisory services—which are what an efficiency audit is—we have no problem with them doing two discrete functions, but I think they should be done discretely and separately. They can be done sequentially—there is no problem there. Should the same personnel do them? Possibly, possibly not. We say they should be kept separate and discrete because effectively an advisory function is a business judgment rule and not all financial accountants would feel comfortable doing that.

Ms GRIERSON—Do you have any suggestions for the committee on improving director behaviour or those aspects of corporate governance?

Mr Davis—How long have you got? I suggest that that is a substantial reference of its own. If the committee wishes to go down that track, we would prefer to take it as a stand-alone, discrete reference for this committee and we will come back to you and give you quite expansive views, rather than rushed remarks.

CHAIRMAN—One of the things that you could say is that in most of these cases that we talk about today very freely—the new ones in 2001 and 2002—there appears to be a lot of corporate greed or individual greed in a corporate sense. How would you view the regulation of directors' remuneration?

Mr Davis—I do not come to this committee with a brief on that matter.

CHAIRMAN—You have no views at all?

Mr Davis—We have views, but we do not come to this committee briefed on that issue. If you had a separate reference on corporate governance we would be happy to come back and talk to you about those matters.

CHAIRMAN—If we were to write to you and ask for your views would you care to share them with us?

Mr Davis—I would have to take counsel within our structure.

CHAIRMAN—A lot of respondents to this inquiry talk about the balance between Australian accounting standards, international standards or whatever accounting standards and a true and fair view of the balance sheet and profit and loss state of the company. Does the ACCI have a view on whether we should put more emphasis on one or the other?

Mr Davis—I do not know whether it would be productive for the legislation to devise the checklist approach. As many of us know, an auditor goes in with what is almost a matrix and he checks things off. I do not know whether it is the best approach for the parliament to be that prescriptive and definitive. You need the two-part test—what amounts to an objective test and what amounts to a subjective test. The objective test is the requirements of the Australian accounting standards. You need that subjectiveness which is the true and fair view. The tests mutually reinforce each other. The essential point that a lot of people seem to be losing sight of in the process is the nature of an audit. We point the committee to accounting standard 202.03, which states:

... the user cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

That is one of the issues people tend to lose sight of in the process. To answer your question, you need to keep both of them in there because they complement each other.

CHAIRMAN—While I hear you, there are those who would argue strongly that once you say that you have audited to the standards, that is to say, that the company has adhered to the standards, you suborn any possibility of giving a view that the results are true and fair.

Mr Davis—I do not think that they are mutually exclusive. One is subjective. The true and fair view empowers the auditor and it is the bloodhound versus the watchdog approach. It reminds the auditor that it is not just a mechanical checklist process—you tick the box, get a score out of a hundred and then you pass through. It is not a multiple-choice exercise, and nor should it be. It is not a mechanical exercise that can be done by computer. You cannot just fill it

in on a web site, send it in and the auditors give you a score out of 10 which you are told in 30 seconds and then you do not have to bother. You need that element of judgment that goes with it so there is an investigative function in there. It then becomes a question of what constitutes true and fair; how deeply is the auditor expected to go in there? The law says that they have to be alert to the possibilities of wrongful practices. They are not to be told to go looking for it with a conspiratorial mind or to expect malfeasance everywhere they look. We would expect the two approaches to remain in place.

Ms GRIERSON—If the auditor had a requirement to project the viability of the business, would that not be a measure that would see the practice change? Would there not be stronger and more rigorous practices in place if that sort of accountability were given?

Mr Davis—In addition to law, my background is in econometrics and one thing they teach you in econometrics is that the past is not necessarily a guide to the future. The same applies to financial accounting: you cannot necessarily forward extrapolate what has happened in the past as a number of conditions might apply. ASIC will readily tell you that there are about 7,000 corporate failures in Australia every year for a range of reasons including death, incapacity, loss of interest, marital status et cetera. Corporate wrongdoing probably accounts for one per cent of those at most. I do not think that a financial accountant would be any better at predicting the future than anyone else. A series of figures and practices do not necessarily give a guide. The board could change the direction of the firm a month after the audit and decide that there are new opportunities, that the company will get out of four or five areas that had been the company's backbone and go into new areas. That has no bearing. It comes back to the separation of functions. Financial accountants have a different skill set to business advisers.

CHAIRMAN—Thank you very much, Mr Davis. If we have further questions and we write to you, we would be pleased if you saw fit to respond.

Mr Davis—And if the committee wishes to consider the question of corporate governance, we would be happy to come back and talk to you on a dedicated matter.

CHAIRMAN—We will take that issue under advisement.

Mr Davis—I can see Senator Murray's eyes sparkle.

CHAIRMAN—For us to be relevant to CLERP 9 it is important that we get on with this inquiry, get it finished and get our advice out there in the public's face. This is the only public inquiry around on this issue and we want to get it right. However, we also have to be relatively quick.

[10.20 a.m.]

EDGE, Mr William Rodney, Chairman, Australian Auditing and Assurance Standards Board

JUBB, Dr Christine Ann, Acting Executive Director, Australian Accounting Research Foundation, Secretariat, Australian Auditing and Assurance Standards Board

CHAIRMAN—Welcome. Thank you for your submission. Where do you think the balance lies between prescription and principle in terms of setting the standards?

Mr Edge—We firmly believe in a conceptual framework which is principle based rather than rule based. A subjective view is that the rule based regime of the United States has seen some of the demises that have happened there, whereas the non-United States territories, of which Australia is a leading one, follow conceptual frameworks.

CHAIRMAN—I somehow wound up being a member of the Australian Accounting Standards Board advisory group. I tended not to go but I subsequently decided to go and I was advised that it would be like watching grass grow. I observed that there seemed to be an extremely long time—I realise that you are not writing the standards; you are auditing the standards—between recognising the need for a standard and everybody finally agreeing and signing off on it. Can you comment on the timelag?

Mr Edge—If you understand the difference between accounting standards and auditing standards, from the point of view of auditing standards I would very strongly defend our productivity and timeliness. In terms of accounting standards, I would have to have understanding of the due process that needs to be gone through—not dissimilar to this process here. Quick reactions to problems are often not appropriate and consultation and due deliberation are warranted.

CHAIRMAN—You heard me mention to ACCI that Professor Houghton said we need something very creative and perhaps unconventional to come up with some solutions that reassure the public that the relationship between audit and board practice, or audit and corporate governance, is balanced about right. We cannot just do nothing, because the public will not accept that and the share market will suffer dramatically. You are very involved in auditing. Many audit firms and individual auditors argue that the unlimited liability nature of the Australian regime makes it more difficult for them to report fairly and honestly on the activities of a company for fear that they might be subject to a law suit by its directors or management. What would you think if we changed the Corporations Act and asked that auditors be corporations rather than natural persons?

Mr Edge—You have brought a number of things into one area there. Firstly, I am encouraged by the discussion that has already been held this morning about doing work other than purely giving attestation on financial statements. The indication that you are venturing out into other areas of performance is a very positive comment. The difficulty is that the liability of auditors makes us very risk averse in that regard, as you would well see from the demise of Andersen. If

your objective in having a limited liability company was to give the auditor greater protection to be a little more cooperative or to broaden the scope of the audit, I think I would encourage it.

CHAIRMAN—There might be two objectives, one of which is the one you have just described—that is, to be more proactive. There is another. It has always seemed to me—and there will be those who disagree with me—that the best judge of quality is the marketplace. I think all the failed communist and socialist regimes have proved that. That is not to say that capitalism is perfect, because it is not. We have certainly seen that very well in the United States; we have seen it in Australia too, but not in as big a way as we have seen it in the United States. But I cannot think of a better way to assure auditor quality than to allow the market to judge the quality through the share market.

Mr Edge—I take that on board. I hesitate marginally, because you are referring to the fact that market price will reflect the view of that entity. Again, one of the limitations of that—it is a circular argument—is that, if audit firms were publicly listed companies, the only thing the public would have access to would be financial statement accounts, which would have been audited. They would not necessarily have access to other issues as to the quality, other activities or performance of that audit firm. It is much the same as what you have just said about whether auditors should get outside the financial audits for their existing clients. It is a mirror coming back the other way. For the market to be fully informed they will make judgments based on financial results and not necessarily on the quality of performance, unless there is a direct relationship between quality and financial performance.

CHAIRMAN—One of the things that has attracted me from the day we started this inquiry and I started reading submissions is the question: who audits the auditor? The answer, at the moment, is nobody. Do you have a view about that?

Mr Edge—I do have a view. I continue to emphasise that I am expressing the view of the Auditing and Assurance Standards Board here, rather than a personal one.

CHAIRMAN—You can give us both.

Mr Edge—That is a fair point. I am also a partner in PricewaterhouseCoopers, an audit firm. I would think that the demise of Andersen has been evidence enough of the severity of poor judgment that may be made by an audit firm. In a lot of the discussion we have about whether we are independent or not because we are paid a fee by the client and/or do other services for the client, you must understand that most audit partners—I generalise—understand the repercussions of doing a bad audit and that the repercussions are huge in an unlimited liability environment. I can assure you that that is in itself a mechanism to maintain appropriate behaviour. Other than that, we have the CALDB and the accounting bodies which enforce disciplinary procedures against poor performers.

CHAIRMAN—Sometimes.

Mr Edge—And we have peer review.

CHAIRMAN—Does that really work? I have information that says that none of the associations have tossed anybody out for years, no matter what.

Mr Edge—I must admit that the publicity given to disciplinary proceedings is not widespread so I cannot give an authoritative comment on that. But I guess we have to go back to the heart of this issue and firstly you would need to ask, 'Has there been substandard behaviour for there therefore to be a need for action to be taken?' That goes back to the heart of this entire inquiry: are you inquiring of substandard behaviour of auditors or are there other reasons for the corporate failures or other activities that are foremost in your mind? There may have been other legal cases or actions against parties other than auditors that have rectified the circumstance.

CHAIRMAN—There are certainly a lot of recommendations out in the marketplace—and, in fact, there is some kind of public perception—that auditors doing other consulting work for the firms they audit is inappropriate and has led to perhaps graft, corruption and people with blinkered views. Do you have a view on that?

Mr Edge—Absolutely. Without being defensive—and, as you can understand, speaking from an audit perspective it may sound like I am being defensive—there is clearly no research of any nature that categorically shows that there is a problem with independence based on carrying out other services. In fact, the research findings—and Professor Ramsay did quite a good literature review in his report—are mixed. Our argument is that the greater the knowledge the auditor has of an entity, the more improved the quality of the audit will be. We would encourage doing other work to improve the quality of the audit.

Ms PLIBERSEK—It has been suggested to the committee that the significant statutory role of the audit has been overshadowed by the commercial and service orientations and that failures in auditing independence are the result of auditors trying to balance their commercial service provider relationship with that of a watchdog or a regulator. Do you think there is a need to introduce changes to dilute the commercial and service provider relationship between an auditor and a client and enhance the statutory role of auditing? If so, what sorts of changes do you suggest?

Mr Edge—I think that is similar to the comment I have just made. The quality of a statutory audit or an audit of financial statements is improved by virtue of the auditor having other knowledge and doing other services for the client. Most particularly, we are becoming specialists in our own right, not just in financial statements or audits but in industries, subsectors within industries and other developing characteristics.

Ms PLIBERSEK—But you do, I suppose, accept that those functions need to be carefully separated out within—

Mr Edge—No, not at all. As I keep trying to reinforce, I think the greater the knowledge the audit team has, the higher the quality of the audit will be. As I heard from the previous commentary, the audit team is indeed that. When you talk about rotation of audit partners or other things, you have to understand that there is a certain knowledge base within an audit firm, that there are specialists and that the greater the knowledge you can gain from clients and from doing other services throughout the audit firm's network, the greater the quality of the audit will be.

Ms PLIBERSEK—You do not think that there comes a time when the relationship is too comfortable?

Mr Edge—There may be occasions when indeed independence is not maintained, but we are coming back to the cost-benefit argument: how often are these and are they breakdowns or are they a recurring problem? I would think, if they exist, they would be isolated breakdowns and not recurring problems.

Ms PLIBERSEK—I wanted to ask you something about the idea that the chairman has floated of changing partnerships to listed companies, and I was imagining how Arthur Andersen would have performed on the stock market if that were the case. It is quite a serious question; I am not being silly.

CHAIRMAN—No, I did not say you were, I am just sleepy.

Ms PLIBERSEK—Maybe it would have performed very well for a time and then the bottom would have fallen out of it. So the idea that the stock market, as you say, has a particular insight into the quality of the audits is not necessarily the case, because you are judging on a big-name company's ability to draw in business and on their profit margins. There is no way of judging the quality of their audits until something goes belly up really, is there?

Mr Edge—That is a valid comment. There are many players in the market—there are regulators, analysts and shareholders, as well as journalists, who can give a lot of information to shareholders on which they can make a judgment. All I suggest is that you make a judgment carefully. When you are making investment decisions, you make them based on good information. If a client of Andersen's collapsed and that impacted on your decision making, that is a valid call, but I would just caution as to whether that in fact is evidence of poor quality or whether that is just impacting on your decision making based on market behaviour.

Ms PLIBERSEK—There has been some debate concerning the place of the true and fair requirement of an audit and that merely stating that an audit complies with the accounting standards is a triumph of form over substance. Some have argued that the true and fair override should be reintroduced into law and that it be accompanied by enforcement sanctions sufficient to prevent a repetition of past abuses, while others argue that there is no place for the true and fair override. What is your view, and should there be a section of the Corporations Act that states that an audit must be demonstrably independent as well as complying with the accounting standards?

Mr Edge—Demonstrably true and fair?

Ms PLIBERSEK—Yes.

Mr Edge—I have not consulted the board on this particular issue, but I think I can give a fair summary of what the attitude of the board and my predecessors has been. The idea of true and fair has always been difficult to define. I will not put that challenge before you now, but it is a difficult one. The accounting and auditing standards setting boards believe that true and fair can only have a meaning within a framework, and that framework is accounting standards, so that you can in fact benchmark or gauge what true and fair means within that framework. Again, that

framework has been one with a conceptual base, which we have in Australia, and we combine that with a belief of having substance over form. So my initial reaction is that the accounting and audit boards would both prefer not to have a true and fair override. They would prefer to have true and fair in accordance with accounting standards. The risk of having an override is that it brings in an element of subjectivity that, at this stage, I do not believe has any real definition. The current standards allow that, if you are not satisfied that compliance with accounting standards gives a true and fair view, there is the option to disclose extra information. That would be the way we would prefer to see it going forward as well.

Ms GRIERSON—Various and varying viewpoints have been expressed to the committee regarding widening the scope of audits. One would suggest that your role is very much about looking at the role of audits. One thing that we have canvassed is that, rather than imposing additional audit requirements, other options could be explored like mandating the internal audit committees. I would have thought that perhaps your body would be interested in something we have been discussing, and that is signalling each year an area of audit risk or noncompliance that you have identified as a potential problem which widens the scope beyond the existing one, much like the taxation commissioner might target something each year. Is that something you would or could do? Is it worth doing and does it fit into your audit risk project that I note you are developing and that we would perhaps like to know more about?

Mr Edge—Absolutely. I am encouraged by the views you are expressing about moving outside the financial statement audit area. Internationally, the international board remains within that area. In Australia we are called the Auditing and Assurance Standards Board, and the element of assurance is there to indicate that there is a lot of other information that needs to be, or could or should be, reported. For it to be credible, it needs assurance—it needs an auditor to give assurance on it. So we would be encouraged by any widening of the audit role and we would like to support that.

The difficulty, or the reservation, is that firstly you have to establish a reporting framework so that you can give audit assurance upon that framework. Secondly, there is the issue of liability. As you get into areas which are less defined—and you have particularly mentioned viability going forward or efficiency or other areas—you need to give the auditor protection against unlimited liability in respect of those more difficult judgmental areas.

Ms GRIERSON—Maybe this is outside the committee's terms of reference and, probably, outside your submission, but we talked a lot about confidence, expectation gaps, investor confidence, making informed judgments when you invest and the marketplace regulating itself through shares et cetera. I would suggest to you, and I would like your views on this, that it is becoming more difficult for the ordinary shareholder, who is perhaps linked to a managed fund of some kind or is very much removed through a superannuation company or firm, and perhaps there may be less rigour and independence in that process that makes sure that the market judgment is accurate. Could you just respond to that briefly for me?

Mr Edge—I am not quite sure where you are leading with this, but I think you are saying that there is a greater reliance on the audit product because shareholders and others are getting further removed from their investors.

Ms GRIERSON—From the actual purchasers of those shares, that is right.

Mr Edge—I think that that is valid. It comes to the heart of what an audit is. If I held up two sets of financial statements, one which was unaudited and one which was audited, one would hope that you would both respond by saying that you had more confidence in the one that was audited. There is the value adding of an audit product. I think greater responsibility is probably being placed on auditors by that distance, complexity of business transactions, size and nature of organisations.

Ms GRIERSON—Yes, I think that is a major challenge.

Mr Edge—I would agree.

Senator WATSON—One of the reasons for the failure behind the recent US corporate collapse was the capitalisation of expense in the early operating life of that company. Do Australian standards permit such a practice, and, if so, what are the limitations on this discretion?

Mr Edge—I have not studied the exact circumstances of WorldCom, but the issue of capitalisation, or expensing, has been a long debated one. I would venture to suggest—with qualification, that is, as there is a lot of investigation with WorldCom to continue—that there are probably far deeper problems than just a capitalising or expensing accounting treatment. I believe that the value of the underlying entity must have been of question quite substantially. I think there is a lot more to come to the surface, in particular—

Senator WATSON—I realise that, but one of the issues was that capitalisation of expense. That is the issue that I would like you to focus on. We realise that there are lots of other problems, but that was one of them.

Mr Edge—We certainly have accounting standards in Australia. I have not studied that particular exercise, but I would suggest that our standards would have prevented that from happening, had they been appropriately applied.

Senator WATSON—What do the Australian standards permit?

Mr Edge—You are making me struggle now.

Senator WATSON—Why say that? In the last three years a number of Australian companies have adopted this practice.

Mr Edge—I would have to defer to the accounting standard there, which I do not have accessible right now.

Senator WATSON—Can you take the question on notice?

Mr Edge—Sure.

Senator WATSON—In your submission you raised the issue that there was a major project in the pipeline. Does it cover such issues as quality and independence? Who is doing that study? It was a little bit vague.

Mr Edge—Sorry, were you referring to the audit risk project?

Senator WATSON—Yes.

Mr Edge—That is certainly linked to audit quality, not so much to independence.

Senator WATSON—Who is conducting it? Are you conducting it?

Mr Edge—The International Auditing and Assurance Standards Board is leading the work.

Senator WATSON—Are you doing any work here on it?

Mr Edge—Only to the degree of supporting the work of the international board.

Senator WATSON—Could you elaborate a little bit more on that?

Mr Edge—It is re-examining the risk model that auditors follow. That has come from the developments in the US and the developments of the larger firms, which are all moving a little bit more to risk in terms of understanding the business and risk as managing a business, rather than purely limiting it to financial statement risk, which has been the traditional approach.

Senator WATSON—Arising from the recent failures, do you see any move towards harmonising the standards boards in your own audit oversight?

Mr Edge—Harmonising the Accounting Standards Board?

Senator WATSON—No, harmonising the operations of the two bodies in Australia—between the Accounting Standards Board and the Auditing and Assurance Standards Board.

Mr Edge—The work we do is quite different.

Senator WATSON—I know, but is there a need for a greater harmonisation?

Mr Edge—I do not believe so.

Senator WATSON—Why?

Mr Edge—I believe we are both performing quite satisfactorily. The Australian Accounting Research Foundation, up to about four or five years ago when CLERP was introduced, supported both the accounting and auditing boards. That has benefits for administration and there are some efficiencies in the research processes. The content of the two boards—the subject matter—is quite different. They do liaise when necessary.

Senator WATSON—In terms of the end result, isn't it necessary to harmonise them a little bit more than has happened in the past? We look at it from a bit of a different perspective, quite often.

Mr Edge—No. One is looking at the preparation of financial reports and one is looking at the assurance provided on those financial reports.

Senator WATSON—The perspective we are coming from is that of the end user. I can understand why you want to do it from a professional point of view but, in terms of the end user, I think there would be a greater feeling of assurance, to use your word, if there were a greater harmonisation or interaction between the two.

Mr Edge—I suspect not, but I am basing my judgment on history—that is, on the history of the projects we have undertaken and the nature of those projects. We harmonise where appropriate, but I would suggest that the preparation and the assurance on information do have quite different objectives. Harmonisation or coordination does take place but it is not that frequent, so I am not convinced that there is benefit there.

Senator WATSON—Finally, as an auditor, what are the areas of greatest risk that you pick up in auditing a public company? Where do you discover the areas of greatest risk, as a practising auditor?

Mr Edge—I think the area that is most difficult is the going concern decision on entities—that is, will they continue to be viable, going forward? We have to make that assessment 12 months out from the financial reports. That is often very difficult, where you have quickly growing organisations or new technologies venturing into markets that are unknown. That is probably the most difficult area that we would see.

Senator WATSON—And the next area?

Mr Edge—The next area would probably be controls—the risks over controls operating within organisations. The risk model is all about trying to improve our understanding of the outputs and of the way the entities are managed, and I think that that is probably one of the most difficult areas, particularly in industries such as financial services or others where there are large volumes of transactions that in total have a large financial effect.

Senator WATSON—Given the two significant areas of risk, do you think your audit report should specifically refer to that and quantify or outline the measures that are taken to minimise that risk?

Mr Edge—Both of them are considered by the auditor in the auditor's role. I would be happy to take on board whether that needs to be taken one step further by direct reporting to the shareholders. The board would be happy to consider whether the current audit report we issue is providing the information, which you allude to, that users would like to know.

Senator MURRAY—I ask you to take this on notice. I was also interested in that major project on audit risk. If you talk about a risk model, it would assist the committee if you wrote

to us outlining the risk model and the terms of reference that you are examining. We would then be able to understand exactly what you mean by audit risk.

Mr Edge—Okay.

Senator MURRAY—Thank you for that. The other point I want to touch on briefly is liability. Liability is always the other side of risk. It is the other side of the coin. It seems to me that the thought being put into all sorts of law now, apart from this, is that responsibility has to be shared and that liability should be joint and not joint and several. That is an important consideration. The alternative to exploring the issue of corporatising the profession is to address the issue of liability and responsibility so that they are shared. That automatically means that you capture directors, managers, internal advisers, valuers and all sorts of people apart from auditors if liability is not several and is merely joint. You might need to take that point on notice and give it some thought.

Mr Edge—No, I am happy to provide an answer now in the sense that I think the accounting profession—and again I speak for the Australian Auditing and Assurance Standards Board—would like to see proportionate liability or mechanisms that take effect over liability. Proportionate liability seems a very fair process where you are held liable only for the proportion of the loss that is caused by your negligence and not for the total loss. That seems to be a very equitable process. We acknowledge that we are in a business situation and we need to bear some risk, but only the risk that can be attributed to us. That is a positive thought and it is something that the accounting bodies have been trying to progress for a number of years as one way of reforming liability, and I would encourage further consideration of that particular issue.

Senator MURRAY—There is also the issue of—how can I describe it?—cellular responsibility. Let me explain what I mean. In a professional firm, be it of lawyers or auditors, you get teams or cells of people with a particular practice or interest. In a law firm, they might be the cell that does the commercial work, and the other partners who do the criminal or personal injury work take it for granted that they are operating to professional standards and doing the ethical job they should be doing. If that cell is corrupted by bad, improper or criminal behaviour, the question is: how much responsibility should the entire firm bear? There is the implication that there is absolute knowledge about the behaviour of one partner or one team by all partners and all teams and, frankly, that is just nonsense.

Mr Edge—That is a fair statement. The saving factor there is that the firms have quite rigorous processes in respect of quality assurance within the entire practice. While you may not know exactly what the other parties are doing, you know that they are complying with certain quality controls and processes which will ensure a quality outcome.

Senator MURRAY—I would challenge your answer. I think that the profession has already accepted that it has not being doing that because the decision to put in oversight boards accepts that the partnership as a whole might not be aware that a partner team or a cell is operating below standard.

Mr Edge—No, I would challenge that. My firm has just announced an audit standards oversight board, but that is only a reaction to say that there is a concern in the market and, in some way, we want to try and be proactive in responding to that.

Senator MURRAY—Let me provoke you—you are not telling us that it is a public relations exercise, are you?

Mr Edge—It is a legitimate reaction to market concern. It is certainly not admitting that our quality processes are not adequate, but we are acknowledging that we are always prepared to continuously improve.

CHAIRMAN—I just want to finish off on this proportional liability issue because I think it is very important. My understanding is that in England audit partnerships may incorporate as limited liability partnerships or companies or whatever the hell they are. Is there any evidence to suggest that their performance in audit has prevented more corporate collapses or provided the market with better information than we have in Australia?

Mr Edge—I do not think there has been enough time for that to be evidenced. The introduction in the UK has only been recent, and it was introduced in the US only a matter of a few years ago. I am not sure we would have the evidence in our hands now.

CHAIRMAN—I thought it was only some states in the US.

Mr Edge—That is my point. Some states have limited liability partnerships but I am not sure that we have seen enough time transpire.

Mr CIOBO—Obviously all of these issues are interrelated, but I just wanted to tease out the scope of audit aspect for a second. I wonder whether there is some ground for the following—I would be keen for your comments on this. Is there a role for scope of audit to be purely a compliance mechanism insofar as the compliance side of it goes—with the auditing standards, the provision of an overview of how the companies perform for that particular year and an accurate reflection of the transactions that took place in the accounts? That could have attached to it the situation we have now with unlimited liability and so on. I am wondering whether, in the same way that PWC has its assurance services co-located with its audit services, it could have running parallel to that an assurance role that would perhaps have limited liability attached to it so as not to negate any incentive for a proper opinion about where it is all going and how things might look in 12 to 18 months time. If it was more of a crystal ball gazing exercise, you could perhaps limit liability and get a more accurate picture flowing from that. So there would actually be quite a definitive split between the compliance aspect of an audit and the assurance side of it. If you tried to incorporate that into a principles based model, would you then seek to put those principles into the standards as well, as far as the board is concerned?

Mr Edge—That is in effect what has been happening for some time now anyway. For engagements where we are allowed to cap liability, we endeavour to do that in our letter of engagement—we would cap our liability to a certain dollar amount. The difficulty has been that not all clients accept that and clients often ask us to undertake work that is outside a reasonable liability cap. But your model is a very sound one. It still assumes that unlimited liability for an audit—a financial statement audit or a compliance audit—is reasonable. I guess I would have to challenge that and wonder whether or not there is an unfair burden being borne by the financial statement auditor at the moment. But with that reservation your model is a sound one.

Mr CIOBO—When you say that at the moment the two principal risks as you see it are, firstly, going concern and, secondly, management controls and risk management, is that captured by your stock standard off-the-shelf audit? I would have seen the two principal threats—certainly in terms of the evidence we have seen, and not necessarily in this order—as being fraud and the independence of the auditor per se. I guess it depends on which way you are approaching it, but is that captured at the moment?

Mr Edge—At the moment it is captured to the degree that it impacts on the financial statements. I think where you are going is to a whole host of other risks and other governance areas that would benefit from having an auditor carry out services or provide assurance.

Mr CIOBO—Could you do that by incorporating the assurance side of it into standards, as part of that principles based system?

Mr Edge—Yes. And we are trying to do that. Clearly that is part of our work program: to provide standards that allow assurance to be provided on non-financial and other information. It is very early days in both the establishment of a reporting model and the establishment of auditing standards over that reporting model.

CHAIRMAN—Thank you very much. Will you get back to us on those things and, if you would not mind, provide answers to further questions that we may put to you in writing?

Mr Edge—Absolutely.

CHAIRMAN—Our time line is very tight because, in order for us to respond in time for the government to take account of this very important public inquiry on the CLERP 9, it is important that we table a report in a reasonable time. We cannot watch the grass grow in order to get there, so we may need to ask you further questions.

Mr Edge—Thank you very much.

[11.07 a.m.]

LONG, Mr Brian James, Chairman, Board of Partners, Senior Audit Partner, Ernst and Young Australia

PICKER, Ms Ruth, Partner, Business Unit Director, National Audit and Accounting Services, Ernst and Young Australia

CHAIRMAN—Welcome. Thank you for your submission. I notice that in your submission you invited the committee to look at the way in which you internally do your work and the way in which you exercise internal controls. I will ask my colleagues, but I am inclined to accept your invitation. As long as we can fit it into our program, and if my colleagues can come along, we are likely to accept your invitation.

Mr Long—We would be delighted to have you.

CHAIRMAN—Do you have a brief opening statement?

Mr Long—I will be brief. I have given a written opening statement to the inquiry's secretary, which you have and I am sure that it will be circulated. I want to make two or three points. Firstly, we absolutely endorse the statement by the Institute of Company Directors that the cornerstone of corporate governance rests and has always rested with the competent ethical behaviour of directors. Secondly, as a matter of statement, from an Ernst and Young perspective—and I am sure I speak for the profession—the trust and confidence that come from our independence are the fundamental essence of the existence of an auditing firm, so we do not take them lightly. Listening to a lot of what is said in the marketplace and in the public debate, one might be led to the conclusion that the profession, for commercial reasons, has sought not to consider questions of independence. Nothing could be further from the truth. I am sure that all firms would hold that view. In our case, for instance, two years ago our global chairman worked very closely with Arthur Levitt, who was then chairman of the SEC, in dealing with the independence issues surrounding consulting firms.

The consulting firm issue became a major issue because of the dramatic growth in consulting businesses over the decade that lead to that resolution two years ago. The upshot essentially was that we divested our consulting business for precisely the reason that there was a perception, which we thought was important, that providing consulting services was not consistent with audit independence. I just want to make two other observations, and I am happy to take questions on each of these areas. One is the audit expectation gap, which is a dilemma for the auditing profession and has not been resolved. The gap relates to what an audit is and what it relates to in terms of the assurance provided to financial statements, and what an audit isn't: it is not an absolute assurance as to financial soundness, it is not an attest to future financial performance and it is not an attest to business plans being achieved. In the case of corporate failure, this gap becomes a chasm. The answer to closing that gap is to come at it from both ends, in communication from the profession, which has been done but needs to be done better—and I think there is an improvement there too—and, moving from the other end, enhancement of the scope of the audit, and a lot can be done there.

Scope will be taken on willingly by the profession, provided that they are satisfied on the liability questions. Where could that scope be? It is no coincidence that, while the law allows an audit or a half-year review for public companies, most companies choose a half-year review. You might say one of the reasons they choose that is because there is a lower cost. A continuous audit will add more value than an audit that is not continuous, and a half-year audit rather than a review is one of the ways where you will make the audit more continuous. Another way will be in the continuous reporting regime, which is presently not subject to any independent assurance, given that the market does not react to the audited financial statements because they typically come out three months after the fact: the results are announced and the market is moved by the public announcements that companies make which, by and large, are not subject to any assurance. That could be one way of enhancing the scope of an audit and closing this expectation gap.

On the question of auditor independence, we think that, rather than a legislative solution, the proper course is for boards to act properly in exercising judgment around what the auditor might be asked to do for a company in the way of services, and whether or not the audit should be rotated is in the proper purview of boards acting properly. We do not think there is a silver bullet solution here, certainly not in legislation, because legislation assumes one size fits all and that is not necessarily an appropriate conclusion to reach. I am happy to discuss that in more detail, if you wish. Lastly, we did, in our written submission, refer to the question of limitation of auditor liability—I heard some of the discussion with the last witness. We certainly would be happy to talk about those areas. We fully support changes in that regime, whether it be limitation of liability, incorporated entities or limited liability partnerships, or in proportionate liability questions or issues.

CHAIRMAN—Professor Houghton of the University of Melbourne said in a paper that we need a:

creative and probably very unconventional solution that ensures high-quality competence and independence ...

Thinking about the competence issue, and combining the competence issue with your suggestion of limited or proportional liability rather than unlimited liability, what would your view be on the Corporations Act being amended to require audit firms to become corporations rather than to require them to be natural persons?

Mr Long—I think we would be supportive of that. Any step to limit the liability is a step towards, in the end run, protecting the capital markets and the way in which the capital markets are served. I think the instability that comes from unlimited liability attaching to major accounting firms is nowhere more evident than in the demise of Andersen Worldwide. The spectre of a re-occurrence of that and the reduction of the major accounting firms from four to three is untenable. If limitation of liability is one of the ways of doing that, then that is an appropriate solution. I do not see the question of limitation of liability in any way leading to the competence or performance standards or issues associated with audits; I think it goes more to protecting the framework in which that work is performed.

CHAIRMAN—If we have to judge the competence of audit firms, is there a better way other than the market to judge that competence?

Mr Long—When you say the market—

CHAIRMAN—The share market.

Mr Long—Do you mean the incorporation of audit firms in a publicly listed sense?

CHAIRMAN—Yes, indeed.

Mr Long—I will ask Ruth to add some comments to this, but I think it would be a very competent promoter and underwriter who would entice someone to invest in an auditing firm with the sorts of risks that we face. Putting that to one side, I think the issue of market performance of a publicly listed audit firm would, frankly, give me cause to be more concerned than satisfied that it would provide a solution. I will ask Ruth to comment on the broad issue but it is around the operational performance of the work rather than the financial performance. Publicly listing would bring a focus on the financial performance of audit firms, which would not necessarily be a positive.

Ms Picker—I would like to comment on that. One of the things that would concern me would be exactly that: the focus on financial performance. In one of the previous questions you commented about the oversight board, I think. In our view, adding layers of oversight does not do anything unless there is an embedded culture of risk management and compliance. The oversight layer may well be a deterrent because people will know they will be caught out in the annual review and so on, but it does not prevent unethical behaviour; it does not prevent people doing the wrong thing.

The approach we have taken is to have, for example, a large accounting and auditing standards team of six partners and 20 staff, all of whom are not highly chargeable. Their role is risk management. Their role is to make sure that the other partners and staff do comply with the policies and procedures and that we have a linkage between what we do and what we call our unit or income assessment committee. We actually report the results of risk management findings to that committee, because it is part of the performance measures of the partners to make sure they comply with risk management key performance indicators. It is not enough only to comply with the financial measures. We need to make sure that people are measured and rewarded based on compliance, not only on financial measures. So I would be very concerned about that because I think that would change the culture and the behaviour. The right culture and the right behaviour are at the core of independence and ethical behaviour.

CHAIRMAN—There are many who expressed concerns in their submissions about the incompatibility—that is, some would argue that there is some incompatibility—between a true and fair statement of a company's financial affairs versus adherence to the accounting standards. Do you have any comment on that?

Mr Long—This is not an original notion, because I have read about it elsewhere, but there is a thing called the auditor's dilemma. The dilemma is this: an audit opinion either expresses a view that a set of financial statements or financial information is fairly presented or not; it is on or off. It is black or white; there are no shades of grey.

Therein lies a dilemma: you can compare two companies whose audit opinions look identical and on a spectrum of conservatism—if I can use that term—of accounting or reporting practices, one might be constantly at the aggressive end, and one might be constantly at the conservative end. Each of the practices might be acceptable, but their quality is substantially different. They get the same audit opinion. If you are a rating agency, you get a AAA, a BBB or one of many grades in between, but you do not get that in an audit opinion. I may have drifted from your question a little, but the point about acceptability of accounting practices is the most difficult area for the audit function. You can have accounting practices which are acceptable within the accounting framework that are not high quality and you cannot tell from the product of an audit process which is which. I am not sure whether that is what you were getting at. If not, put the question again and I will have another go.

CHAIRMAN—I hear you, but some people argue that if the audit confirms that the company adhered to the accounting standards then you might not be able to say that that provided a true and fair view of the financial state of the company.

Mr Long—I see. I understand your question. You are asking, not withstanding adherence to the accounting standards: is it possible to have financial statements which are not true or fair? I might defer that question to Ruth as a member of the accounting standards board but not speaking in that capacity.

Ms Picker—No, I will speak in my capacity as an auditor. When we had the true and fair view override 10 or so years ago, it was probably one of the greatest causes of trouble to us as auditors because companies would say, 'I'm special and I'm different and therefore the way I want to do it is better than what the accounting standards say.' I know that, in the international standard, they are proposing to allow the true and fair view override to apply in 'rare and exceptional circumstances.' The history in the UK shows that it is not used only in rare and exceptional circumstances exactly for the reason that each company will say, 'I am rare and exceptional. I am special and that is the reason for me to ask for the override to be applied.' In my capacity as auditor, I would not support it at all because it makes the auditor's job very much more difficult. One of the threats to auditor independence which comes through in the IFAC framework is the threat of intimidation from management. The true and fair view override can be part of that intimidation threat because they will say, 'If you don't allow us to do what we want to do and say it's okay under the true and fair view override, we will replace you.' That has certainly happened.

Mr Long—I agree with that notion. I have operated in both regimes. We have not always had the requirement to adhere to the accounting standards. In the past, there was the opportunity to depart from the accounting standards and companies were permitted to depart from the accounting standards and auditors were obliged under the rules to form a view about whether that was a departure with which they agreed. Frankly, I think that opens up more problems than it solves.

CHAIRMAN—So far, I suspect that not enough public information has been available on WorldCom to make definitive judgments, but it seems to me and probably to all my colleagues absolutely incomprehensible how an audit could have confirmed the financial affairs of the company when $US3.85 billion worth of expense was logged to capital. Can you imagine how that could happen?

Mr Long—I can imagine how it could happen and I cannot see how it could escape undetected. To be honest, I know no more about WorldCom than those who have read the newspapers. For example, one of the difficult issues in auditing and, I suppose, in financial statement preparation, is exercising judgment in certain areas around the sorts of rules contained in the accounting standards.

There are questions about whether or not you have an asset. I do not know the WorldCom circumstances, but there has been much debate here, for example, about whether a customer list is an asset. Is money spent building a customer list an asset? If a direct cost is incurred which derives a customer that produces a cash flow stream for you into the future, is that an asset? Some would say no, and the costs you might incur should be written off, while there are some who could construct an argument, perhaps competently, that there is in fact an asset there which is observable and which may have a contractual element. However, two different people looking at it might make two different judgments. I do not know WorldCom and $US3.8 billion is a lot of money; I doubt whether it relates to customer lists.

CHAIRMAN—There are people today who argue—rightly or wrongly—that the remuneration standards for company directors worldwide have gotten literally out of control and probably, in terms of shares, share options and performance bonuses, contributed to the demise of companies such as Enron, WorldCom and, no doubt, HIH and perhaps One.Tel; I do not know. Do you have a view?

Mr Long—There are two parts to that question: firstly, accounting for those things when you do issue them and, secondly, from a corporate governance point of view, finding an appropriate way to reward performance of executives. I think you could look at each of those questions and address them separately.

Senator MURRAY—And over what time frame.

Mr Long—And over what time frame—do you mean on the accounting?

Senator MURRAY—On the reward. It is what I call 'short termism'.

Mr Long—If we talk about change and continuous improvement, this is absolutely an area for change and, I think, for continuous improvement. There are appropriate equity based compensation arrangements that can be formulated which align the interests of executives with the interests of shareholders. Equally, we have all seen—and, I am sure, could all quote—examples of where those equity based compensation arrangements disalign, in effect, the long-term interests of shareholders with the perhaps short-term interests of executives.

CHAIRMAN—Are those matters for regulation or for development of culture over time?

Mr Long—In that area certainly the latter, because I think that is a corporate governance issue for boards of directors. They have the skills and competence to exercise judgment in those areas. If you look at the fundamental premise of why you are rewarding executives and at mechanisms and determine whether or not those mechanisms are effective, to me that is the heart of corporate governance. But legislation, perhaps through accounting standards, will assist in getting consistency in treatment in those areas.

CHAIRMAN—But we, the shareholders of Australia, are not very happy at the moment—and I suspect shareholders around the world are not very happy at the moment—in thinking that there is enough corporate greed out there that has led not only to the massive collapse of very major corporations but also to very poor auditing results where these companies had clean audits going into exposure of massive problems. How do we, the share buying and owning public, regain confidence in the corporate world?

Ms Picker—The New York Stock Exchange recently issued an exposure draft for qualifications of directors and they are moving further towards the Blue Ribbon Committee's recommendations that the non-executive directors be independent—so they have made a distinction between non-executive and independent—and that a majority of the board be truly independent. They are aligning that much more closely with the concept that we have of auditor independence, other than that they do still allow them to invest in shares although there are some restrictions on that. That is possibly a role that the stock exchange here could play. They have guidance notes but not very strict rules on corporate government. The stock exchange here could bring in those kinds of rules and have a look at what is happening overseas.

CHAIRMAN—Could you send us some detailed advice on that view?

Ms Picker—Yes.

Ms PLIBERSEK—I have two questions, the first of which is to Mr Long. You mentioned that the public statements of companies are not subjected to particular scrutiny as they are progressively released. Do you have a suggestion for what kind of scrutiny would be appropriate?

Mr Long—There are probably a range of things that could be done there. I mentioned the half-yearly issue. I think the way the rules presently work is that there is a choice of audit or half-yearly review. What tends towards the selection of the choice might be economically based, I would suggest. Clearly there are some companies that should be audited pretty regularly because of their risk profile and maybe their financial instability. I think there should be some way of providing guidance on the two choices here—review or audit—and on when they should choose an audit, identifying the criteria when they should do an audit. That is one point.

Continuous disclosure is a very difficult area. I do not have a well thought out proposition there, but if public announcements were required to be subject to a degree of assurance, however provided, as to completeness—there is nothing omitted that should be there—and as to the acceptability of what is said, I think that might draw a degree of attention within boards of directors to what is said and how it is said. Oftentimes, boards of directors approve a continuous disclosure release where the material that leads to that disclosure comes out of the continuous disclosure system within a company. Continuous disclosure systems are presently not required to be subject to independent assurance, and they could be. So there are a couple of areas, I think, where that could be done.

Ms Picker—There is another area which has caused problems—and somebody on the committee has, I think, referred to ED 105, the exposure draft on the so-called trilogy of financial statements. One of the problems that ASIC had was that companies were issuing a

media release on a market announcement saying, 'Our headline profit is this,' but that headline profit they were quoting was the profit that they wanted to present, not the statutory profit that had been calculated in accordance with the accounting standards. So you could say that that is misleading information because the reporting that goes into the newspapers is what the companies are trying to get through with that announcement rather than what you would read if you read the full profit-and-loss statement. You would see that it is not that profit; it is some other amount. That is cause for concern, and that could be covered by some requirement for an audit or a review of that announcement.

Mr Long—That is an undue emphasis type of matter.

Ms Picker—Yes.

Mr Long—Companies might decide that the emphasis should be placed on the EBITDA—earnings before interest, taxes, depreciation and amortisation—because it is close to cash flow. Sophisticated investment markets understand that, but mums and dads may not. They just see this big number and think that this company must be doing very well but, when you drive down to the profit after tax, it has actually made a loss. There are two different stories there.

Ms Picker—The Accounting Standards Board tried to deal with it by allowing companies flexibility, because one of the issues the board has is harmonisation with international standards. International standards allow a lot of flexibility. In fact, they still allow more flexibility than ED 105—the new 1018—will allow. So the board had to try and come up with this balance between allowing the flexibility but not promoting misleading information—and also satisfying ASIC's concerns. Companies will be allowed in their statutory profit and loss to derive EBITDA, for example, but they will not be able to put it in bold or highlight it above the statutory profit figure.

Ms PLIBERSEK—Thank you, that is very clear. I also wanted to ask you, Ms Picker, about the factors that you mentioned relating to the intimidation threat in the IFAC framework. Could you expand on that a little bit for us.

Ms Picker—In terms of the IFAC framework?

Ms PLIBERSEK—Just generally.

Ms Picker—The first example of the intimidation threat that they give is a disagreement with management. If the auditor disagrees with management on a particular issue, there can be the threat that management will say, 'You agree with me or else we'll sack you.' One of the counters we have, at least in the Australian framework—which they do not have in the US—is that ASIC have to consent to the auditor's resignation. I actually see that as a very strong counter to the intimidation threat. It is very difficult for the auditor to resign here, whereas in the US you can just resign and walk away. ASIC will not let you resign because they want you to qualify—that is what they try to get the auditor to do. I think that is quite effective. It is quite difficult from an auditor's point of view, and sometimes there are cases where the auditor really does want to resign—they will qualify and then they want to resign—and ASIC will not let them. But I think that is a very good counter to the intimidation threat.

Senator MURRAY—I just have two areas to ask about. Firstly, I am quite a longstanding member of the Joint Standing Committee on Corporations and Securities—now Corporations and Financial Services—and we examined, as part of one of our inquiries, the process by which directors are elected and selected. For over four years now I have been advocating that ASIC and the ASX should get together and produce best practice guidance for the election and nature of directors. Frankly, I am moving to the opinion, given current events and the pivotal responsibility in the Corporations Law that directors have, that they have been delinquent in not taking it up. Would you regard that as an urgent area for those two institutions to address?

Ms Picker—It is important, but I do not know the scale of urgency.

Senator MURRAY—Let me explain my context. The chairman and other members of the committee, quite rightly, have stressed that confidence is now a key issue. This inquiry and the consequences of CLERP 9 are as much about restoring confidence as about finding mechanisms. I consider there to be a loss of faith, again, in directors. That emerged in the eighties with the dreadful creatures that destroyed so much of Australia's reputation, and now that feeling that everybody in the boardroom is a crook has come back. They are not. But you do need some mechanism, and there simply is not a guidance note, a set of guidelines or anything that spells that out.

Mr Long—Are you suggesting that, from a regulatory point of view, there should be a set of rules that guide how you go about selecting?

Senator MURRAY—Not so much a regulation that you apply, but in the sense that ASIC and, indeed, the ASX produce guidance notes and they say, 'We have consulted. This is the best way in which you should have processes for electing directors. This is how the ballot papers should be worked out and how selection is carried out—what kind of criteria should be met, and what kind of training and experience they should have.' It is pretty self-evident stuff.

Mr Long—Can we take that on notice? We would not mind putting some thoughts together on that. I am not sure that it is necessarily the area for ASIC to be involved in—that is my personal view—but I think some guidance is appropriate. Ruth mentioned the Blue Ribbon Committee report in the US as it relates to audit committees. I think that report absolutely provides leading edge best practice information about how an audit committee might function more effectively. I think some sort of study and guidance around skills and competence of directors, selection processes and things like that would be very helpful.

Senator MURRAY—The second area I have to ask about is what this committee would describe as a 'performance audit'. Quite correctly, the Corporations Law and the market concentrate on determining that the financial statements are as they should be. One idea that has been expressed in this committee, which I would like your reaction to, is the idea that the performance audits would be not mandated but that the ASX and/or ASIC would be given the authority to be able to say to companies that, because of market signals, they are concerned and that, as the regulators or the institutions in this area, they want to companies to have a performance audit conducted. A performance audit, as you know, relates to effectiveness, efficiency and practice—the achievement of outcomes relative to your financial statements, strategies and everything else. It is not mandated, but it gives them a trigger to pull if they are

getting worried about a company. You might like to take that on notice or you might like to respond now.

Mr Long—Perhaps we can take it on notice. I understand entirely the concept. A little like my response earlier, whether that is in the armoury of a regulator or whether it is applied by some other mechanism, I am not sure, but let us give some thought to that and we will happily come back with a comment.

Senator WATSON—Would you mind prioritising those areas of greatest audit risk?

Mr Long—I can give you my view. If you ask a different person, you get a different view, I suppose.

Senator WATSON—Based on your experience.

Mr Long—Yes. If I think about where I spend most of my time and energy with companies from a risk point of view, it is around judgmental areas: the selection of a method of accounting; the selection of a method of disclosure; the judgments around the recoverability of the value of an asset; and the implicit assumptions used in establishing what future cash flows, for example, you might derive from a particular investment. I think they are the most difficult areas, and they are the areas, frankly, where the greatest risk is. A minor judgment call on a key assumption in the present-value calculation of the value of an asset will give rise to a major write-off or not. That is the most difficult area.

Senator WATSON—Do you think the audit report should be prescriptive in terms of how you have assessed these various judgments?

Mr Long—I think the answer to that is no. In part, the dilemma that I referred to earlier is not necessarily solved by changing the audit report. I think that dilemma is solved by better corporate governance and disclosure by, let us say, audit committees. One of the requirements of the Blue Ribbon Committee report is that audit committees produce an annual report which is published in conjunction with the report to shareholders. If, for instance, audit committees were required to report upon not the acceptability of accounting practices but the quality of accounting practices where judgment has been exercised, that might be one way you could get greater transparency in the quality of the accounting. Disclosure of accounting policies is one way, but oftentimes there are choices that might legitimately be made that are each acceptable but the quality may be different. Time spent by audit committees focusing on some of those areas would be very productive.

Senator WATSON—You do not think it would help to enhance the public's confidence in auditing by giving prominence in a report to the fact that certain areas are judgmental areas and that we have satisfied ourselves as to the basis for establishing outcomes et cetera?

Mr Long—No. We should not resile from the fact that the financial statements are the directors'. The judgments that are made are theirs, the accounting policies that are selected are theirs and the disclosures that are made are theirs. If, in conjunction with that responsibility that companies and boards of directors have, and good corporate governance that might be set by rules requires additional disclosures—or accounting standards for that might require additional

disclosures—that is the framework within which the audit opinion should be expressed. I do not think that it would be helpful, frankly, for that disclosure to be made by the auditors. It is most appropriately made by the company.

Senator WATSON—I do not mind who actually makes those disclosures but I believe there is a need for some transparency. There is a market-to-market basis of assessing things like receivables and cash, but in terms of judgments made, in sometimes the most critical areas, there is very little to give some guidance as to the direction of the company in accepting some of these judgmental issues. I agree with you: I see this as one of the areas of greatest weakness. We need to somehow focus on and address this. I am trying to tease out a way of how best to address it. You have gone on the defensive and say it is not an auditor's responsibility. I probably agree with you, but we are not here to assess blame; it is not a court of law. We want to try and provide a new yardstick that will restore confidence, and this is an area of weakness.

Mr Long—I do not disagree with the observation. I think transparency is an enhancement but it is just a question of where that enhancement is made.

Ms Picker—The SEC has recommended that a statement of, I think, the five most critical accounting policies and some scenario planning—what assumptions were made in applying those policies and whether there would have been a different result under various scenarios—be made in the financial report by the companies' directors. I think that would be useful for us to have here.

Senator WATSON—Just roughly, what proportion of companies that you audit have audit committees?

Mr Long—In the public arena, 100 per cent. When you say 'that you audit', do you mean Ernst and Young?

Senator WATSON—Yes, Ernst and Young.

Mr Long—I cannot give you that view because I do not have that to hand, but it certainly applies to all the companies that I am involved with.

Senator WATSON—Do you believe there is a need for a legislative change to raise the bar in terms of failure, where corporate officials fail to give auditors complete and accurate information?

Mr Long—I assume you mean raising the bar in terms of culpability and liability of executives.

Senator WATSON—That is right, yes—put them on notice.

Mr Long—Yes, we will take it on notice. I think the answer—

Senator WATSON—No, put these people on notice.

Mr Long—Clearly, the answer to your question is yes. How that is done is a different question. I think it is an entirely unacceptable environment if people are of the view that you can mislead someone who has a responsibility under the law and escape scot-free. I think that is an inappropriate position.

Ms Picker—If I could comment on that, in my experience in dealing with audit clients, where there is a very open level of communication with management and with the directors, where they freely communicate to the auditor on a very regular basis what is happening in the business, that is the best way to do a good audit. You need a lot of open communication between the two. Where you are dealing with an audit client who does not want to speak to you or to tell you what is going on, it is very difficult to audit in those circumstances. I think to encourage that open communication is important. It encourages a trust between the two.

Senator WATSON—Obviously a lot of attention is given to the annual reports. Do you think public announcements should have the approval of the auditor, because quite often these are quite significant in terms of influencing share price?

Mr Long—That is the issue I was referring to earlier. Continuous disclosure and public announcements would be enhanced if they had some degree of assurance attached to them.

Senator WATSON—From the auditor?

Mr Long—I think the auditor is well placed to do that in many cases. Some of the announcements that are made are not susceptible to an audit involvement, but some are. I think some rules there about assurance would be appropriate.

Senator WATSON—As an auditor, do you ask for all the public announcements, press announcements, emanating from a company in relation to its financial activities?

Mr Long—As an auditor, I would get access to all announcements.

Senator WATSON—You might have access to them, but are you specifically given or do you request all press statements?

Mr Long—Let me answer that in two ways. Firstly, if it is an announcement to the market and it is on the web site, we take access. That is one of our processes. But, as Ruth said earlier, one of our other processes is to maintain a continuous and open dialogue with companies and with all key executives in the companies, including the company secretary and the person responsible for public affairs, announcements and investor affairs. Part of our process is to ask for that information.

Ms GRIERSON—I suppose that this committee has been set up in response to a very real need; one that you would think everyone would be responding to. Most submissions that we have received support self-regulation. If I am to be convinced that self-regulation is the way to go, then there should be stand out reactions from the industry itself as a result of this clearly demonstrated problem in the economic sector. So besides independence of audit companies—and obviously there has been an instant, and very thorough, response—are you seeing other stand out practices? Are you seeing six-monthly audit reports being requested? Are you seeing an increase in communication? Are you seeing more rigour by internal audit committees? What

increase in communication? Are you seeing more rigour by internal audit committees? What is the industry itself doing that might suggest that they are capable of self-regulation?

Mr Long—My personal experience is that with respect to each of the boards and audit committees of companies that I am involved with, I have seen a visible elevated interest in all of these areas and that interest is real. Many would say, quite rightly, that the corporations have performed properly; they have been diligent, conscientious and have behaved in an appropriate way. In truth, the vast majority of corporations do. In the context of continuous improvement I have seen that, whenever you have the catalysts that we have had in the last six months or so, it is a reason for change. It is a catalyst for rethinking and re-examining, and everyone is doing that. They are looking at reassessing the charter of the audit committee. They are looking at what they are doing and reassessing the charter of audit independence. Many companies have publicly restated their commitment to independence and restated some internal rules that they have developed and published. There are some notable examples of that and it is quite commonplace. It is a question of: 'I don't think we have been doing anything wrong, but let's take another look at it. What are we doing? Why are we doing it, and can we do it better?' All of that is in the context of continuous improvement.

Ms GRIERSON—We have the principle of true and fair in audits. Do you think the principle of true and fair occurs in terms of remuneration of directors? What should we do to make sure it occurs?

Mr Long—I am afraid that is outside my scope of competence. I am not a remuneration expert.

Senator MURRAY—Maybe it is true and not fair!

Mr Long—You are right: in most cases, it is true; they did get what they said they got. Seriously, the issue does not fall presently under the purview of the audit role. Frankly, I am not sure that it should. I think it falls squarely within corporate governance and squarely within the responsibility of directors. Independent non-executive directors behaving properly in the best interests of shareholders will find the right answer. If we are looking at continuous improvement, perhaps it is in the processes involved in compensation.

Ms GRIERSON—If you choose to enforce it in some way, what measures should be taken?

Mr Long—I think the fresh air of disclosure is usually the best disinfectant to a problem, and enhancing disclosure might well be the best answer. If there are long-term incentive arrangements, then give us a little more detail about how they are formed and whether or not there are hurdles. Disclosing whether or not there are hurdles is good disclosure. As I say, the red-face test at the end of the day is probably the best test. If you are happy to lay all the detail out, let it be examined and not feel jeopardised in any way about the quality of your judgment, that is not a bad test.

CHAIRMAN—We have to move on. However, in your report to us, you state:

We recommend that a thorough analysis of the current financial reporting, regulatory, oversight and disciplinary framework be undertaken and an appropriate model be introduced.

Do you have such a model?

Mr Long—Not yet.

CHAIRMAN—Who do you want to develop it then?

Mr Long—To be candid, I think the major accounting firms have been deep in discussion around this area and lots of ideas are being promulgated. I am not sure whether they have been formulated and delivered in any final way. The point of our observation is simply that we put our hand up and say that we are more than happy for change in these sorts of areas. While we are perfectly comfortable, the reason for our invitation to visit Ernst and Young to see what we do in relation to risk management and independence and, frankly, protecting the firm from being involved in something that we would rather not be involved in, and managing quality, is that we think those processes are pretty good. They are globally driven and everyone is very accountable. We are more than happy to open that up to an appropriate degree of review. I am happy to flesh out those thoughts and submit them if that is helpful to the committee.

CHAIRMAN—We will expect to hear from you in due course, and reasonably soon, in answers to questions that you have taken on notice today. Thank you for your submission and for coming today. We are attempting to wind this up and to report in late September or early October to reflect a proper time frame for CLERP 9.

[11.57 a.m.]

CLARKE, Emeritus Professor Frank Lewis (Private capacity)

DEAN, Professor Graeme William (Private capacity)

WOLNIZER, Professor Peter William (Private capacity)

CHAIRMAN—Thank you for your joint submission and for coming to talk to us today. In your submission, you indicated that in your view the current raft of reform initiatives being promoted, such as audit rotation, are cosmetic and do not address the fundamental issue that audit failure is a function of the quality of information that is being provided to the external auditor. Would you like to expand on that?

Prof. Dean—That comment is drawn from an analysis of company failures over the past four decades. One of the things we would like to get across to the committee is that there is some evidence available about company failures—in particular, unexpected company failures. From our perspective, the issue is the unexpected nature of the failure, which has implications for accounting and auditing that we think are pertinent. To that effect, we have provided the committee with monographs and books going back to the 1960s and 1970s by Abe Briloff in the US and Professor Chambers in Australia, and work that Professor Clarke, Professor Wolnizer and I have been involved in in that area.

We would also like to note that it would be perhaps useful for the committee if an analysis were done of the current failures in terms of the nature of the failures—whether or not they did involve accounting/auditing issues—and past failures. That information is obtainable from sources like inspectors' reports and statements of claim in courts and is publicly available. We believe it ought to be provided to and analysed by the committee. In terms of the accounting and auditing relationship, we do not believe that you can divorce auditing from accounting, and that has been the essence of our submission.

Prof. Wolnizer—I would like to reinforce the point that an audit report is a warrant of the quality of information that is contained in financial statements. The audit function goes directly to the heart of the quality of financial reporting and accounting, so it is hard to imagine that one could have first-class auditing in the absence of anything less than first-class accounting. To some extent, I think the quality of the audit is directly connected with the quality, or the audit testability, of the information that is contained in the financial statements.

CHAIRMAN—Let us test that a little bit: I am the chief financial officer of WorldCom and I have booked up salaries to the capital account. Are you gentlemen really telling me that the auditor—in any kind of test—should not have found that information?

Prof. Clarke—I do not know that that is what WorldCom actually did, with respect. It certainly capitalised expenses, but the capitalisation of—let us imagine—wages and salaries, as you suggest, is very unlikely to have been much of a substantial matter.

CHAIRMAN—All right—capitalised expenses.

Prof. Clarke—It is a very interesting situation, because virtually every company—whether or not it has failed—capitalises expenses one way or another. For example, every company—failed or otherwise—that has goodwill in its balance sheet has capitalised expenses. Indeed, any company that has non-current assets listed at historical cost or historical cost amortised has effectively capitalised the expenses. That is endemic in the system that we have. That is the first point.

The second point is that, by and large, it is not so much a problem of the capitalisation of the expenses; it has more to do with the definition of an asset that currently pervades the professional pronouncements in the way in which accounting is done. The general definition of an asset at the moment, which I think underpins accounting in Australia, is the existence of future benefits—that is, some sort of expenditure, I guess, that is incurred that gives rise to an expectation of future benefits. In fact, the previous witness before this committee made that point. The definition of an asset that pervades conventional accounting at the moment is not a reference to something that the firm has; it is something that it expects to get in the future.

That is a very peculiar situation it seems to me and it certainly is not one that contributes in any way to the derivation or calculation of the salient financial characteristics of companies. In particular, I do not know how one can possibly determine in any reasonable way the solvency of an enterprise by reference to some expectations. The previous witness, for example, mentioned in particular what happens when you discount those expected future cash flows. Obviously, the rate of discount has quite an implication for the end number. The capitalisation is endemic in the system and is greatly linked to the way in which an asset is identified at the moment. I think AAS9—and do not take that as gospel—was withdrawn in Australia in 1996, and currently the capitalisation of expenses would occur depending upon the way in which those preparing the accounts interpreted the matching principle and in line with the definition of an asset.

CHAIRMAN—So in your view it is totally the company's responsibility—the auditor is only required to audit the statements insofar as that they seem to add up?

Prof. Clarke—No, that is not my view at all—in fact, quite the contrary. What we have said in our submission—and we have made the point in a number of publications around the place—is that, generally speaking, as long as the true and fair override is in its present position, subservient to compliance with the accounting standards, it is quite likely that the current situation will prevail. We would argue that the true and fair override ought to be there. If the true and fair override was there, no auditor could reasonably go along with the proposition that money spent—money that the firm no longer has—represents an asset.

CHAIRMAN—The last witnesses told us that they had a view that Australia's unlimited liability regime in respect of auditing—I remind you that the Corporations Act requires auditors to be natural persons and not corporations—is detrimental to their reporting fairly and reporting issues that they might uncover in the course of an audit for fear of legal liability. Would you like to comment on that?

Prof. Clarke—The point was made, in putting that question to either the previous witness or the one before them, that if auditors were to be incorporated then, in the event of collapses and

the involvement of auditors—let us say, Andersen at the moment—the share price would drop. Consequently, they would lose work and they would either lift their game or disappear. But I would point out to the committee that, were that to happen—were audits to be incorporated—I think we would have a situation like that in the US at the moment, where in fact the share price of the remaining four in that sort of scenario would possibly not be much better than Andersen's would have been before it disappeared. KPMG, for example, has certainly got a cloud over it in respect to Xerox and the AIM mutual fund; Pricewaterhouse Coopers has in respect of MicroStrategy; Deloitte and Touche has in respect of Adelphia Communications; and Ernst and Young has in respect of Computer Associates and PNC Financial Services Group.

In the UK, in April, I think Coopers and Lybrand were successful in their appeal against the fine awarded against them in the Barings case. But on appeal, I think they still have a fine of £250,000 and the costs involved are roughly £635,000. So if all of these companies were incorporated in those settings, I think we might find that the share prices of the major accounting firms, on the scenario that was being put earlier this morning, would be extremely low.

Ms GRIERSON—So you think that might be resisted?

Prof. Clarke—By whom?

Ms GRIERSON—By those audit firms?

Prof. Clarke—No doubt.

Prof. Wolnizer—I guess the question somewhat goes to the heart of the question of professionalism and what it is to be a practising professional. Of course, there is no evidence to suggest that, if there was limited or unlimited liability, that would have any impact upon the reliability of the audit opinion. I think the critical thing in our submission is on that point.

The greatest impediment is the huge discretion that prevalent conventional accounting standards give to the reporting enterprise. Those preparing the accounts have inordinate discretion about what they will report and how they will report it. Under a regime where you have statutory enforcement of accounting standards, there is a scenario where the auditor is necessarily bound to compliance with prevalent standards. Those standards give huge discretion to preparing accounts. It seems to me that auditors, however ethical, however proper, however upright, however saint-like, can do nothing about that. Unlike many other professions, when auditors have to form an independent opinion the ethical part attaches to the independence of the auditor-client relationship, but there is no explanation about the independence of the evidence upon which the auditor has to form an opinion. So while the auditors have to be independent of the client, they do not have access to evidence on all matters outside the reporting enterprise when forming their opinion. That is the connection that I think goes to the heart of our submission.

CHAIRMAN—With the greatest respect, if I have a storeroom full of stock and I do not use a standard costing system to cost stock in and out of the store but simply take the value of the stock at what it costs—let us say, I do not manufacture the stock; I buy the stock; I put it in at whatever I paid for it and take it out at that, and then we make the profit—and the auditor comes

in and all he looks at is my store count and what value I put on things in store, does he have any responsibility to decide whether or not the stock has any actual eventual commercial value in the marketplace?

Prof. Dean—The rule for valuation of inventories is the lower cost and net realisable value.

CHAIRMAN—I realise that, but what responsibility does the auditor have?

Prof. Dean—I believe every responsibility to—

CHAIRMAN—But that requires him to then look beyond the books and to check and see that in fact the stock has that marketable value.

Prof. Dean—In that particular case, there may be some external market price to do the attestation. If you take the capitalised expense exercise or you take the discounting of future cash flows 20 years out, there is very little to which the auditor can go to attest to the value that has been placed in the books. I think it is a different case.

Ms PLIBERSEK—You talk about the auditors going beyond their current scope. We have had a lot of evidence from the other perspective, which is that that would be an unreasonable requirement of auditors and an unreasonable cost to the business. I wonder whether you have any comments about what that would cost business, for a start?

Prof. Clarke—Could I, in a sense, pose a counter question: what is the cost of not doing it?

Ms PLIBERSEK—I think we all agree that there are some very good examples of the cost of not doing it.

Prof. Clarke—Precisely.

Ms PLIBERSEK—I am just playing devil's advocate here. Our first witness this morning was from ACCI. I would suspect that his response to that would be, 'But what you are proposing is imposing an enormous cost on the vast majority of businesses,' when his estimate was that one per cent of corporate collapses in Australia are due to auditors not picking up dodgy practises in businesses and the other 99 per cent are due to people dying or losing interest or the businesses just going bad for some other reason. Is there any way of quantifying the sort of impost you are talking about?

Prof. Wolnizer—I do not know whether it is an impost. I do not think there is any way that one could quantify the cost to business or the community of one way or the other. Financial statements are the only financial instruments by which the community, investors, market participants and regulators can know about the financial affairs of companies. That is the first point. In the CLERP, there was a very profound reform recommendation to move to market value accounting or what we might call marked-to-market accounting, where assets would be reported at their current market selling prices and liabilities would be reported at their selling prices—a proposition with which the three of us wholeheartedly agree.

Were there to be such a system of accounting in place, I believe that that would transform the rigour of auditing. Auditors would then have the opportunity—indeed, they would have the responsibility—to test the assertions of the reporting enterprise and the values that are attached to assets and liabilities against evidence that would be adduced beyond the reporting enterprise—from the marketplace directly or through independent valuations in some cases. This would put auditing as a quality control function, if you like, on a very different footing, and it would enable auditors to form an opinion about the financial performance and positions of firms independently of the reporting enterprise. At the moment, they do not have that privilege.

Prof. Dean—It is hard to imagine how directors can currently meet their obligations regarding solvency tests unless they already have that information. So there is a question of additional cost—we are looking here at what gets reported. But that is an aside.

Prof. Clarke—At the end of the day, it is a truism, no doubt, that companies collapse because they run out of money. I would go out on a limb and say that the truth of the matter is that, of virtually every company listed on the Australian Stock Exchange and in most other places as well, neither what is now called the statement of financial performance nor the statement of financial position is indicative of the actual amount of money that the firm has or is necessarily going to have in the future. Consequently, nearly all of the financial indicators that are conventionally calculated and paraded around the place, from rate of return to earnings per share and all those sorts of things, by and large are incredibly misleading—with the best of intentions and, more importantly, absolutely in compliance with the accounting standards. That is the crux of the matter. We are not talking about an accounting system that cannot be manipulated by those who want to say that black is white; we are talking about an accounting system or, if you like, a whole accounting auditing scenario where those who want it to work can make it work because, with the best intentions and, as Peter said earlier, with the greatest of integrity and all those sorts of things, the current system cannot work—in fact, it does not work.

Ms PLIBERSEK—I was interested to hear you speak of the quality control function. I think that our first witness, in particular, was very clear in stating that there was no quality control function and that the job of an auditor is simply to tick off compliance. It is very interesting for the committee to hear the divergence of views on that. You mentioned a couple of examples of other information that an auditor might draw on to give a better view of whether a company has got money in the bank or not. Can you just elaborate on that a little bit more? What sort of information do you think auditors should be drawing on, other than the financial statements that they are presented with by the company?

Prof. Dean—I will state it in the negative: perhaps they should be looking for things outside of the information generated by the people preparing the reports. There needs to be some independent information that can be externally corroborated.

Ms PLIBERSEK—Like what?

Prof. Dean—We can look at individual aspects. If, in fact, you were to have a marked-to-market system of accounting in place, you could look at what the market prices of those assets were, which would be independent of what was stated to be the case by the directors. There are directors and accountants in this room. There are second-hand markets for second-hand assets

and there are new markets for new assets—there are prices for everything, every day. It is a furphy to argue that there are not prices.

Prof. Clarke—I reached out and picked up the first balance sheet on my shelf yesterday, and it happened to be BHP's for 1998. To illustrate our point, in the notes under 'Property and plant and equipment' there is a list of 40-odd items—land and buildings, plant and machinery, mineral rights and all sorts of things like that—for which there are about, depending upon how you want to count them, 30 different valuation bases. But not one of the numbers is necessarily indicative of how much money any of those assets actually embodies at the date of the balance sheet and/or any amount of money the firm will necessarily have in the future. All that adds up to $40-odd billion of BHP's assets. I argue that that is absolutely in accord with the accounting standards. I have not checked but you will probably discover that BHP got an award in the annual report awards in that year—it gets one nearly every year. It is a paragon of compliance with accounting standards—good accounting, according to conventional wisdom. It is absolutely useless in trying to identify whether BHP is solvent or whatever.

Senator MURRAY—One of the mechanisms the committee has had an interest in is the internal audit mechanism. Only companies of a sufficient size can have a quality internal audit function, so we will accept that as a start. One of the attractions of internal audits is their capacity to provide continuous audit to mirror continuous disclosure, if you like. The committee have been considering whether it is possible to enhance that function in any way, probably less through legislation than through regulation. One of the small devices we have thought of is that the internal auditor should be required to report to the board and not to the chief executive. I would like to ask that specific question but, given your deep understanding of these matters, I would also like you to comment on the internal audit function and its effectiveness in these issues.

Prof. Dean—I accept the proposition that, as long as you move the reporting of the internal auditor away from, perhaps, the chief executive officer or a dominant personality, that has to be a positive move.

Prof. Wolnizer—I am inexpert on the matter but internal audit is an internal management driven control mechanism that goes to performance auditing and continuous auditing, as you say. Well and efficiently conducted, one would expect a sound system of internal audit to mitigate fraud within the enterprise. But the connection between it and, let us say, earnings management and the complexion that the reporting entity wants to put on its financial statements is not entirely clear to me. While you might have a robust, continuous internal audit function operating so as to minimise fraud and to enhance efficiency and effectiveness of the controls within the enterprise, there is no doubt that the position of the internal auditor would be strengthened if the reporting line were to the board. That is a reasonable proposition. But the connection between such a system and the integrity and reliability of the financial reporting function is not entirely clear to me.

Prof. Clarke—Senator Murray's point is well taken. Traditionally the internal auditor has been a troubleshooter for management and in those circumstances is beholden to management. To that extent, the internal audit probably has not added much to the external audit, yet the external auditor has to rely to a great extent on the advice and various other information he gets from the internal auditor regarding the effectiveness of the internal controls and things of that

order. I think that external auditors are more than aware of some of the inconsistencies that exist where the internal auditor is beholden to management.

I would be rather surprised if in fact that was a major problem, certainly amongst the sorts of auditing firms that are in the spotlight at the moment. I would not think that that is a major problem, to be perfectly honest. I take the point that, were the internal auditor to report to the board, it would seem to be better than reporting to managers, but then I thought that, at the moment, directors were in many ways under a cloud. So it does not seem to achieve much. But they certainly have responsibilities to inform the external auditor of the state of play—and of course the external auditor does not normally take that as said. I do not see it as a major player in these sorts of events, if the external auditor is on the job. I think, for the most part, they are.

Senator MURRAY—In companies where tangibles are the major component of the balance sheet and asset valuation is therefore an absolutely vital element in the assessment of a company's real market health—to use your analogy—you then move on to the issue of the valuer. It is my belief that, certainly in the eighties, the valuers were the most culpable profession in the scams that went on. You cannot address the issue of authenticating the quality of price assessment unless you have truly independent valuers. In other words, the arguments about the necessity for true independent, true quality audit which has true access to quality information have to apply to those who support the structure. In my view, the most important of those people is the valuer. How do you react to that proposition?

Prof. Dean—I would agree with the importance of the valuer. In fact, since the 1980s, the valuation profession has engaged in a number of activities to try and improve what were perceived to be deficiencies in the 1980s. One of the issues that relates to your question would be perhaps to have the valuer's name included in the valuations that appear in companies' financial statements.

Senator MURRAY—And a statement as to the independence of appointment?

Prof. Dean—That would be consistent with the previous suggestion—for independence of the auditors in verifying the statements, yes.

Ms GRIERSON—You mentioned assessing assets against future benefit, or actions against future benefit. Obviously, companies will take risks, so I think the real challenge is risk management, or audit of risk management. Just quickly, what are some parameters that you would use that do not discourage risk-taking that may have benefits in the long term but certainly is not irresponsible?

Prof. Wolnizer—In a competitive economy, it goes without saying that there are going to be some successes and some failures, and there is nothing wrong with that. The real question is whether the financial reporting system, in an accurate and timely way, flags to all the participants what the state of health is of a company. As I see it, the function of financial reporting is to give an indication of good, poor or other financial conditions. It is the unexpected, surprise nature of these collapses that absolutely stuns the community—where a company on one day discloses that they have assets of several millions or billions of dollars and then, with a complete surprise, they are found to be utterly insolvent. It is the extent to which this is a reliable system of financial instrumentation and the community understands those

things. Nobody is going to want entrepreneurs and companies not to take market risks. That is the nature of the business. It is whether or not the financial reporting system, in an accurate and timely way, gives a reliable indication of the financial capacity of the company to engage in market activities.

Ms GRIERSON—How do you reform the accounting standards in such an extensive way, when they are based on international standards, as it were?

Prof. Wolnizer—I will ask Graeme to comment but, just because there is a move towards the international harmonisation of accounting standards per se, it does not make them any better, qualitatively or in any way, because they are all of the same kind. Personally, I think the reform suggestion in the CLERP of moving to marked-to-market accounting is a very profound and far-reaching reform suggestion and agenda.

Ms GRIERSON—Can I suggest to you that that sort of suggestion of a reform has not come from the profession itself?

Prof. Wolnizer—I would not be surprised about that.

Senator WATSON—Are there any significant differences that stand out regarding reasons for failure of large corporates now, compared with failures in the eighties?

Prof. Clarke—I do not know that there are that many differences. At the end of the day, it is again a truism that companies fail because of a whole raft of circumstances such as bad decisions—which everyone is entitled to make—and so on. The most important thing is the familiar characteristic of the failures in the sixties, seventies, eighties and now—indeed, if you want to go back, you can go back 40, 50 or 100 years; certainly all of the last century—where you would find that the dominant characteristic is their unexpected nature. They were unexpected because their financials did not disclose their current wealth and progress in the way that, by and large, everyone expects that the financials ought to disclose.

We have argued categorically that companies do not fail because of accounting and auditing. What has happened is that this nexus between rather non-serviceable accounting—which is not very useful for making evaluations about the financial performance of companies and so on—and auditing has been such that companies perhaps have continued long after action would have been taken to wind them up or something of that kind. Consequently, it has exacerbated losses. That is the real evil of corporate failure.

Senator WATSON—Wouldn't you agree that, during the 1980s, one of the reasons for some of the most prominent corporate collapses was the siphoning off of cash through internal management companies which were controlled by the directors?

Prof. Dean—Yes. If you look at the structures in Enron, HIH and One.Tel, where you have from 200 to 600 to 800 subsidiaries, you have similar types of opportunities—and, it appears, actualities—occurring today as occurred in the 1980s and in the 1960s with Reid Murray and Stanhill; they were the same structures. We believe that that is one of the problems facing auditors as well: they are nearly on a 'mission impossible' because of the complexity of the corporate structures.

Senator WATSON—What is your solution?

Prof. Clarke—In our 1997 book, *Corporate Collapse*—there is an advertisement!—we argued that auditors are on a mission impossible and we very rigorously criticised consolidated financial statements. Indeed, we have an article coming out next month or so, in which we offer an alternative. The group structure certainly lies at the root of some of the sorts of matters that you talk about such as syphoning of money; you have probably got in mind Bond and Bell Resources and so on.

Senator WATSON—Could you give us a copy of that when it sees the light of day?

Prof. Dean—The article?

Senator WATSON—Yes.

Prof. Dean—Yes, I can send you a copy. We have the galleys for that.

Senator WATSON—Also on this question of mission impossible, listed amongst your references is an article in *Abacus* in March 1995 which raises the question of whether audit committees are red herrings. Would you care to comment on that as a lot of people seem to think that the solution lies in audit committees?

Prof. Wolnizer—That is mine. I could have been rather more forthright and said, 'Audit committees are red herrings,' but I was more circumspect and posed a rhetorical question.

Senator WATSON—Please be forthright to us.

Prof. Wolnizer—Particularly since the 1980s when the whole matter of corporate governance has been under such a spotlight, audit committees have been seized on around the world as a panacea for corporate governance problems. I argue in that article that they most certainly are not the panacea. There is nothing objectionable about audit committees. It is incontestable that it is helpful to auditors to have access to a committee of a board of directors, comprised primarily of independent non-executive directors, which is independent of the management of the company. That is an incontestable proposition. However, it is universally held that one of the major benefits of that is an improvement in the quality of financial reporting. People who sit on audit committees are, like any other director, constrained by the nature of the information to which they have access. They have no way of finding out whether the information provided to them is reliable and factually based. All of that sits within a context of conventional practice that gives inordinate discretion to the reporting enterprise. Just to define an asset as an expected future economic benefit puts the whole question into the realm of enormous subjectivity and private opinion. If the community was to look to audit committees as a profound solution to the problem of corporate governance and to increase the quality of audited financial statements, I fear that we may be disappointed. Nearly all the companies under the spotlight right now had audit committees.

Prof. Clarke—A major function of an audit committee is to ensure that the accounting standards are being complied with. Arguably that is to the disadvantage of the investing

community at large rather than to its advantage if our criticism of the accounting standards is valid.

CHAIRMAN—Thank you very much.

Prof. Dean—Can I just make a point? We did not have a chance to make an opening statement. Could I send you a written copy of this statement and table it?

CHAIRMAN—We are happy for you to table that.

Proceedings suspended from 12.38 p.m. to 1.30 p.m.

AZOOR-HUGHES, Ms Dianne, Technical Director, Pitcher Partners

CHAIRMAN—Thank you very much for coming today and for your submission. Do you have a brief opening statement? When I say that, I mean really brief.

Ms Azoor-Hughes—Pitcher Partners works in the middle market, so we are really focused on independence issues relating to medium sized and large family businesses. As accounting regulations and professional rules have developed, the focus has been very much on capital markets and capital market needs. We have found that the rules that have been set at that level flow down into smaller companies, and sometimes they are quite impractical and onerous. Therefore, we bring that point of view today.

CHAIRMAN—From your point of view, is the Ramsay recommendation of a compulsory independent audit section of a board practical?

Ms Azoor-Hughes—It would be very difficult. To implement something like that would perhaps just be paying lip service to a requirement which would not have any benefit. In terms of a listed company, you need independent directors—non-executive directors who are removed from the day-to-day operations of the business—and one of their main purposes is to make sure that the interests of the stakeholders are being protected. In terms of a family business, most of the time the directors are also the owners and their needs are aligned. Therefore, when there are independent directors the purpose becomes rather clouded as to why they are there and whose interests they are protecting or looking after.

CHAIRMAN—You could probably remind me of the name of the trucking company in South Australia that was a family owned company, and I think $20 million went walkabout. It was KNS Trucking. Are you familiar with that?

Ms Azoor-Hughes—No, sorry, I am not familiar with that one.

CHAIRMAN—Then I will not pursue it. One of the things you said was that the current accounting standards limit the auditor's ability to report on the accuracy of financial reports. Can you go into that in a bit more depth?

Ms Azoor-Hughes—A lot of the media coverage and public coverage of accounts seems to take a view that the accounts should come up with a figure for profit, assets and liabilities—liabilities are probably more clear cut—and that there is one answer which is the correct answer, and, 'Why can't the auditor find that value?' The way the accounting standards are structured is very much based on the intentions of management as to how they will direct that company's business. Therefore, they allow for various different valuation bases to be taken into account. Depending on your perspective and your intentions, one basis might be more appropriate than another, and that is the professional judgment that the auditor needs to use. There is certainly not one answer which is the correct answer.

CHAIRMAN—Having said that, though, is there a conflict between the accounting standards and a true and fair evaluation of a company's financial records?

Ms Azoor-Hughes—We do not believe there is a conflict because the accounting standards have a provision for substance over form. Therefore, if the accounting standards are promoting a course of action that is following the form rather than the substance of the transaction, we already have that provision which is effectively a true and fair override by a different name.

CHAIRMAN—You said that there is a general lack of understanding of what the auditor's report actually means and of the accounting framework using the preparation of financial reports. You went on to say that, within the framework, the auditor can only report on the reasonableness of financial reports, not the accuracy.

Ms Azoor-Hughes—That is right.

CHAIRMAN—Do you believe that we need to change some of the rules surrounding listing companies, annual reports, the provision of information and the expansion of the continuous disclosure rules?

Ms Azoor-Hughes—It depends on your objective. At the moment, the accounting standards are focused on performance, and performance is a very subjective measure. If you look back 20 years or so at the accounting standards, they were very much based on transactions and historical amounts—the recording of transactions. That was your objective—to record transactions accurately. It would mean stepping back, say, 20 years and doing just that. So I believe it is more about educating the public to understand that financial reports portray performance as defined by the accounting policies. I think previously you were asking about choice of accounting policy. There is a lot of information already in the financial report and if users refer to it they will understand which basis of accounting has been chosen and which valuation methods have been used. I guess with the appropriate skills they will have an understanding that a judgment has been made that this valuation basis will be used rather than another. I think it is more a question of education.

CHAIRMAN—You understand that the reason we are here is because of a spate of very dramatic corporate collapses in Australia and now, particularly, in the United States. In that context, it is certainly important to us that we try and come up with some solutions that will help reassure the public, recognising that we are the greatest shareholding nation on earth per head of population. We do not want everybody out there becoming concerned that their investments are all going to God because company directors did the wrong thing and the auditors never picked it up. It has been put to us by some respondents to this inquiry that Australia's unlimited liability rules in respect of auditors inhibit some auditors in giving a true and fair view of the company's operations. Do you have a view on that?

Ms Azoor-Hughes—I guess it might inhibit them in that they might lose that audit client. But from our view, if a client was putting pressure on our firm to follow an inappropriate policy, the greater risk for us would be the reputational risk. If we were to go along with that policy just to keep a client happy and if that policy was inappropriate, I think the reputational risk would be huge. I recognise that there is an issue there. I think that, in practical terms, an auditor has to weigh up the reputational risk against the risk of losing that client.

CHAIRMAN—If the Corporations Law was changed to either allow you or require you as an audit firm to be a corporation, how would that affect you?

Ms Azoor-Hughes—In terms of applying professional standards I do not think it would have any effect. It would certainly have a beneficial effect in terms of reducing liability. Listening to some of the earlier discussions, I was a bit anxious about the conversations on accounting firms being listed because I think that would change the focus, perhaps, away from professional behaviour to achieving the best results for the shareholders. I could see that having a negative impact on audit quality rather than increasing audit quality. I do not know that shareholders understand the quality of a product so much as the bottom line that is reported.

Ms PLIBERSEK—You mentioned—I am paraphrasing—that auditing is about performance according to accounting standards; it is not really about the financial health of an institution. Is that basically what you were saying?

Ms Azoor-Hughes—Yes.

Ms PLIBERSEK—You said that the public should be educated to accept that it is about performance according to accounting standards. There is all this effort to get people to invest in the stock market. There is a substantial effort on behalf of the government and certainly there are plenty of ordinary people who have superannuation and who have started to take an interest from that perspective. What means do they have to make considered assessments other than reading the *Australian Financial Review* or talking to their stockbroker? Do you think that there is a role for auditors to take a more proactive approach to giving people an indication of whether an entity is healthy?

Ms Azoor-Hughes—The auditor reports on historical information. The historical information of what the company has done in the past 12 months is only one indicator of how it will perform in future. There are lots of other factors that could change the direction of that company. It might have a strategic change in direction, it might have a change of directors, technology might change or a new competitor might come into the market. There is an unreasonable dependence on an audit report and a set of financial statements as being an indicator that a company will continue to be profitable or continue to hold a dominant position simply because in the previous 12 months it has had that position.

Ms PLIBERSEK—You commented on large family-owned companies perhaps being judged by different standards and not having to have the same audit requirements. Would you say that while they do not have the same responsibilities to shareholders and that shareholders can be entrusted to look after their own interests, they do still have responsibilities to people who are not shareholders—for example, employees and creditors? Do you think that there is a danger that, as with this trucking company $20 million fraud, the inevitable flow-on is that either people are sacked or creditors miss out if it has a substantial effect on that business? Do you think that what you are proposing has impacts not for shareholders but for other stakeholders?

Ms Azoor-Hughes—I am not familiar with the case that you referred to.

Ms PLIBERSEK—I am sorry; I meant to make a general point.

Ms Azoor-Hughes—If that were a fraud, I do not know that you could depend on the audit to pick it up, especially it was perpetrated by high levels of management. That applies whether it is a listed company, a large proprietary or whatever sized company. If it were a manipulative fraud

by people with authority it is highly unlikely that the auditor would find it, except by stumbling across it, because the intention is to conceal those transactions. In terms of responsibility to employees, creditors et cetera, they certainly do have responsibility to all those people. I am not suggesting that the company should not have to prepare accounts or that they should not be audited. We are putting forward the view that in the content of proprietary companies there is a different kind of relationship in that we do not have a three-party relationship—it is a two-party relationship. Much of the independence debate is directed at making sure that the auditors remain objective in a three party relationship. The way that they are seen to be objective is through independence.

In the two-way relationship, the whole point of our being there is to be independent. It is to point out where management are or are not complying with legislation; it is not to put a tick next to a management decision that a board has decided would be a nice thing to do and to justify that to shareholders. In the context of proprietary companies the shareholders and management have the same interests. Our role in many ways, in my own experience, is much more accountable in terms of our independence and objectivity because that is the whole purpose of our being there, and that is from the shareholders' and management's perspective. Although there is an appearance that we are perhaps too close, or there could be an appearance that we are too close, the reality of the relationship is that we very much have to maintain our independence, otherwise we are not serving the purpose of being there. Does that make sense?

Ms PLIBERSEK—Yes.

Senator WATSON—It has been put to the committee that people are not surprised at the extent of some audit failures because nowadays auditors simply do not do enough coalface work. Would you like to comment on that?

Ms Azoor-Hughes—Did you say 'enough coalface work'?

Senator WATSON—Yes. In other words, they rely far too heavily on sampling and, in old parlance, do not do enough green ticking.

Ms Azoor-Hughes—There are two aspects to that question. In terms of very large enterprises like the multinationals and listed companies and the risk based audit approach, I can certainly understand what you are saying about not being at the coalface. Because of limited resources and because you report on the financial statement as a whole, you direct your audit towards certain areas of the business and you might rely more on representations from people who are closer to the business. In the context of large proprietaries, which is our area, that rarely happens because large proprietaries are usually not as diversified as multinationals and we do a lot more coalface work in that arena because they do not have the management structures which allow you to go to different levels and depend on representations; you need to go right back to the actual systems. The context is quite different.

Senator WATSON—You talk about the need for a two-tier or three-tier structure in the sense that one size does not necessarily fit all and you put the case very strongly about large private or family companies. What are you really suggesting? Are you suggesting that the two-tier approach in respect of these companies comes within the ambit of the very small exempt proprietary companies? Should that be lifted? Are you suggesting the three-tier structure where

you have the proprietaries, the very small ones and the family ones in the middle? How are we going to legislate for your requirement in terms of the one size does not fit all approach? We have to give some expression to that. I can understand what you mean, but how do we achieve it?

Ms Azoor-Hughes—In terms of the financial reporting requirements, we are not really contesting those at the moment. We accept the need for the provision of financial information to creditors, employees or whoever if they need access to that information through the lodgment of accounts. The comments were really made specifically in terms of auditor independence and perceptions of independence. A lot of the proposed rules relate to perceptions of independence where you want shareholders and investors to see a clear separation between management, audit and auditors.

Senator WATSON—Has this independence issue been overstated?

Ms Azoor-Hughes—No, not at all. Certainly in terms of listed companies there is a need to protect the perceptions of independence because investors and shareholders do not have access to management other than perhaps through questions at the annual general meeting. They do not have access to that information and they cannot question their decision-making capabilities. In contrast, a proprietary company has a maximum of 50 shareholders and any member with a five per cent shareholding can request information and meetings to be held. They can more easily access any financial information they need. There is an additional bureaucratic layer where you are looking for an appearance of independence from auditors when, from the very nature of the business, they need to be close to the company to understand how the company operates and some of the relationships within it.

Senator WATSON—I agree with you that accounting standards appear to be driven increasingly by management judgments. From the point of view of Pitcher Partners, how does your audit process work in terms of assessing risk evaluation of judgments?

Ms Azoor-Hughes—Risk in the evaluation of judgments?

Senator WATSON—Assessing risk of the company and assessing valuation judgments.

Ms Azoor-Hughes—They are very much client specific in terms of the judgment being made, the other evidence available to support that judgment and the valuation basis being used. Often, there is other information with which we can corroborate a judgment being made. Depending on the aspect that we are looking at, we might look for an independent expert valuation from a third party. Certainly, it is a high-risk area. I guess there can be a point of struggle. If you have a directors' valuation and they say, 'This is what we think,' but there is nothing else to support it, that is a point of contention. We need more evidence to support that kind of valuation.

Senator WATSON—So you are quite happy to report that a balance sheet meets the standards on the basis of a directors' valuation?

Ms Azoor-Hughes—No, not on its own.

Senator WATSON—Do you qualify your report?

Ms Azoor-Hughes—Depending on the extent of other information available we would make sure there was full disclosure as to how the directors had arrived at that valuation. There might be a modified audit report to refer to that.

Mr CIOBO—I am interested in proprietary companies. As I understand your submission, one of the principal differences—and, therefore, one of the drivers behind your push to separate the need for the perception of independence as strongly as it is with listed companies—is that there are external equity holders. Given the significance of some proprietary companies, would it not be reasonable to adopt a one size fits all approach, given that although there may not be external equity holders there are creditors, investors and so on, all of whom might be looking at factoring in to some extent the audit opinion to their decisions about their interaction with the company on an ongoing basis?

Ms Azoor-Hughes—I am not aware that trade creditors refer to the financial report to any large extent. Financial providers certainly do have an interest in the financial statements. A lot of our clients have close relationships with their finance providers, and they will ask us, as auditors, to carry out additional testing or to perhaps carry out audits more regularly than just annual audits. Therefore, from my point of view, it is tightly covered, because the finance providers are able to command whatever accounting information they require on a more timely basis than purely annual statutory accounts.

Mr CIOBO—Who bears the cost of that?

Ms Azoor-Hughes—The client. It is the cost of obtaining that finance.

Mr CIOBO—So the compliance cost for finance, as such, is how they view that?

Ms Azoor-Hughes—Yes, I think so.

Mr CIOBO—Therefore, I take it that you would not see any great problem in having a separate standard. I am just thinking of market efficiency, especially where you get a large number of proprietary companies that subsequently list. Certainly, would it not be fair to say that a lot of potential equity investors would want to look at a track record? There may be differences that have resulted over time and it might not be a level playing field, so to speak, in terms of the assessment they make. Would it not therefore be reasonable to seek to apply that one rule?

Ms Azoor-Hughes—Are you saying that it will not be a level playing field because the auditors were not seen to be independent?

Mr CIOBO—However this inquiry might go with regard to scope of audit and all those types of things, I can see the potential for there to be differences if we differentiate between listed and proprietary.

Ms Azoor-Hughes—I do not think that there would be any differences in the quality of the information being produced, because that would be a breach of professional standards. Going

back to the finance providers, at the moment the market dictates what additional information is required and, depending on the level of finance and the other securities within the business, that really determines how much information the banks want and how frequently they want it. A lot of private companies do not have any external finance; they might be financed by money that is within the family already or by private investors. Again, private investors are also able to command additional information if they are required to do so. By just putting in an additional legislative requirement for, say, half-yearly audits or increased audits, a lot of companies would have to bear that cost for no real benefit.

Mr CIOBO—Would you say that, in your interaction with proprietary companies, your scope of audit would tend to be more broad than that of most listed company auditors?

Ms Azoor-Hughes—I think so.

Mr CIOBO—What anecdotal testimony can you provide in terms of what you see as the benefits or costs flowing from that?

Ms Azoor-Hughes—Quite often large proprietaries do not have a lot of internal expertise or internal experts to give them assurance that their internal controls are working efficiently or effectively, and that is outside the scope of an audit, but because they do not have that internal expertise quite often we will be asked to do work on internal controls—that is, more compliance work. Again, it depends on the size of the client as to whether we incorporate that into a statutory audit or that is a separate engagement. Allocation of resources is also a factor. In a lot of large proprietary companies, their energies and resources are focused on managing the business rather than on compliance so they would ask us to check that they are complying with laws and regulations.

Mr CIOBO—A large number of submissions to this committee have indicated that potential unlimited liability on a broader scope of audit is an inhibiting factor. Does that factor into the decisions made by your partnership about scope of audit?

Ms Azoor-Hughes—In terms of accepting new clients, very much so. Auditors are perceived to have deep pockets, unfortunately, so it is certainly a consideration.

Ms GRIERSON—I found your presentation very interesting because, taking up the points we have just explored, your audit scope seems to be wider because of the needs of your clients. Therefore, you are not separating the functions that we have talked about in terms of the need for independence in audit services from the actual audit—that is, other advisory services. You are coupling them together and, in a way, doing continuous auditing. You are probably getting more disclosure and more performance audit information as you do that, so that if you were caught up in a new regime that was much tighter than that then I can see that that would be a difficulty. Whether what you are doing compromises the independence or the advice that is given, I am not sure, but it does seem that your submission is important for us to consider because it is obviously functioning in a different way. Perhaps because it is functioning in a different way, you also in your submission have had no resistance to suggesting that the standards be quite radically changed. Am I misreading your submission or are you quite happy to have the accounting standards changed?

Ms Azoor-Hughes—Do you mean the accounting standards or the auditing standards?

Ms GRIERSON—The accounting standards.

Ms Azoor-Hughes—I think that is a separate issue completely. There are deficiencies within the accounting framework which I think everyone recognises, which is why they are continually being revised and updated. I am not able to comment on the framework.

CHAIRMAN—Professor Houghton of the University of Melbourne has suggested that audit firms should have an independence board or group within their company. Do you have such an operation? How do you feel about that?

Ms Azoor-Hughes—I think it is important because there is always a risk of a partner becoming too close to a client. Within our organisation, I am a technical director and I have no affiliation with clients. My role is to make sure that a partner remains objective and that there is not a conflict of interest. If ever a situation arose where there was a potential risk, it would be referred to me to examine more closely and we would resolve that.

CHAIRMAN—You would be well aware that there are those in the marketplace proposing that audit firms not be allowed to do consulting work for their clients in addition to performing the audit function. What is your view?

Ms Azoor-Hughes—I think you have to be careful to look at the nature of the consulting role. There is IT consulting and then there is general advisory work. IT consulting is incompatible with an audit, because it quite often relates to the way computer systems are implemented and the controls within those systems. To then go in and audit those same systems is certainly a conflict of interest, and they should be separated. I do not see a conflict of interest in terms of ongoing advice. It is usually a function of your knowledge of the business, particularly with our client base. You become close to an industry or the industrial practices of your client and you can see where there might be efficiencies or where a process that they are using is ineffective. Whether you call that audit advice or consulting advice is a very grey area. If you audit their system for cash receipts and you can clearly see that they could do things in a different way and save costs, is that advising and consulting or is that part of your audit?

CHAIRMAN—You would be well aware that in the Commonwealth jurisdiction in the public sector we have financial audits performed for and signed by the Auditor-General, but the major amount of work that ANAO does is actually performance audits of all sorts of things to do with how departments operate and how they undertake the mandate that they are given by government or by legislation. If we could find some way to relax the unlimited liability requirement on auditors, do you see that that could help add value overall, not just for large proprietary companies but for the whole auditing sector of our economy?

Ms Azoor-Hughes—Performance audits are certainly very beneficial. The difficulty I see is how you define the scope of those audits. When the Audit Office conducts a performance audit, it is restricted to one particular area or department; it is not across a multinational, for example.

CHAIRMAN—That is not necessarily true. From time to time they will do a performance audit on an issue that goes across the entirety of the public sector.

Ms Azoor-Hughes—Is the scope of that review the same? Is it a review? I think there is a difference between a review and an audit. For example, if you wanted to conduct a performance audit of a multinational, you would really need to identify which business streams—which areas—you were looking at. It would be quite difficult to define a scope and to communicate that effectively without creating a bigger expectation gap in many ways. I do not know that it would be feasible, for example, to go to BHP and provide an audit report with the statutory accounts which said, 'We have conducted a performance audit.' It would be too broad, and incredibly costly as well.

Mr CIOBO—You said something in your submission which I thought was curious. You said:

> *If* audit failures are found to be a factor contributing to corporate collapse (and this is not yet proven), then it is more likely that it is the firm's audit *process* rather than auditor independence ...

Maybe I am misreading this, but it seems to me that implicit in that statement is a comment that the audit standards may contain deficiencies—or are you saying that it is an application of the audit standards by the auditor?

Ms Azoor-Hughes—An application, certainly.

Mr CIOBO—Is that something that you see as systemic, or is it a one-off?

Ms Azoor-Hughes—I think a firm's audit process could have a systemic deficiency. I think it goes back to Senator Watson's comments about being at the coalface or taking an overview and a risk based approach. If the audit process focuses on management representations and audit risk at a high level, there is the potential for audit failure if you do not do any coalface work.

Mr CIOBO—If it is a process problem, what is your recommendation to this committee about obtaining the application of standards in line with the expectation, rather than auditors applying standards that they see as fit and proper, which in fact leads to the sorts of failures that we have seen? How can you build the check and balance into the system so that you are getting the appropriate application of audit standards?

Ms Azoor-Hughes—I think the check and balance already exists in terms of the peer reviews that are carried out by the accounting bodies, and perhaps increased surveillance in that respect would assist.

Mr CIOBO—Peer review.

Ms Azoor-Hughes—Yes, and the feedback from those; they are very useful.

CHAIRMAN—Ms Azoor-Hughes, thank you for coming and for your submission. If we have any further need for information we will write to you; would you be happy to respond?

Ms Azoor-Hughes—Yes, certainly.

CHAIRMAN—It is our intention to try to report by late September or early October, to make sure that this public process and whatever recommendations this committee makes are part of CLERP 9 and considered by the government.

Ms Azoor-Hughes—Thank you very much.

[2.08 p.m.]

FRANCIS, Mr Richard Daniel, Head of Australia and New Zealand Centre, Association of Chartered Certified Accountants

CHAIRMAN—Welcome, Mr Francis. Do you have a brief opening statement, or shall we proceed with questions?

Mr Francis—If you would like to proceed, I am happy to comment or add information.

CHAIRMAN—Before I start asking in detail about your submission, one of the things I would like to know is what membership base you have in Australia.

Mr Francis—The ACCA has a membership base of approximately 1,200 qualified members in Australia, out of a total membership of about 92,000 worldwide. I suppose there are three areas of interest in our presence in Australia: our membership and our office here, and we are also cited in the Corporations Act for the purposes of registered auditing.

CHAIRMAN—How does your company differ from the two rather larger companies: CPA and the National Institute of Accountants?

Mr Francis—I think the main difference is that ACCA are unique in being a truly global body; we have 300,000 members and students in over 160 countries. Also we have a perspective that is different from the Australian bodies in the sense of, for example, our recognition in the UK and our involvement with the EC and a number of global bodies and global projects.

CHAIRMAN—Do you have a view about Ian Ramsay's recommendation that boards of listed companies have an independent internal audit board?

Mr Francis—I think the internal audit function and internal audit committee—did you say committee?

CHAIRMAN—Yes, but a committee of the board rather than an internal committee of management—that is to say, made up by independent members of the board.

Mr Francis—We support strongly that the role of the non-executive director should be stronger in the area of management of the internal audit committee and of appointment of auditors. We do support that.

CHAIRMAN—You believe that is a function of recommendation or regulation?

Mr Francis—On the whole, we feel that any form of major change in corporate governance should be carefully considered. Further research is being undertaken. There has to be some care in jumping in and legislating. Certainly that is one of the areas that we would support.

CHAIRMAN—In Australia, as you would know, rather than—as in the United States—having quarterly reports, we have annual reports and continuous disclosure, but it is this committee's understanding that continuous disclosure is not audited. Do you have a view about whether what we are doing represents world's best practice, and what about the Americans or the British?

Mr Francis—British practice does not focus on quarterly auditing; it focuses on continuous auditing. We support continuous auditing and reporting issues more transparently as and when they occur. I would not say that we would campaign particularly strongly against quarterly reporting but we feel that it tends to contribute towards the short-termism, which is prevalent.

CHAIRMAN—In Great Britain, is the continuous disclosure also audited?

Mr Francis—I think that the continuous disclosure comes from things like stock exchange regulations, so it is not, to my knowledge, audited.

CHAIRMAN—Would you have a view about whether it should be?

Mr Francis—I think there are practical issues there. One of the issues that has been proposed in the UK is a statement in the financial reports that identifies the factors that contribute towards the value and the risks to the value of the company. That encourages a more open disclosure regime than exists at the moment. Flowing from that, principles come down as to whether issues should be reported as and when they arise. I do not have a particular opinion at the moment as to whether that should be audited or not.

CHAIRMAN—Professor Houghton of Melbourne University has recommended that audit firms themselves have an internal independent board, function or body. We would appreciate your view on whether you support that, either in a voluntary or compulsory sense.

Mr Francis—We would see that as contributing to the efficiency of the audit as an internal review. On the whole, we are a little sceptical about the concept of internal review and peer review. We do not feel that that is particularly an area of emphasis.

CHAIRMAN—In 3.4, you said:

It is, however, no longer credible or acceptable for the process—

that is, the process of regulating accountants—

to be controlled by practitioners or by the professional bodies to which they belong.

Mr Francis—I think this is one of the main points we have made in our involvement in the development of the Accountancy Foundation in the UK. The idea of people regulating themselves has been taken away from that regulatory structure so that there are no professional accountancy bodies represented within the Accountancy Foundation, and we feel that is quite important for the public perception of the regulatory framework being independent of the profession. It is still important that those regulatory committees have an understanding of and

expertise in the profession, but to have a professional body mandated to be on those boards seems us to be people regulating themselves to some extent.

CHAIRMAN—But if a firm's management or board—whichever—decides to perpetrate fraud and to hide it, what would lead you to believe that some external regulatory body would be more likely to find that than would the auditors by self-discipline?

Mr Francis—We are not suggesting that the auditors or the professional bodies should not be heavily involved in that process. But, if we are talking about the context of a regulatory environment, there needs to be an environment that is independent of the profession in order to see that it oversees the profession.

Prof. Clarke—We understand that in Great Britain there is proportional liability for audit firms rather than unlimited liability, as in Australia. Would you care to comment on the differences and on whether you think the UK experience has led to improved or reduced quality of audit?

Mr Francis—I would be happy to get information and to submit that, but I am afraid that is something I am not in a position to comment on.

Senator MURRAY—Directors are elected to a company by one vote to one share. That leads to a dominant financial interest or an oligopoly of financial interests controlling boards; even where a director is non-executive, it invariably means they are not independent. The way to overcome that—and it has not been adopted in Australia and it is a campaign I have been on for a long time—is that independent, non-executive directors should be voted in on the basis of one vote to one shareholder. You can do that either to the main board or to what I refer to as a 'corporate governance board'. But if the entire motivation and belief in audit committees and their ability to contribute to better standards rests on directors being both non-executive and independent then you have to separate them from the dominant financial interests as well as from management. Would you support the concept of a voting system of one vote to one shareholder to achieve that, or have you not thought about it much?

Mr Francis—The issue of non-executive directors being elected by specific groups or interests is something we have thought about, and there should be consideration given to alternative methods of appointment which are not purely inspired by the controlling shareholders. I am not sure if I would actually say one vote to one shareholder, but certainly there could be some provision to appoint certain non-executive directors to the board other than by the current method.

Senator MURRAY—The only alternative is to rely on the hope that, within a board of directors, there are competing financial interests. That happens at times. But my experience of judging these matters is that most often there is a congruence, which is why I used the word 'oligopoly'—or cartel if you like; an oligopoly of financial interests.

I just cannot see how you can possibly generate independence unless you limit the power of the dominating financial interests and those people who are so separated. The best mechanism—internal, cheap, easy to do—is one vote, one shareholder, and also to have those same people appoint the auditor. You do not have an auditor who is directly related or affected

by management or the dominant financial interests, and you do not have independent non-executive directors who are directly affected or dominated by management or the dominating financial interest. You can see how it would be a cheap, internal, flexible mechanism which can easily be applied.

Mr Francis—I am not sure if that would not lead to some chaos as well, if it is a board elected without any reference the proportional shareholding. I think it might be necessary to have it. Certainly, one of the major problems at the moment is that it is really management who appoint the auditors and management, who manage the CFOs. There has to be some mechanism to break that down. That begins with the non-executive directors and the audit committee. You then need ways of making that more independent from the dominant shareholders and the management. I think that that would be one of the principal areas to look at.

Senator MURRAY—If you are interested in the matter, I will send you my work on corporate governance boards if you want. But I would ask you to give it some more thought, because the issue of independence cannot be addressed unless you separate out appointment—or how people achieve things—tenure, separation and remuneration.

Mr CIOBO—I have got a question regarding scope of audit. It has been an issue that has flowed through a number of submissions and also been of interest to this committee. In terms of scope of audit, the interplay with the scope and the fact that there is unlimited liability at this stage, I would be interested in your comments on the opportunities to broaden the scope, what the relationship is with liability and, basically, how your professional body views moves in that regard.

Mr Francis—The scope of the audit is certainly something that needs to be looked at. I think the public expectation has changed. Therefore, the traditional view of the auditor as passing a judgment simply on the financial statements might have to be modified. We feel that that role needs to be developed and clarified, certainly in the area of taking on non-audit figures, non-audit work and audit work. We feel that the role of the auditor probably needs to be broadened and made more specific.

Mr CIOBO—Obviously independence is a crucial aspect, because I note you also stipulate that you would like to see the inclusion in the annual report of the fees that are paid and also a prohibition on any auditors that have gone across to be senior executives. How do you then see the relationship between the scope of the audit and that motion of independence? Given your very strong push for there to be a very high level of independence, do you therefore see that, with the broadening of the scope, that is in some way affected, and how do you implement safeguards to overcome any lowering of the independence threshold?

Mr Francis—We have got a number of recommendations there on both the external regulatory framework and on the internal corporate governance. We are saying that we have addressed things like the method of appointing auditors, the mechanisms for reviewing the quality of the audit and any concerns, and greater transparency in reporting. I think that whole range of suggestions that were made in our paper need to be in place. The main thing is to remove any perception of imbalance. That is why we have emphasised things like relative fees as being important. I think that those sorts of areas—dependence on fees as too high a proportion of the practice—would be important.

CHAIRMAN—Regarding paragraph 3.3 of your submission, I have had some difficulty in coming to a complete understanding of what you are telling me about the new UK model. Do I understand correctly that it is an oversight organisation that both sets the standards for accounting and auditing and acts as a disciplinary body for the entire profession—and that it does not include accountants or their representative bodies?

Mr Francis—No. I think the framework for it could be described as the Accountancy Foundation Review Board, and the review board does not have representatives of professional bodies, as such, on it.

CHAIRMAN—But does this body also set the accounting standards and the auditing standards?

Mr Francis—My understanding is that it would be reviewing the setting of those standards.

CHAIRMAN—How does it review them when it has not got technical expertise?

Mr Francis—It can have accountants on the board. We are not saying that it does not have accountants on the board; we are saying that they should not actually be representing specific accounting bodies.

CHAIRMAN—I guess I understand. Did I already ask you whether you have a view on the liability issue?

Mr Francis—Yes, I think so.

CHAIRMAN—I am sorry about that; I am getting tired.

Ms PLIBERSEK—Mr Francis, I am sorry. You really have got the raw end of the deal. Our last two witnesses have really not got us at our best.

CHAIRMAN—We apologise, but you do have to understand that, on 2½ or three hours sleep, we are going downhill rapidly.

Senator MURRAY—We are going to have to come to some kind of opinion on the issue of accounting standards, which I think is going to be really difficult. I see four options available. The first is that pretty much that the world muddles on as it is, with a multiplicity of what we might call sovereign accounting standards. The second is that we head towards a modified American model—since they dominate 51 per cent of the world's market capitalisation, we all join in with their view. The third option is that we, broadly speaking, go to what is known as the European view. The fourth is that there is some kind of international agreement instead which takes the best of everything and tries to arrive at a harmonised model. Speaking for myself, I have always, almost automatically, accepted the desirability of harmonisation; it just seems to make sense when you have so much cross border corporate and accounting activity. Where are we going with all of this? What real prospect is there of real consistency and harmonisation in the relatively short term, over the next five years?

Mr Francis—A number of international bodies, as you know, have put out various statements on international corporate governance, the IFACs code of ethics and so on. It is necessary to encourage the regulators and governments to talk to each other and to seek that harmony. The principal problem is obviously going to be that, if you have a big difference between the EC model and the USA model, that is really where it breaks down. The question at the moment is whether the reaction of the USA will be to continue putting in more regulation or to move away, towards the principles based and towards the Europeans' style. If it does not do that, that is the major stumbling block.

Senator MURRAY—In your opinion, should we be hanging on to the coat-tails of America regardless, simply because of their size and dominance, or should Australia, which is so small—say, one per cent of the market cap—kind of wait and see?

Mr Francis—I do not think it should move too quickly; I think there is a certain element of wait and see. Enron was a turning point in history for the accounting profession in suddenly drawing worldwide attention to the accounting issues and to the whole issue of auditing and financial reporting and, therefore, there is a huge amount of worldwide debate and research going on at this point in time. One of the things we have suggested is that short-term measures may be a mistake until there is more evidence on specific issues.

Senator MURRAY—I am conscious of the collapses in America, and I am conscious of the collapses in Australia. Have there been equivalent collapses of similar sizes in Europe in recent times?

Mr Francis—Not as spectacular. There is a concern that the same thing can happen—I do not think there is any complacency about that—although there is a feeling that the UK-EC position is more satisfactory than the one in North America.

Senator MURRAY—You know where I am going with this: we have statements from witnesses that we are pretty well near world's best and that we have a terrific system and so on. If Europe has come out cleaner than America and us, then that might—and I am not saying it does—on some readings indicate that their system is in fact running better than ours is. Of course, it could be just a timing thing; something might be coming around the corner that none of us knows about. It is an interesting view, isn't it?

Mr Francis—Yes, I think it is. Perhaps that is the most difficult point that you raise: you have to consider whether you should take more note of the European model and style and move in that direction as opposed to the American style.

Senator MURRAY—I had some discussions the other day with the ASX, and I put these four propositions to them. In listening to me, one of the people I was talking with obviously misunderstood what I was saying and berated me for implying that we should charge after the American system, which I do not imply. But I have had the sense from some quarters in the professional field that a modified American system is the way to go, simply because of their size and importance in the world market. I wonder if that sense is accurate or if the Australian bodies are more or less interested more in the European system.

Mr Francis—We tend to think that the American rules based approach tends to reflect the litigation based environment that exists there and that that is a response to that more than it is to better, more transparent financial reporting.

CHAIRMAN—Thank you very much, Mr Francis. We appreciate your submission and your coming and talking to us today.

Mr Francis—Thank you.

[2.34 p.m.]

AGLAND, Mr Reece Graeme, General Counsel, National Institute of Accountants

ORD, Mr Gavan, Technical Policy Manager, National Institute of Accountants

CHAIRMAN—I welcome the representatives of the National Institute of Accountants. Thank you very much for your submission and for coming today. Do you have a very brief opening statement you would like to make?

Mr Ord—Yes. We will try and make it as brief as possible.

CHAIRMAN—Regardless, it should be no more than two minutes flat, full stop—because I will ring the dong!

Ms PLIBERSEK—You also have the capacity, if you want to make a longer statement, to table that statement, and that will be incorporated in the record of today's proceedings.

CHAIRMAN—We are happy for you to table it.

Mr Ord—We will try and make this as exciting as possible. The National Institute of Accountants is the third professional body in Australia. We have 12,000 members. Our members work in all areas of the accounting profession, including audit. We have a very real interest in what this committee is looking at. The NIA has taken a very active role in the profession, particularly recently, and we are keen to ensure that the high standards of the Australian profession are maintained.

In our submission we raised a number of points, and I will quickly speak to them. In the recent spate of corporate collapses here, in the US and also in Europe we have found that there has been no systemic failure of the corporate governance framework, including accounting and auditing, but that there have been individual cases of what seems to be management fraud. What we need to do and what this committee needs to do is ask how we can better target that fraud. Our submission looks at how we could improve our system so that we can better target individual cases. As was stated last week by the chartered accountants and the CPA, the Australian accounting profession is one of continuous improvement. We have always taken an evolutionary rather than a revolutionary approach. That has worked well for us and that is why the Australian accounting profession is so well regarded overseas.

Possible improvements that we have identified include an overall umbrella body for the profession, involving the government and the three professional bodies. Within that framework—which is the same as what the CPA proposed—this body would set the professional and ethical standards for the professional bodies and in legislation. There could be some kind of accreditation board for specialists. There could be a board to look at audit competencies for audit registration and a disciplinary process involved in that. The NIA supports the Auditing and Assurance Standards Board, AuASB, becoming a statutory body like the Accounting Standards Board, and that would come under the oversight of the Financial

Reporting Council or a similar type of body. The auditing standards should have the force of law in the same way as the accounting standards do.

We support and mandate independent audit committees, and such audit committees should be composed of non-executive directors. We went into some detail in our response to Ramsay on the appointment of auditors, but we think the independent audit committee should play a large role in the appointment of auditors and that, following on from the 1997 audit working group report, there should be some form of audit competencies for the registration of company auditors.

Also, there have been a lot of questions about limiting liability. It is not an issue we have looked at in great detail and it is probably an issue for a separate inquiry, because, as you can see, there are quite a lot of things going on at the moment. But, in the accounting field, we could look at the US model of limited liability partnerships or the UK model of proportionate liability or, as the chairman has stated before, the corporatisation of audit firms. All that would limit the liability of auditors and help people who are already involved in the audit profession to stay there and encourage people who are not in the audit profession to go into it. We do not want to see a situation where the audit profession goes out of existence or has little effect because the standard of auditors has declined because people do not want to do auditing. There is a similar issue in the medical profession.

CHAIRMAN—Professor Houghton of Melbourne University has suggested that every large audit firm should have an independence oversight board to manage their independence and to help with the public perception regarding independence of auditors. Have you formed a view about that proposal?

Mr Ord—We have not formed a view about it. We just became aware of it this morning, when you read from the transcript of last week's hearing. Once we read that, we support the comments made last week by Stephen Harrison, the CEO of the chartered accountants, that such an independence oversight board within an audit firm may not help the perception problem. We talk about the audit expectation gap. If, say, one of the big four firms were reviewing their own internal processes, the public perception may not be helped. In our submission to Ramsay we propose that there be some kind of umbrella body—whether they undertake a review of the audit independence of such audit firms—and recommend that every year such a board report on the state of independence of audit in Australia, so there would be a more overarching view from an independent body rather than from someone within one of the big audit firms.

CHAIRMAN—Wouldn't it be a very expensive process to set up a body to go and audit every auditor?

Ms PLIBERSEK—You would do a sample. You would not reaudit audits, would you?

Mr Ord—No. We definitely would not reaudit audits. It would be a general overview by a body such as this umbrella body. They would take a sample and make a statement on what they perceive to be the state of independence of audit in Australia. This could include statements on how improvements could be made by these audit firms. It would not be a total reaudit.

CHAIRMAN—Not an audit of listed companies but an audit of the audit companies.

Mr Ord—That is right. We are not proposing that; we are just looking at a general review of audit independence based on maybe some sample audits, some interviewing of the audit partners of such firms and the key stakeholders as well.

CHAIRMAN—What is your view of audit firms undertaking consultancies with the firms that they audit as well?

Mr Ord—The non-audit service question has raised a lot of issues. Our opinion reflects that of a study done by the University of New South Wales which says that there is no real empirical evidence that actually impairs independence. However, there are certain issues within non-audit services, particularly internal audit and IT systems, that increase the risk to independence. Our proposal is that those areas be carved out of the activities of audit firms. The reason for that is that, once again, there is a perception of a risk that independence of those firms could be impaired if they do such consulting services—but that is not all consulting services.

CHAIRMAN—If you do that by regulation and you force audit companies to remove a portion of their business, in effect, is there not also a risk that some or all of them might then decide to exit the auditing business and instead stay in the consultancy business and we wind up with no auditors?

Mr Ord—When we talk about the larger firms, there is quite a distinction between partners: there are audit partners and consulting partners. Here we are talking about some of those consulting partners breaking away, similar to what Andersen Consulting did to Arthur Andersen a few years ago—which is quite fortuitous, actually.

CHAIRMAN—That is not a good example.

Mr Ord—There are quite a number of distinctions between the partners. One partner does not do auditing and do consulting. They would do audit or something else. There is a distinction.

CHAIRMAN—Do you see any differences between the audit function and the consulting function for large publicly owned companies versus, say, large privately owned companies?

Mr Ord—The NIA mainly represents smaller practitioners, and our opinion on that is that that view is the same for both smaller and larger firms. Once again, the audit partner would do audit work and the consulting partner would do consulting work. Where the consulting work goes into internal audit and IT systems, there should be a separation of that particular function from the audit function.

CHAIRMAN—I did notice that in your submission you said that the FRC should stay and that there is no synergy to be gained by combining the development of auditing standards with accounting standards and that, if anything, this would detract from the accounting standards development process. We thank you for that—that statement is clear enough—but we have had some controversy and a number of different opinions, I guess, surrounding the issue of true and fair versus absolute adherence to the standards. Can you tell us the view of your organisation?

Mr Ord—The reason for that statement is that we see there may be a conflict if the people developing accounting standards are also the people who develop auditing standards. The reason for that statement was that there should be a separation of the people who develop the auditing standards from the people who develop the accounting standards.

CHAIRMAN—That was one issue—we thank you for that view; I understood what it was about—but the question is: when an audit firm goes to do an audit, is there not a conflict between signing off on the company's accounts on the basis that it represents a true and fair analysis of the worth of the company, its balance sheet and its profit and loss statement, and strict adherence with the accounting standards? Is that conflict so great as to cause us to change the balance; is it about right?

Mr Ord—That is not an issue that has been raised with us by members who are auditors. They have not found any real conflict between the true and fair view and adherence to accounting standards. That is not an issue that has been raised with us by our members.

Senator MURRAY—Your recommendation 6 is an interesting one which builds on your theme that self-regulation has not got that much going for it any more. You recommend that:

The Accountants, Auditors & Liquidators Disciplinary Board replace the Disciplinary Committees of the NIA, CPA Australia and ICAA to ensure greater independence from the investigation process ...

Instinctively, that sounds like an attractive idea, but I see two classes of discipline: one which relates to standards—ethical standards and the standards of work done and the propriety or not of the person concerned—and another which relates to internal matters, in other words, organisational disciplinary things such as failing to observe proper behaviour within the organisation. I assume you would not want to take that second part away.

Mr Agland—No, it was really in relation to saying: you have the Company Auditors and Liquidators Disciplinary Board looking at similar issues to what the CPA, the NIA and the ICAA disciplinary boards look at.

Senator MURRAY—All right. The question that arises from that is: would you be recommending that those three bodies assist in the funding of that single disciplinary entity? Do you have a view as to how?

Mr Agland—As they are our members, we would definitely have a role in providing funding. As to the exact amount, I would not want to guess how we would come about that. You would need to look at the percentage of each of their members involved in those areas and at the size of the firms. The NIA has only 12,000 members compared with the CPAs, which has 97,000, versus the chartered, which would have about 37,000. The chartered 37,000 are the larger end of the scale, so they would normally provide a greater percentage of the funding than would, say, the NIA.

Senator MURRAY—Naturally.

Ms GRIERSON—I note the difference between the previous submission and yours in terms of the oversight body. You suggest representation which would be fifity-fifty profession and

government; their model would have a more independent focus, with much more public representation. Why have you rejected any public involvement in the body?

Mr Ord—We have not rejected public involvement, and the government could appoint outsiders as well. When we refer to 'the government', they are government appointees. We would like ASIC involvement because they are integral to the system.

Ms GRIERSON—I misread that. I assumed you meant 'government bodies', which is a bit more than 'government's decision'. You would have noted that there are several people here who are not accountants but who perhaps have a role to play. I am just making that point.

Mr Ord—We recognise the importance of other key stakeholders in the profession, apart from the professional bodies themselves; their input is very valuable.

Ms GRIERSON—Yes, employees and shareholders are important.

Mr Ord—Accountants are the gatekeepers to commerce, as a judge once said, and we are here to protect the public interest.

Mr CIOBO—Further to what Ms Grierson raised with respect to this body, when I read your submission I understood the fifty-fifty composition of government and practitioners but not why you sought to include government.

Mr Agland—As we said previously, it is not 'government' but that 'government appoints'. The government would have to choose those people from a diverse area. The ASX would be one area. There would be quite a few different areas. We did not want to be the ones to say, 'One person from here, one person from there and one person from over here.' Rather, we suggest that the government choose 50 per cent but that it draw from that wide grouping of individuals.

Mr Ord—The other reason we think the government is involved is that it regulates on the edges the accounting profession. It is very important that it is involved. It regulates auditing, liquidators and tax agents, and that is important to what a lot of our members do, so it has a very important role. The reason we put this board forward is that the basis of regulation in government legislation, both at state and federal level, is very ad hoc and it greatly confuses our members as to the areas where they can and cannot be regulated and where they have to be licensed and not licensed. Government involvement in this committee and this oversight board can actually lead to a better and more cohesive approach to regulation of accounting.

Mr CIOBO—The question is whether it would. There has been discussion, as I understand it, for years and years about chartered merging with CPAs. That has been an ongoing issue for many years and has never been resolved, despite how close it often comes to that. This is a rhetorical question: I guess in practice you would see those barriers as being overcome by the development of a board such as this, not necessarily in terms of membership of the respective professional bodies but in terms of a sense of harmony of the professions in the development of these standards.

Mr Ord—I would agree with those comments. It is difficult for me to comment on what the chartered and the CPA may do in the future. I think they have tried to merge five times. When I talk about a 'cohesive approach', the accounting bodies actually work quite well together; it is the collaboration with government which sometimes is difficult and leads to difficult situations, such as the current problem with the Financial Services Reform Act.

Mr CIOBO—Could I keep exploring the proposal in terms of the government appointments? One of the possible implications down the track with a pinnacle body like this, where you perhaps have a systemic failure or instances of failure, is that you might have the broad public misconception that this is a consequence of poor decision making or policy development by government. You might even get a foot dragging in the sand by certain government agencies out of fear of political repercussions or outcomes. Do you foresee that as a potential negative side effect of the development of a body like this?

Mr Ord—That is a negative side effect. The experience overseas where government regulates the profession as a whole is that it is a very slow process of change. Australia is far more adaptive to change because there is more of a self-regulatory environment. But what you are saying is quite true. That could be a negative to the proposal.

Mr CIOBO—But you do not see it as a negative that outweighs the benefits?

Mr Ord—No. We do not see that as a negative that outweighs the advantages.

Mr CIOBO—What is the NIA's view on scope of audit and its relationship to liability?

Mr Ord—The scope of audit as to what an audit—

Mr CIOBO—It has been submitted to us that there has been reticence among certain groups to broaden the scope of the audit because they feel that that has implications in terms of their exposure. What is your membership's view on that?

Mr Ord—This issue has come up, and I believe it has a lot to do with the audit expectation gap, which you would have heard quite a bit about. As I said before, the accounting and auditing profession have worked quite well. One of the problems is the perception that we have not managed the audit expectation gap well enough. The NIA does not believe that there is a need to increase the scope of audits. We believe they work quite well. There have been individual instances of failure which we must overcome. There is no systemic reason why we should increase the scope of audits.

CHAIRMAN—Thank you very much for coming and for your submission. We appreciate your evidence and we will certainly send you a copy of our report when it is completed. Is it the wish of the committee that the additional submission by Brian Long of Ernst and Young, No. 45, dated 28 June 2002, be accepted as evidence and authorised for publication? There being no objection, it is so ordered.

Resolved (on motion by **Ms Plibersek**):

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 2.58 p.m.