COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Reference: Review of independent auditing

MONDAY, 8 JULY 2002

SYDNEY

BY AUTHORITY OF THE PARLIAMENT

INTERNET

The Proof and Official Hansard transcripts of Senate committee hearings, some House of Representatives committee hearings and some joint committee hearings are available on the Internet. Some House of Representatives committees and some joint committees make available only Official Hansard transcripts.

The Internet address is: **http://www.aph.gov.au/hansard**

To search the parliamentary database, go to: **http://search.aph.gov.au**

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Monday, 8 July 2002

Members: Mr Charles *(Chairman)*, Ms Plibersek *(Vice-Chairman)*, Senators Colbeck, Hogg, Murray, Scullion and Watson and Mr Ciobo, Mr Cobb, Mr Georgiou, Ms Grierson, Mr Griffin, Ms CF King, Mr PE King and Mr Somlyay

Senators and members in attendance: Senator Murray and Mr Charles, Mr Ciobo, Mr Griffin and Mr King

Terms of reference for the inquiry:

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

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

WITNESSES

Committee met at 10.02 a.m.

CHAIRMAN—The Joint Committee of Public Accounts and Audit will now commence taking evidence, as provided for by the Public Accounts and Audit Committee Act 1951, for its review of independent auditing by registered company auditors. I welcome everyone here this morning. This is the third in a series of public hearings. It will examine evidence from major audit firms, organisations representing directors, internal auditors and consumers, and a vocal campaigner for audit reform. Further hearings will be held in Melbourne later in July.

The committee has been receiving some very interesting and thought-provoking evidence in this series of public hearings. This is possibly one of the most challenging issues the committee has had to deal with in a very long time. It is clear from the evidence we have received so far that comprehensive and broad-ranging reforms are required. There has been too much tinkering at the edges in the past. It is time to identify and address the core issues. We cannot afford any more failures on the scale of One.Tel or HIH.

The committee will begin by hearing from PricewaterhouseCoopers, who will explore ways in which audit firms can enhance audit independence and competence. The committee will then hear from the Australian Consumers Association. We are interested in investigating what needs to be done to protect the shareholder and to ensure that the audit function meets public expectations. The committee will then take evidence from Mr John Shanahan, who has been a vocal campaigner for audit reform. The committee will then hear from the Institute of Internal Auditors, to discuss what needs to be done to improve internal auditing processes and practices. In the afternoon, the committee will also take evidence from Deloitte Touche Tohmatsu and KPMG, to see what steps they have taken to enhance audit independence and what further steps need to be taken to rebuild public confidence in our financial reporting framework.

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

[10.04 a.m.]

HARRINGTON, Mr Anthony Patrick, Chief Executive, PricewaterhouseCoopers

McCAHEY, Ms Jan Elizabeth, Professional Standards Partner, PricewaterhouseCoopers

CHAIRMAN—I welcome representatives from PricewaterhouseCoopers to today's hearing. We thank you for your submission, which was quite comprehensive. Do you have a brief opening statement? By brief, I mean no more than two minutes maximum, because we have lots of questions.

Mr Harrington—Chairman and members of the committee, thank you for allowing me to appear before you today. I think it is fair to say that the subject of corporate governance has never been in the limelight as much as it has over the past few month. However, corporate failures in bear markets are not historically unique. When similar events have occurred in the past, they presented opportunities to revise and improve the system. So, too, the current headlines represent a fresh opportunity to improve corporate governance. However, we must be careful not to overreact. In Australia, we have a number of exceptional business leaders—the likes of David Murray and Michael Chaney to name just two—therefore it is disappointing that the misdeeds of a few have had the effect of undermining confidence in the auditing profession and business in general.

At PricewaterhouseCoopers, we have an extensive quality control approach supported by a dedicated team of five partners and 35 senior staff in Australia alone. We have a dedicated independence office led by a full-time partner. This office constantly monitors adherence to policy—for example, no employee can hold shares in any global audit client. We recognise the importance of auditors not only being independent but being seen as independent. In addition to supporting the Ramsay report recommendations, in our submission to Treasury last March we recommended and recommitted ourselves in action to delivering the highest quality best practice audit. We have issued a new 10-point plan for a quality audit, including the creation of an audit standards oversight board chaired by the Hon. Gordon Samuels.

Public trust in our capital markets can be strengthened, if all the participants in corporate reporting commit to working together to build a robust global corporate reporting framework grounded in transparency, accountability and integrity. Transparency is the obligation to willingly provide to shareholders the information needed to make decisions. But just providing information is not sufficient; it must be accompanied by a commitment to accountability. That means taking responsibility. This can only occur when an ethos exists that values that and where an understanding of accountability also exists.

For example, management must hold itself accountable for using shareholders money to make decisions that will create value for those shareholders. Auditing firms are responsible for never forgetting that their work serves the interests of the public and the shareholders, not the management that simply writes the cheque. Analysts are responsible for providing objective research that is free from any bias due to the economic conflict of interest. Every market

participant must commit to this ethos and collaborate with all others. The market is only as strong as its weakest link.

Finally, even transparency and accountability do not automatically earn the public trust. In the end, both depend on people of integrity. Individuals of integrity do the right thing—not what is expedient or even necessary but what is permissible. Doing the right thing cannot be compromised, especially through actions that purport to create value for shareholders but which ultimately betray them. We look forward to working with the committee to help achieve this goal.

CHAIRMAN—Thank you, Mr Harrington. In your submission, you said—and I think I quote accurately—that 'there is a three-legged stool in investor protection, audit management and corporate governance and that each leg has its own role to play in addressing market risks.' Why did you leave out accounting standards?

Mr Harrington—I do not think there was a conscious effort to leave out accounting standards. I think accounting standards are important and in our submission to this committee today we see the importance of moving towards, as I think is now recommended, a global set of accounting standards by 2005.

CHAIRMAN—It is true, is it not, that some of these more recent major collapses in the United States would tend to indicate a real abuse of procedure—that is perhaps yet to be proven in the major Australian collapses? Rules were perhaps bent; they may have been followed but the substance of the issue to be addressed was not followed accurately?

Mr Harrington—In the submission that we have put before you today and in our previous submission to Treasury, PricewaterhouseCoopers has a strong view in following a substance over form approach in respect of accounting standards and the application of accounting standards. In addressing some of the concerns that you have quite rightly raised, my view is that the environment that now exists in the United States is different to the environment that exists in Australia. A very black-letter law, rules based approach to the application of accounting standards has probably created some of the difficulty that now exists in the US. In light of recent events in the United States, you are seeing increased commentary on a need to move to a principles based set of global accounting standards.

CHAIRMAN—I think I read somewhere in this lot of briefing papers that financial reporters report that 80 per cent of corporate leases are reported as finance leases rather than operating leases and probably the reverse percentage ought to be reported, if a substance based rather than a form based approach were applied to those leases.

Ms McCahey—I think perhaps it is that 80 per cent of leases are actually reported as operating leases.

CHAIRMAN—Yes. Sorry, I got it back to front.

Ms McCahey—I think the area of lease accounting has been a difficult one over a long period. There are proposals internationally to revamp the rules on lease accounting so that all non-cancellable leases would be seen on balance sheets as liabilities and assets, but we do not

have those rules at the moment. It does become one of those areas where great judgment is required.

CHAIRMAN—Isn't watching the accounting standards change like watching grass grow?

Ms McCahey—Some would say that is a good analogy.

CHAIRMAN—You don't need to impugn yourself. In our first lot of hearings we had a paper, which is reproduced in this month's *About the House* magazine, in which Professor Houghton said:

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

I do not think any of us would disagree overly much with that, except there are some who say that we do not need to make much change at all. He talked about 'high quality competence and independence', where the words of our inquiry tend to focus on independence. I think this committee is undoubtedly more concerned with quality of outcomes than it is with purity of independence per se. In thinking about that, it occurred to me that perhaps the best judge of quality was the marketplace and that, if that was so, we should consider changing the Corporations Act to require auditors to be corporations and therefore subject to marketplace evaluation of their quality, rather than requiring them to be natural persons. Do you have a view?

Mr Harrington—Yes, I think the profession would have a view. I clearly do. There are probably two parts to that question. Firstly, dealing with the structure of the profession, I think we are behind in reform in that area; there is a need for the availability of either incorporation or some other form of limited liability structure to apply to the profession in Australia. I think the events of more recent times have been somewhat the equivalent of a lightning rod to the profession. No-one would have anticipated some 12 months ago that a firm of the size and reputation of Andersen Accounting would for all intents and purposes no longer exist today. In that context it is important, if we are to maintain the quality that we all desire in respect of the auditing profession, that the profession itself be in a position where we can continue to attract the best and brightest of the talent available. To do this will necessitate some changes to limited liability.

I read into your other point, and please correct me if I have got this wrong, a view that incorporation and, potentially, public listing of audit firms is where you are headed. I think that the role the profession plays is an important one and maintaining that level of professionalism and balance is critical to ensuring a quality output. In some respects, from a profitability point of view and from the point of view of the stresses the public company environment may put on an incorporated audit firm, let alone the likelihood of finding appropriate investors given the current risk profile that exists for the profession, the market forces would probably make an incorporated listed approach a less than desirable one for the profession. The focus should be more on the area of oversight. I think it is fair to say that continual improvement should be part of all parts of business; we recognise in the profession that continual improvement is a continual part of the way we operate. Hence, you may have noted our move towards forming an audit standards oversight board in Australia. Although that is an incremental step, it is an important

incremental step to provide a set of robust oversight arrangements in the context of our own firm's audit standards, quality and independence approach.

CHAIRMAN—My view is simply that nothing will ever replace culture in an organisation. All the regulation and oversight that you can do might be helpful and it might not, but nothing will ever replace culture. Someone said to me—and I cannot remember who it was—that when Arthur Andersen put his signature on the bottom of an audit, he put his entire life on the line. That represented Arthur Andersen: everything that he put his life into he put into that statement that he believed that the statement was true and fair. How do we change the culture of the industry, if you call it that, without making some very basic changes?

Mr Harrington—I would probably challenge you a little bit. That is a very provocative question. Within the profession I know my firm in particular, having been in it since 1975, and I know that my fellow partners take their roles and the responsibilities of their roles exceptionally seriously. There is no doubt that in recent times, as a result of the bear market that we now find ourselves in, there have been a number of corporate failures and to some extent it is evident that a number of those probably arose as a result of a lack of integrity in a few of those organisations. But you need to put this debate into perspective. Our firm alone signs something like a thousand audit reports a day, globally. Although failure has occurred in substantial corporations, we are talking about a dozen or so corporations that are being exposed to this.

On behalf of PricewaterhouseCoopers, I would say that the desire to ensure that the right thing is done is paramount. Through the audit process, a fundamental tenet of the way we operate is that appropriate challenge is made of a corporate set of accounts before they are issued. Our mission is about quality and, if you had the opportunity to work with a number of audit partners in our firm, you would understand how seriously they take—as you put it—putting their signature to any set of accounts on an annual basis. There is a lot of good audit work that by its nature goes by in silence: it is achieving what an auditor is meant to achieve, meeting the requirements that ensure we do not have the extensive spate of corporate collapses we experienced many decades ago.

Senator MURRAY—Mr Harrington, you are really referring to the statement in your submission which says:

> For example, PricewaterhouseCoopers globally signs some 360,000 audits a year, around 1,000 a day. The good work undertaken during this process is by its nature silent and low key.

When I listen to you, I think that your assurances surely cannot be relied on, by virtue of human nature and the lack of information anyone would have in a giant organisation of that kind. If Arthur Andersen had sat before us 12 months ago and made the very statements you make now, we would have listened with respect and accepted those statements because, as you know, the people we have known in Australia in Arthur Andersen have provided major input to the Ralph review, the assessment of international tax systems. They have provided advice to government, major corporations and individual organisations. Whilst there undoubtedly were people of very high integrity within the Arthur Andersen group, nevertheless those people could not prevent what happened to Arthur Andersen. As people trying to assess what else needs to be done, how are we able to be sure that that same weakness is not apparent in your firm or in any of the other major auditing firms?

Mr Harrington—I just reiterate my point about our audit standards oversight board approach. The key objective of that board is to oversee quite independently the systems the firm has that relate to monitoring quality control, independence, education processes in respect of financial statements and audits of public companies in ensuring that they maintain appropriate professional and regulatory standards in that approach. If I was to point to one specific difference where we have taken it upon ourselves to deal with this perception issue, that is an obvious example. I would say that you cannot paint every firm with the same brush. At some stage in the past, the firm you have referred to actually said in its advertising that not all accounting firms are alike. To that extent, I must now agree.

Senator MURRAY—I think someone famous once said, 'You would say that, wouldn't you?'

Mr Harrington—I do not say that flippantly. I have a great deal of respect for the partners in that firm. Clearly, as the story is told and as the story unfolds, greater detail about the events in the Houston office that caused a chain of events—and I do refer to it as a chain of events—that led to a loss of confidence in the ability of that firm to undertake its role effectively will be understood by all. From what I have seen and heard to date, I think there is a difference in the firm's approach.

In my opening statement, I referred to the extent of our quality control and review procedures. I think we have quite extensive procedures in that regard, and I am happy to hand over in diagrammatic form our quality control system within the firm. It has a number of very significant elements and parts to it. The most important one behind all this, which I think the chairman of this committee quite rightly referred to, is the culture in the firm. Our firm prides itself on the fact that audit partners are seen as having important roles, not just within the firm but in the context of their roles within the community. In this respect, the whole support structure around the quality emphasis within our firm is there to support the individual partner. In a practical context, how does that work? If an individual partner finds themselves in a position of conflict about a particular matter of disclosure in a set of accounts with a client, then that partner is not left alone to solve that problem by themselves. They actively engage and are engaged with the whole quality support structure, and the review process that exists within the firm to ensure that the outcome is an appropriate one kicks into gear. I believe the quality control procedures and independent procedures in our firm are quite different and are quite extensive.

Senator MURRAY—If possible, we need shorter answers, Mr Harrington, because a lot of my colleagues will need to question you. You cannot really protect either your firm or your clients against human nature. You can just try to minimise the situation, which I think is what you are doing. I recall that in the Bond matters, for instance, a senior partner of a major audit firm went to jail—he was from another firm, not yours. I think that is really the point to be made: if you are moving to heal yourself and to improve your systems, that is of assistance, but you cannot be alone in this matter as auditors. I want to move on to another question. If you were to prioritise one area where you think, outside of the audit firms, there needs to be real and urgent reform, would you be able to do that for us? Is there any area you regard as a weakness in the system of minimising unnecessary risk in the area of corporate failure?

Mr Harrington—I think the key area is around the current corporate reporting model. In our submission today we have outlined a number of critical points and suggested changes that we believe should be made to the existing corporate reporting model. We have suggested that there be a greater focus on the quality of corporate reporting—for example, greater commentary on issues like the quality of reported earnings year on year would assist with transparency. As we have already said, we believe there is a need for a global set of accounting standards. Having those would be a good step forward. There is also, as we have said, a need for a substance over form approach to the application of accounting standards. Also, I recollect that some years ago there was the concept of a principle accounting officer in the Corporations Act. I think the role of the CFO must be clarified in the reporting process and potentially both the CEO and the CFO, in a set of annual reports, should attest that the annual reports that they issue comply with the Corporations Law.

Senator MURRAY—Do you think the internal auditor ought to report to the board and not to the CEO?

Mr Harrington—I think there is a dual reporting role, because the internal audit function can clearly provide insight to the audit committee in a number of respects but it can also be—and should be—very useful in ensuring risk management policies and procedures are properly in place. In that context I think that in this area of the audit expectation gap that is constantly referred to there is clear need for the scope of the external audit process to be reviewed and extended. The whole area of corporate risk management policies and procedures should see a sharper focus in the corporate reporting model. The audit committee, and potentially the board in its more fulsome sense, should comment in the annual report on the adequacy of their corporate risk management policies and procedures. The audit report could well be extended to ensure that that commentary, unlike other commentary in the accounts, is appropriate.

Senator MURRAY—My last question is related to shareholder control. It seems to me that companies that get into trouble are characterised by overdominant management—or an overdominant financial interest—who do not present their financial status in its true light. It seems to me that one of the ways in which you can mitigate that situation is to improve the process of electing directors, which is not best practice in every situation. In particular, you can ensure that independent non-executive directors are genuinely independent by electing them through the mechanism of one vote for one shareholder and not one vote for one share, which is what presently applies. If you have 1,000 shareholders and two of them control 50 per cent of the company, those two shareholders control the board. However, if you want to elect an independent non-executive director and you have all 1,000 shareholders voting equally, they can genuinely have somebody independent there. What is your reaction to that?

Mr Harrington—The committee has probably seen them, but I would draw the committee's attention to the proposed changes to the New York Stock Exchange listing rules in respect of directorships and the requirements that are proposed in respect of independent directors. I think those proposals are good proposals. We have been making suggestions in the context of audit committees, the role of audit committees and the necessity for independent director involvement with audit committees, and the proposed listing rule changes in New York cover that topic as well. I think they are a good step forward. To go to your point of moving to one shareholder having the right to one vote as opposed to one share giving the right to one vote in an election of directors—

Senator MURRAY—Independent directors.

Mr Harrington—I would not agree with that for the election of independent directors.

Senator MURRAY—Why?

Mr Harrington—I do not believe it would be a fair reflection of the economic interest or entitlement that the broad shareholder group clearly have in the corporate entity.

Mr CIOBO—Mr Harrington, you made the comment that the keystone of an audit is quality. I am interested to know where that quality is perceived to lie? Is the perception of quality market based or is it geared toward PWC or toward the client? I guess to some extent it is a combination of all three, but I am just wondering what you see as being the principal overriding determinant of a quality audit? To whom is it directed?

Mr Harrington—We have a clear obligation to a range of stakeholders who have an interest in the published accounts. They are numerous. The underlying issue of quality goes to the core of those stakeholders being able to rely on that report. In that context, we would be happy to hand over to the committee an outline of our 10-point plan for a quality audit. It starts with the accounting standards oversight board and quite practically sets out a number of changes and enhancements that we have proposed for our firm to reinforce the emphasis that we already have on producing a quality audit. I would hate this committee to think that, as a firm, our audits are done—or were done in the past—in anything other than a highly professional, high quality way, in the context of existing auditing and accounting standards.

Mr CIOBO—If you take it then that quality is geared towards the marketplace—the stakeholders—I think you are the only one of the 'big four' companies to have developed an independence office—

Ms McCahey—Are we talking about the audit standards oversight board?

Mr CIOBO—No, I am talking about internally, within PWC.

Ms McCahey—I am not sure; we certainly have an independence office.

Mr Harrington—We certainly do have an independence office.

Mr CIOBO—But you are the only one of the 'big four' to have one?

Mr Harrington—I am not sure. I cannot comment, other than to say that I know that the other firms take issues of independence seriously.

Mr CIOBO—Sure. What was the driver for developing that office? Is it a perception issue? Is it a real quality control mechanism within PricewaterhouseCoopers? Do you feel that having a board of this sort—or an independence office, as I think you call it—is something that is fundamental to achieving a quality outcome?

Mr Harrington—I think there is a clear recognition that independence is important and that the perception of independence is equally important. One of the issues that we are constantly monitoring and that, through this independence office, we keep a tight check on, is ensuring that as a firm we maintain and manage our independence appropriately. So the short answer to that question is that independence is important from an audit perspective. However, the reason I have continually referred to the need to enhance corporate reporting in my representations to this committee is that I think it would be a truly sad outcome if the only reforms and enhancements that came from this process were with respect to the audit function. I think a lot can be achieved if a broader focus on the corporate reporting area is undertaken.

We find ourselves in what I would call a new age and a new environment—with technology and broader involvement. I am sure a number of you here have been involved in the shift towards increased privatisation that has occurred. We have a lot more investors in the market—some 50 odd per cent of Australians now have an interest in the capital markets. Technology has provided information in a much speedier and more accessible fashion. In this new age, a sharper focus on quality corporate reporting to ensure transparency is, I think, the mission critical area for reform on a go forward basis for the 21st century.

Mr GRIFFIN—I am a bit intrigued by your confidence that global accounting standards will be a big part of the answer. I will make three points about that. Firstly, normally when you are talking about global standards they tend to be the lowest common denominators. Secondly, they tend to be minimum standards. Thirdly, they tend to be governed to a great extent by the biggest market, which in the case of this sort of stuff is the US, I would say.

Ms McCahey—I think that what we have achieved in setting accounting standards over the years is the establishment of a global board with the right skills and experience set to develop accounting standards. We have all been critical, before the establishment of this board, of the previous board's capability to set international standards, because it did seem to us that the board did not have the right set of skills and experience. There was a tendency to vote for the solution that one had at home and that did develop some standards that were not as robust as the ones we would have liked.

Regarding the influence of the biggest market, you referred to the US. It is the biggest market and it will continue to have a strong influence in accounting standards setting. Despite the fact that we are critical of the very detailed rules based approach of the US to writing accounting standards, I think we have to understand that the US has the most comprehensive set of accounting literature at the moment and it is fair to expect that its experience will not dominate but will be very influential in the international scene. That is just the way it is going to be: the global solution will be best, and it is not for smaller countries to continue focusing on developing their own rules now, thinking that they will be better.

Mr GRIFFIN—As you mentioned though, the main concern is that, although the laws that have been developed might be very long on detail, as standards they are pretty much fictional—and the application with respect to laws in the biggest market seems to suggest this.

Ms McCahey—I think that there are problems with all sorts of standards. Standards that are heavily rules based tend to drive people to outsmart the rules. Rules that are heavily principles based tend to be used by people who want to misuse them to drive trucks through. You need a

mix of both. Of course the standards themselves are not the only answer; it is the application of them in practice that is the key at the end of the day.

Mr GRIFFIN—There are some comments in your submission regarding the unlimited liability environment in Australia. You assert that there are some real difficulties there. Could you briefly talk about that? Do you have any examples?

Mr Harrington—I assume you are referring to the profession. I think that the future of the profession will necessitate dealing with the unlimited liability position that we now find ourselves in. I mentioned earlier that, without addressing that position, the ability to attract the best and brightest into the profession, when you have an alternative to work for one of the major banks or you have any other international opportunities, might be affected. You might find yourself having that choice, where you can have a career for some time, working for a firm like ours, with that unwarranted personal risk from both a career point of view and a professional point of view.

Mr GRIFFIN—Are you saying that you have found that to be the case?

Mr Harrington—We are only in the early days of this, but we are starting to see amongst our graduate recruitment population greater inquiry and concern about the current events.

Mr KING—I have no issue with anything you have had to say on financial reporting. Thank you for your contribution. I am more interested in the issues of corporate governance and the auditor's role. The issue raised by Senator Murray of the overmighty executive in the modern corporate environment is a significant one. I noticed in the recent HIH inquiry that it was suggested that the audit process there was worthless. I am wondering whether we need to look at this whole process again. It seems to me that there might be an argument for saying that the whole question of auditing ought to be optional, so that people know that the hundreds of millions that they are paying out in some cases are not really necessary and that that is not really a protection for shareholders. What do you say about that?

Mr Harrington—I think—and you would imagine that I would say this—that the audit roles and the corporate governance roles that independent directors play are essential parts of ensuring confidence in the capital markets. You can identify a number of cases where best practice exists. Some of you may have seen David Morgan's comment in respect of Westpac that there are best practice examples where the corporate governance model and the role that the auditor plays work very effectively. There are clearly examples in more recent times—but they are not historically unique—where business failures have arisen in cases of dominant CEOs or non-participatory boards or a lack of board skills.

I referred earlier to the changes in the listing rules for the New York Stock Exchange. In those changes, I think there are some very good proposals that I would suggest this committee might look at. But, to go particularly to your point, I think the issue of oversight, whether that be auditor oversight or board governance oversight, has been a successful model in the past, although you will never eliminate the risk of corporate failure. The objective is to enhance the corporate reporting model to ensure that investors have a greater level of transparency. That would be an important step forward.

Mr KING—It seems to me that your real response to this problem is to suggest a change in the rules on legal liability and a cap on the quantum of liability. What test do you propose for legal liability of auditors in relation to the conduct of the auditor role?

Mr Harrington—Clearly, the current tests in respect of negligence would still apply.

Mr KING—What test of negligence do you propose?

Mr Harrington—I probably would take that specific test on notice. It is a question I would be happy to get back to you about.

Mr KING—It is a core issue, is it not?

CHAIRMAN—Will you please take it on notice?

Mr Harrington—Yes.

Mr KING—If you would not mind letting the chairman know what your test is, I would be very grateful. Finally, what do you say about the corporate governance issue and the idea of corporate governance boards?

Mr Harrington—Could you expand on that question?

Mr KING—We are talking about a board that represents shareholder interest, distinct and discrete from the normal board of directors. We are talking now about, shall we say, a shareholder forum. In some of the proposals, it has been referred to as a corporate governance board. Quite how it would fit into the board requires some examination.

Mr Harrington—There are different models around the world in respect of board governance oversight.

Mr KING—We know that, but what do you think about the idea?

Mr Harrington—My view is that the current Australian model has been fairly effective. It can clearly be enhanced. I do not believe there is a need to move outside the current model. I do believe that enhancing the current model, with the majority of the board consisting of independent directors—taking on board some of the proposals for changes to the New York Stock Exchange listing rules, as I said—would be an enhancement.

CHAIRMAN—In regard to your proposal that there be some limit on liability of audit firms, you also went on in your submission to say:

> In addition, as financial and non-financial reporting information expands, we foresee a corresponding expansion in the matters on which the auditor will report. This could cover issues such as governance, risk management and internal control, and indicators of financial health.

Are you in fact, Mr Harrington, proposing that the audit function include performance audits?

Mr Harrington—I think the inclusion of performance audits is something that we should address. The expansion of the audit role is an important one. Our firm recognises the need for the audit report to stay contemporary. You have probably had discussions and submissions in respect of continuous auditing. The role of the audit does need to be reviewed. The audit function can play a greater role in ensuring confidence, and the report that comes from a firm like mine in that context also needs to be clear, concise and presented in a more user friendly fashion. So this whole area of audit scope fits quite nicely with the need to extend the corporate reporting model, and I think our firm can play a significant role in that area.

CHAIRMAN—Ms McCahey, I believe you were reported in the *Financial Review* on 28 June as saying that 'there were major gaps in Australian accounting standards which were falling behind world's best practice'. We do not have time to explore that today. Could you take that on notice and get back to us and tell us, in your view, what some of those gaps are that you were talking about?

Ms McCahey—Certainly, I can do that.

CHAIRMAN—If you could get back to us on this issue and respond to Mr King, we would appreciate that. We would also appreciate receiving a copy of your 10 points that you operate to and the issue of gaps in accounting standards. We thank you for participating in our inquiry. We hope to report in late September or early October because we definitely want to be considered in this whole range of interests that the government will take into account as a next response.

[10.52 a.m.]

WOLTHUIZEN, Ms Catherine Nicole, Senior Policy Officer, Financial Services, Australian Consumers Association

CHAIRMAN—I now welcome the representative of the Australian Consumers Association to today's hearing. We have received your submission this morning, which makes it a little bit difficult for us. Do you have a very brief opening statement that you would like to make?

Ms Wolthuizen—I do and I will keep it brief. I apologise for the lateness of the submission. I will start with a disclaimer that while ACA is obviously a representative of many consumers who are now investors, either directly through direct investment equities, through other forms of investment or through their superannuation, issues of audit standards and accounting standards are not an area we generally go out and regularly survey our members on. However, on a policy level, we are more than happy to present the concerns of consumers that have been expressed to us that we perceive regarding this area.

This inquiry takes place in the context of a number of corporate collapses, but for many consumers the real question is: what will come next? They are looking for a strengthening of the regulatory environment to protect them against further collapses, or at least give them adequate warning. The issue of audit standards is therefore critical to consumers, as is the promotion of best practice corporate governance. We are very happy to see that this committee has taken those concerns into account in this inquiry, as has the government in terms of its recent announcement of the CLERP 9 review process on top of the Ramsay review and report recommendations.

For consumers, it is not entirely clear what, in many cases, the causes of these collapses have been. It may be complacency. It may be that market downturn is now revealing instances of poor practice. There are a whole range of issues that I am sure have been brought before the committee. The difference now is that, while corporate failure is not a new issue and it has been seen in previous decades, the stakes are continuing to get higher, because now it is an issue of people's retirement incomes. It is mum and dad investors being lured into investing with the promise that they will be provided with not only income in the short term but also their long-term income and income security. So we are seeing new implications for investors who are not necessarily the sophisticated investors of before and who are more reliant on best practice regulation and reporting. That is the context in which I address you today.

CHAIRMAN—Thank you very much for that. It has been said by some that the very large majority of shareholders have not the technical ability to read a full annual report and audit response to that full set of financial figures and make good sense out of whether they will get value for their money if they buy shares in that company at some particular price level. In the context of trying to protect your investors, your consumers, would you care to comment on that?

Ms Wolthuizen—I think the issue of financial literacy among Australian consumers is one that has drawn deserving attention. I know the ANZ Bank is in the process of conducting a

survey of financial literacy. In the area of superannuation the Australian Superannuation Funds Association is about to conduct a similar survey of financial literacy. There is no doubt that there are real concerns with not only how the information is presented but also the education that is provided to consumers and investors so they can comprehend and make informed decisions on the basis of that information. In many cases that will make them very reliant on the advice that they are given. That is certainly an area ACA is quite strongly involved in, looking at standards of advice given, particularly under the FSR reform agenda.

CHAIRMAN—Moving now from Australia to the United States, a lot of the evidence that I have seen reported in our local papers has indicated that WorldCom and perhaps Xerox as well were involved in processes where they perhaps met the requirements of the accounting standards but not the 'true and fair' test. How on earth do we make recommendations? What should we recommend be changed in the Corporations Act, and/or listing on the Australian Stock Exchange or ASIC or any of the corporate governance areas that we can think of, to try and simplify what is reported to your consumers so that they can understand whether a company is in good health? In a situation of an auditor coming forth and having the guts to say, 'I am not going to totally qualify this audit but I think'—he is not going to use the word 'shonky' but he will say—'these practices perhaps were questionable,' should that in fact be highlighted in even the smallest summary of the annual report?

Ms Wolthuizen—There are several issues there. First of all there is the issue of the culture of auditing and of corporate governance. There are a number of recommendations before this committee and that we have presented which are aimed at promoting a more accountable and transparent reporting culture. That is absolutely crucial. They range from looking at the issue of what is disclosed in reports to investors to looking at the role of auditors and at the relationship of auditors with their clients and ultimately who they view their responsibility has been to. We would say that is to investors and the market, not just to the auditee. Beyond that, they include looking at increased penalties for breaches of the Corporations Law to instil some fear in the boardrooms of Australia so that we see the culture imposed not just in terms of setting best-practice standards but also some penalties where those are breached. They also include looking at how the information is in turn presented to investors when, for example, they look at a prospectus document or look at a report.

There are ongoing concerns about how that information is presented. For example, I note that, even early this year, when the Commonwealth Bank released its interim results there were concerns expressed about how those were presented. When you see one of our most well-regarded financial institutions having concerns raised about how it presents its information, you can see the reasons why consumers can be so sceptical and concerned and why confidence is in such free fall around the reliability of those statements. That is not to say that the Commonwealth Bank's statements were not reliable, but there were still concerns expressed. Part of that is a more sceptical market, and that is a healthy thing, but part of it is also that there are discrepancies and that is not going to promote confidence.

CHAIRMAN—Some respondents to this inquiry and some media analysts have tended to focus on the word 'independence' in terms of this inquiry. We view our inquiry as multifaceted: covering corporate governance as well as the audit function and, indeed, the accounting and audit standards themselves. In other words, there is a very broad range of issues to confront. In

your view, is the independence issue more important for your consumers, or the audit quality issue?

Ms Wolthuizen—I think they are both important, but queries are being raised about the degree of independence of supposedly independent directors and auditors, and about auditors' relationships with auditees. We have presented recommendations addressing both those concerns, the first of which would be particularly to look at the relationship of auditors. We support mandatory rotation of audit firms and a range of other measures designed to promote that independence—again, looking at the role of independent directors and ensuring that, where they are meant to be independent, indeed they are and that they are performing that role not only in name but also in the spirit in which it is intended to be performed.

Senator MURRAY—The history of corporate law is really the development of protections within the system, recognising that, if the institution and the system operate well, then you are going to minimise unnecessary risk to investors' funds. I want to talk to you about an issue that I have been on about for six years now: the democratisation of companies. If you take a publicly listed company and compare it with a democracy, frequently it has more shareholders than, say, Tasmania, the ACT, the Northern Territory or maybe even some of the other smaller states. The fact is that many investors do not participate in the formation and nature of the company; they are passive bystanders. Incidentally, I include in that institutions such as unit trusts and so on which represent investors, because there is no requirement on them to exercise their role. There is no equivalent to compulsory voting, for instance, or any of those mechanisms.

It seems to me that democracy has developed, in Churchill's words, as 'an awful system, but the best we have' because it is the system which most generates accountability and most minimises the opportunities for corruption. There are still failures, but this is a democratic society. If you take that analogy, the response of an earlier witness to the question of 'one vote, one shareholder' was for independent directors, either through the corporate governance board model, which is a separate governance outfit, or a mechanism for minimising dominant management and financial interests. With your particular interest in protecting what is often an unsophisticated group, has your body had a look at this issue of the democratisation of companies?

Ms Wolthuizen—We are certainly aware of a great deal of frustration on the part of many smaller shareholders, who feel voiceless and largely powerless when it comes to influencing the decisions of the companies in which they invest. That is particularly in relation to the larger shareholders, who will often make their voices heard very loudly and use their voting power to enforce their opinions on who should sit on boards, for example, who should be appointed and what strategic decisions the company should make. There have been recent instances of investors expressing deep disquiet at how particular companies have been run—issues of profit downgrades, the recent David Jones controversy being an example of that. The issue of 'one vote, one shareholder' would be a way of redressing some of the dissatisfaction that the smaller shareholders feel, in that they do not have a say and do not see the point of going along to AGMs if they are not going to be able to influence the decisions being taken.

Senator MURRAY—Do you think the failure of the ASX and ASIC to introduce best practice guidelines for the election of directors is an act of delinquency?

Ms Wolthuizen—Without looking closer into it, I would be reluctant to make so strong a comment on it but I do think for many shareholders there do need to be stronger avenues and more regular forums through which they can raise their concerns. An annual AGM is not necessarily the best way of giving them a voice and given the difficulties many have in setting up extraordinary meetings—

Senator MURRAY—Are you surprised that ASIC in particular, but also the ASX, have failed to develop a best practice system for electing directors and best practice models for boards?

Ms Wolthuizen—I think there is a reluctance on the part of regulators to regulate where they do not have to and perhaps that is because of the strong resistance put up by corporate Australia to regulations. I think there is a sense, broadly, of reform fatigue and perhaps the regulators are wary of bringing more controversy upon themselves and generating more strife and difficulties with the world that they regulate. Certainly, it has been a problem on our part in many areas where we would have liked to have seen a more prescriptive approach having been taken by the regulator. And that particularly relates to some FSR issues where a guideline approach is taken and that, of course, allows those who are not aiming for best practice to get away with business as usual.

Senator MURRAY—I return to my analogy of mass corporate ownership, or participation if you want to put it that way, with a mass democracy. I would have thought the basic elements of how elections are conducted, who gets to run the place, how the board is to be constructed, how you minimise excessive or dominant influence—in Mr King's word—the overmighty executive et cetera, are not peripheral areas to regulatory and market orientated interest. I would have thought they were core business for ASX and ASIC. I have been very surprised that they have failed to take up these issues far more vigorously.

Ms Wolthuizen—Certainly it may be central to that promotion of an accountable and transparent culture.

Mr CIOBO—Ms Wolthuizen, I am interested in scope of audit and its relationship to informing the public. From an ACA perspective, what do you see as being the key drivers there? Is there provision for an increase in the scope of the audit so that it facilitates a more informed public?

Ms Wolthuizen—If you are referring to such issues as viability and risk associated with strategies being adopted by the company—

Mr CIOBO—Yes, that is correct.

Ms Wolthuizen—I think it is really going to be a question of degree because in some areas you are looking for a fairly subjective assessment of the kind of strategies of the business plan being adopted by the company.

Mr CIOBO—Subjective by the auditors?

Ms Wolthuizen—Subjective by the auditors, that is correct, and that may more properly be the responsibility of investors in the market to assess whether the kinds of strategies being undertaken are going to be viable and in the interest of the shareholders of that company. But, by the same token, there are going to be other instances where you would hope that the auditor would put their hand up and say, 'If the company continues to pursue this path, trouble lies ahead.' Investors would expect that kind of warning in advance if the company itself is not making that disclosure available. I am thinking of the Burns Philp failure in the nineties, when a particular strategy was adopted and it was only once the company had failed that the true risks associated with that strategy were revealed.

Mr CIOBO—I take it from that, that you are in favour of a broadening of the scope?

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

Mr CIOBO—Testimony that we have received—and this is from auditors—is that they are unwilling to increase the scope of audit while there is unlimited liability. Would you be supportive of a move to curtail the liability that auditors are exposed to?

Ms Wolthuizen—I would have to take that on notice because I am not particularly au fait with how the liability issue is at the moment and what impact it would have, whether it would be such a concern.

Mr CIOBO—All of these facets are interrelated. If you increase the scope of the audit, do you then put at risk or jeopardise independence? From an ACA perspective, how do you move to entrench a notion of independence, whether it be a perception issue or an actual internal control mechanism in an auditor's company or partnership?

Ms Wolthuizen—In terms of broadening the scope of the audit—if that is what you are referring to—I am not overly concerned, in the instances where it would be quite evident that there was trouble and that there was quite a risky strategy being taken, for the auditor to make that apparent. This is an issue we are also dealing with in the context of superannuation safety and the responsibility of actuaries to make public their concerns and to report to the regulator where they see a particularly risky strategy being undertaken. I think a similar principle can apply without there being issues of independence being compromised.

Mr CIOBO—So you would not see a trade-off?

Ms Wolthuizen—Not necessarily. I can take it on notice and get back to you.

Mr CIOBO—With regard to principles versus rules, you made the comment that you thought there was reluctance by the regulator to move towards a more prescriptive approach. Yet we have had testimony that indicates that the US system is a fairly prescriptive based rules system and that has led to significant failings. From an ACA perspective, does greater regulation means greater certainty? Is there a risk that by adopting a more regulated approach, one built around prescription, it becomes merely a case of audit being nothing more than a compliance mechanism, rather than an actual litmus test of how a company is performing?

Ms Wolthuizen—I think they are slightly separate issues in the sense that, yes, we certainly support the promotion of an enhanced culture of accountability and transparency. I think a number of the recommendations we have made, particularly in regard to penalties for breach, would go towards addressing that.

Mr CIOBO—Jail terms and so on?

Ms Wolthuizen—That is right. By the same token we recognise that, when it comes to audit standards, accounting procedures, the prescription of rules and how those are to be undertaken, all you do thereby—as it was expressed by a previous witness—is create a network where people look for the loopholes. In our view, you start off by promoting a culture and you do that with a strong regulator and with well-expressed principles. It is also a bit disingenuous to suggest that corporate Australia is not aware of its responsibilities and is not aware of what best practice represents. The question is: do they believe they are going to get caught? You strengthen audit procedures and the role of the regulator to ensure that they have that fear.

Mr CIOBO—So you see that as a safeguard?

Ms Wolthuizen—Yes.

Mr GRIFFIN—On the question of voluntary processes within the industry, the view seems to be coming through that, although overall international standards should be looked at being adopted, generally they see it as something that can be handled in-house to a large extent. Do you view that as being correct? From what you have said so far, you seem to be saying that there is a need for some firm regulation there.

Ms Wolthuizen—I think regulation should set out best practice and follow up where breaches take place.

Mr GRIFFIN—In your submission, you mention the UK situation where the Financial Services Authority has substantial powers in addition to what ASIC has. Could you go through some of those powers?

Ms Wolthuizen—My understanding is that the Financial Services Authority has substantial powers that ASIC does not possess to levy fines in the event of a breach of their corporate governance provisions. We would certainly be supportive of ASIC having similar powers to go in and wield a stick where necessary.

CHAIRMAN—In your submission, which I have speed-read, one of the things you said was:

ACA welcomes recent comments by the Treasurer, Peter Costello, suggesting that continuous disclosure was a feature of the Australian corporate governance framework which made it more robust than that of the United States.

It has been suggested to us by some respondents to this inquiry that, while continuous reporting is a requirement in the Australian context, continuous auditing is not. Considering the fact that it is going to cost the corporations—who distribute income to your constituents by way of a return on their investment—more money if we have continuous auditing as well as continuous reporting, would you support continuous auditing?

Ms Wolthuizen—My first response to that would be that no investor wants to see their entire investment go down the gurgler. Beyond that, we obviously understand that it is the investor who pays in the form of what they lose from their return when the costs of compliance are increased on businesses. I think we would come down on the side that, given the deficiencies in current arrangements and the information provided to investors, an examination of the costs associated with that should be undertaken. If they are reasonable, those would certainly provide the benefit not only of having that information continuously disclosed but also of having that audit process on an ongoing basis.

CHAIRMAN—Some of the auditors and other accountants have suggested to us that perhaps audit fees are too low; that the market is highly contestable and that management too frequently views an audit as an expense rather than adding value. I note that, in the public sector—in the Commonwealth sense; I am not talking about the states—this committee certainly considers that the audit regime undertaken by the Auditor-General provides great value to the Australian Public Service and the way we operate. Would you favour some way to increase not only what auditors do but also what they are paid, so that they do not have to be so competitive and we get better advice?

Ms Wolthuizen—I do not know whether the standard of audit advice is necessarily linked to the fees that are charged. I would be hesitant about saying that we should pay auditors more and therefore we will get a better standard of audit. I think that that outcome can be better and more reliably achieved through other means. I suppose audit firms would say that, wouldn't they?

Mr GRIFFIN—Hands up who knows a poor accountant!

Ms Wolthuizen—Not only that, Arthur Andersen charged high fees and, ultimately, the standard of their advice was not as high as many of their clients would have hoped.

CHAIRMAN—You said that; I did not. We would appreciate it, Ms Wolthuizen, if you would get back to us on those issues that you said you would take on notice. We thank you for your participation. We will make sure that you receive a copy of our report.

Ms Wolthuizen—Thank you.

Proceedings suspended from 11.17 a.m. to 11.30 a.m.

SHANAHAN, Mr John Bernard, (Private capacity)

CHAIRMAN—Thank you for your very comprehensive submission to this committee. Do you have a brief opening statement?

Mr Shanahan—I appear before the committee as an auditor. I am proud to say I am an auditor. I have noticed the comments in reference to the way Arthur Andersen signed his reports. I know a number of audit partners who still have that approach today, in both large and small firms. I do believe that audits in this country are done, on the whole, very well. I find that the actual work done by our staff in audits is done well. In investigations I do, I have found that everything that needs to be found has been found.

I believe we have a failure of our audit reporting function to actually warn in instances where a warning is necessary. Why is this so? I think that is a problem with auditor independence. That is why in my submission I have said I believe that rotation of audit firms, which I know is not popular amongst the profession, is perhaps the way to go.

CHAIRMAN—Thank you for that. We do appreciate your views. You have made a whole string of recommendations. The first one is the level of fees paid to auditors should increase. How do we go about that?

Mr Shanahan—The first witness who appeared before you was Professor Houghton from Melbourne. Professor Houghton had an example. If I remember correctly he said, 'If you had four firms and one was doing the audit for a million dollars and the other three were all doing various things for $2 million, why would you give up the audit at half price?' When you look at what the other firms are doing, one of Professor Houghton's firms was providing tax services, one was providing internal audit services, one was providing internal control consultancies. My view is that, if you are doing an audit of financial statements, the provision of tax services should almost be part of the audit. The provision of the assessment of internal control actually becomes part of the audit.

Auditing is seen more as a cost. Does an audit grow a business? I do not believe very many in corporate Australia say, 'A good audit is how we will grow our business.' They say, 'Audit is a cost. Let us minimise the cost.' If you are an audit firm and you are trying to win audits, you will go to competitive tender. If you can narrow the scope of the statutory audit so you can come in with a reasonably low price, then you need to say, for example, 'Let us sell control services.'

Any audit must check controls. How can you then go and say, 'Let us then sell additional consultancy for internal control reviews'? I believe we should expand what is in the basic audit. Let us do the basic audits properly and, I believe, some of the fees paid for the other non-audit services would fold back into the audit.

CHAIRMAN—Do you support performance audits?

Mr Shanahan—I believe performance audits are a very good move. I know they are widely done in the public sector. When one does a financial statement audit for the private sector, it is interesting that at the conclusion when you sign off the set of financial statements you will quite often have exit meetings where the directors say, 'Why weren't we told that we have bought three different types of PCs and that our expenditure on PCs hasn't been very effective?' The auditor can say, 'Well, we noticed that but we are not doing a performance audit. In actual fact, as long as you have recorded the expenditure correctly and have got the assets there, the fact they are not working very well is not what we were asked to look at.'

There is a fine line here. At which stage do you say, 'Right, as an external auditor of financial statements, let us add in some performance auditing'? That sort of issue would be covered in a management letter, where the auditor will say, 'We have noticed these things on the way through,'—but the management letter does not go outside the board or management. I think it would be a much more interesting life as an auditor if we were doing performance audits as well but, again, you are going to be looking at a substantial increase in audit fees if you want to add performance audits to the audit of financial statements.

CHAIRMAN—There are those who have reported to this committee that the audit is incomplete without examining other issues in the company, and that audit firms fear, with great trepidation, reporting to the outside world what they see as systemic or even partial failures and a lack of risk analysis or risk control in a company, when they are subject to unlimited liability. As an audit partner, what is your view of unlimited liability?

Mr Shanahan—I do not like unlimited liability. In answer to Mr Griffin's earlier question: name a poor accountant—I would happily admit to being one, but I would expect that a number of audit partners in the profession in Australia would, like me, say, 'I am a pauper, a man of straw, there is no point in suing me. You can get only a share of my debt.' I have to be nice to my wife every night when I go home, and other people have trust arrangements. But, faced with Mr Harrington's problem—with unlimited liability—one tends to be of minimal net asset worth. It is the firm that gets sued, not the individual partners. I firmly believe that, to operate sensibly as an auditor, we need some form of limitation of liability. In New South Wales, there is a limitation under the Professional Services Limitation Act, where we are limited to 10 times the relevant fee. Funnily enough, we are never sued on audits in New South Wales; we are sued interstate for new audits done in New South Wales. I believe in a sensible limitation of liability. As auditors, we have no problem with a proportionate share of the blame. When a corporate collapse happens, the directors are men of straw, even more than the auditors, and the only person left standing, with deep pockets, is the audit firm.

Mr KING—You mean the insurer behind the audit firm.

Mr Shanahan—The insurer behind the audit firm? A lot of the firms cover their own insurance. There is also a reasonable excess on all the insurance policies.

CHAIRMAN—You argue very strongly that a compulsory five-year rotation of auditors will—in the biggest sense—address one of the corporate issues that we are looking at, which is the issue of auditor independence. You argue that auditors will be more inclined to report negative findings, if they know that they are going to be rotated every five years than they are under the current regime. You support auditor rotation. Together with some limit on liability, are

we then just transferring risk from the audit firm back to the company—to the shareholders? Are we making you, as a profession, more wealthy without having to be quite as accountable, as opposed to the company that must report to its shareholders once a year and with continuous disclosure?

Mr Shanahan—I believe we are trying to improve the audit function. As a practising auditor, we changed the law some time ago to ensure that an auditor did not have to be reappointed each year. That was designed to give the auditor protection and independence. It is still difficult if you are carrying out an audit and you say, 'I think we should qualify here.' You then find yourself in a situation which is more confrontational than you would prefer. You go to see the company and it says, 'Are you sure this is right? If you qualify, it will have a bad effect on the market. It will have headlines and there will be an ASIC investigation and suspension from the ASX. Your prophecy of trouble will be self-fulfilling. If you really are serious about this, we might put the audit out to tender.' That is a threat to be made. When you spoke to Mr Long and Mrs Picker from Ernst & Young they both mentioned intimidation from management and the threat of putting an audit out to tender.

In my submission I say the best audits I have seen done are where the former ASC refused permission for an auditor to resign. The company could not get rid of the auditor and you could make a call. I believe a five-year rotation would be beneficial. If the auditor is going to say something that is going to upset management and management wants to try and get rid of them, they will not be able to do so for five years. I believe the auditor would then be in a position where he could actually make the hard calls. I believe he should be paid properly for his work. After five years you know you will move on and then another firm will come in and take over your work. At the moment the firms have peer review of their processes, but if I knew my work was going to be torn apart by another competitor firm after five years, my professional standards as an auditor, I would want my audit to be a good audit.

Mr KING—Why wouldn't you just arrange a friendly successor?

Mr Shanahan—Within the profession you have four major firms and a number of large second-tier firms. I believe the firms are all independent of each other and they all prize their own professional reputation. It is interesting that within firms when you want to have a job of yours reviewed you can pick friends of yours who you know, yes, will do it, or you can go and look for a real problem partner who is going to make you turn yourself inside out. I am the sort of auditor who will always ask the real problem partner so that we knew we were getting a good job done. I believe there are auditors out there exactly like me who are proud to be an auditor and we like doing high-quality audits. We are not going to do a cheap audit for five years and hope to be consulting after that.

CHAIRMAN—You said before we started asking questions today, before this hearing, that you had read transcripts of some of our earlier public hearings. If so, you are well familiar with my question about whether auditors should be corporations rather than natural persons. Do you have a view?

Mr Shanahan—I am still trying to make up my mind here. At the moment the Corporations Law refers to having to be a natural person to be appointed as a registered company auditor, but the reality is that we appoint firms to do the audits. I am intrigued that ASIC can take an

individual auditor to the CALDB, yet only two months ago following the demise of Andersen's, when News Corp wanted to shift audit from Andersen to Ernst & Young not at an annual general meeting, ASIC approved the firms to change. They did not approve, say, Bob Charles stopping being the signing auditor and Senator Murray being the new auditor; they approved the shift from Arthur Andersen to Ernst & Young. The reality is that the firms are being appointed. It seems very strange to me that ASIC takes action only against an individual who was the signing partner. I believe that the best structure of a firm is a limited liability corporation. In the US they have limited liability partnerships. As a profession, to act in an unlimited liability partnership is probably not sensible in modern corporate governance. I know surgeons have to operate as individuals. I keep getting bills from their family companies, though. It is a similar sort of situation.

CHAIRMAN—If your company were to become a limited liability corporation and listed on the stock exchange, you would have to have an audit of your accounts. Would you also support, as a measure of quality control of your independence and the quality of your work, a performance audit of your operations?

Mr Shanahan—The answer is clearly yes. We already have quality performance audits. We all have peer reviews. The major firms have peer review of each other. The Institute of Chartered Accountants and the CPA Australia also have a peer review program where our procedures and quality are opened up to review. It is a one-on-one review and the results do not get published publicly, but we get taken to task either by our reviewer firm or by the professional bodies' review committees. I have no problem with our processes being peer reviewed. I do worry that I do not think there would be a big interest in the stock market in publicly listed audit firms.

CHAIRMAN—That might be true but, if the performance audit of your operations was made public, wouldn't that enhance transparency, accountability and process?

Mr Shanahan—It would. I do notice that, on the collapse of Enron in the US, the departing auditor did say, 'But we were peer reviewed and given a clean sign-off by another one of the major firms.' I would think, if we were rotating audit firms every five years, you would be getting a very effective peer review. If, in year six, the new auditor said, 'There is a whole range of issues here that weren't properly addressed and we are going to address them,' I think that would be the most effective peer review.

CHAIRMAN—I hear what you are saying but, in the political process, certainly at the Commonwealth level, you would have to admit that it is not uncommon for an outgoing government to be reviewed by the incoming government—and everything they did was always wrong, no matter what. Is that not reasonable?

Mr Shanahan—I have seen that happen occasionally, yes.

Mr GRIFFIN—Particularly in 1996.

Senator MURRAY—The five-year turnover: I can equate it to buying a business. If you buy a business, you should do due diligence. If an audit was worth $100,000 a year for five years, what you are doing is buying a half a million contract. Do you think, if there is to be mandated

turnover of firms every five years, or even longer if people wish, the mandated turnover should include that the incoming auditor must do due diligence on the actual audit process that they are taking over and publish it?

Mr Shanahan—I have no trouble with mandatory due diligence. That happens before every audit tender. Every audit tender process starts with saying, 'Do we actually want this client?' You are not knowingly going to accept a client whose performance or operating standards are such that you may get yourself into trouble. It is a very simple rule of tender. You do not look for bad clients. I do not believe you need to make that mandatory.

Senator MURRAY—Can you answer the second half?

Mr Shanahan—You said publish it as well.

Senator MURRAY—Yes, that is the killer.

Mr Shanahan—If you said, 'We have been invited to tender by XYZ Ltd and we have chosen not to accept the invitation to tender,' then somebody would say, 'Why?' and the answer is going to be either 'We are too busy and have too much on our plate' or 'We don't think they are a good risk.' If an audit firm can be sued, you are not going to want to say, 'We think XYZ is not a good risk and hands off.' That would be an invitation to some of our litigious law firms to take action.

Senator MURRAY—However, if statute was to legislate that not only must due diligence be done but it must be published for a publicly listed company and to prevent any liability for that due diligence—apart from, of course, recklessness or negligence, the usual provisos—what would you think of that?

Mr Shanahan—I believe that would be a good protection for the shareholder but I query how commercially realistic it is because you would have to be doing a due diligence and, if you are going to publish that due diligence result, you would then want to do a much more extensive and thorough-going due diligence as part of your tender process. If you do that, and you do not win the tender, you then consign that several hundred thousand dollars to, 'Well, it was a nice expense.'

Senator MURRAY—Behind that idea, there are a number of ways you can go: you can increase the depth and the scope of audits, and that can either be by statutory requirements under the financial audit basis or you can add on a performance audit inquiry; or you can say that, when you turn over an audit contract, that is the time for a particularly in-depth appraisal. So once every five years, a publicly listed company would get very thoroughly appraised through the due diligence process that the incoming auditor would be required to do—and they could, of course, turn it down if they then had a look at it.

Mr Shanahan—Indeed.

Senator MURRAY—That would really keep companies on their toes. Of course, the negative side of that would be the danger to market perception and market confidence from a

very negative report. However, the issue that we are on about is ensuring that the reality of a company is presented in its public reporting. That is why I focus on that area.

Mr Shanahan—Senator, I share your concern and your views. My concern as a practising auditor is that you are in effect asking us to do a due diligence audit on acceptance of the client before we actually win the tender. I believe we are doing the due diligence in the tender process itself.

Senator MURRAY—But it is not public.

Mr Shanahan—It is not public.

Senator MURRAY—That is the issue.

Mr Shanahan—Yes.

Senator MURRAY—I will leave it there.

Mr GRIFFIN—How typical do you think your views on some of these matters are to the auditing profession as a whole, because you made the point earlier that a lot of auditors out there are doing the right thing and it is a high quality profession. Given the suggestions you are making, how commonly held do you believe those views are?

Mr Shanahan—I believe that there is acceptance within the profession of audit rotation. Nobody has argued against audit rotation. We are debating whether it should be rotation of the partner or rotation of the firm. Everybody is saying, 'Oh, yes, rotation is good—a fresh approach.' I say, 'Yes, but if you rotate just the partner without changing the engagement team or taking a fresh look at the audit plan, are you really getting a fresh approach?' One could say, 'The HIH auditor who signed the last set of accounts involved the fresh appointment of a new partner.' They had not rotated the firm or changed the overall plan. Rotation per se is good because it is a fresh approach, but I am not convinced that rotation of just the lead signing partner is going to bring that fresh approach. I am intrigued when I hear, 'Rotation is good per se, but not at the firm level.'

I believe the profession as a whole is dedicated to doing good audits. I am worried because of the cost pressures forced by competitive tendering. Somebody said to me, 'Why pick five years?' I noticed that the Managing Director of Woolworths said that he will put everything to tender every five years no matter how good the service is that he is getting. If that is going to be the view in corporate Australia, and you often hear of tenders every five to seven years, I believe five will be an effective period. The first year is a start-up audit and it is one where, as Senator Murray said, you go through and look at everything closely. You need to develop your knowledge of the client and you do that over the first two years. Those audits are perhaps the less effective but the first one is your first time there so you are looking at everything closely.

For the last three audits, you have a client knowledge and a good system; you can make the calls that need to be made without fear of being terminated or having the audit put to tender because you are treading on management's toes. When you talk to audit partners—you have heard this from Ernst & Young—yes, the threat of management intimidation is something that is

there. As an audit partner, I never worried about the level of fees I was selling to other parts of my firm but the fear of losing an audit client is a real no-no in any professional services firm. I believe there is a strong degree of support for high quality audits and rotation is well accepted. I go further and say, 'Let's rotate the firm.' I do not disagree with a lot of what you have heard and the submissions you have had before this committee.

Mr GRIFFIN—In your submission you also suggest reinstalling the 'true and fair' requirement. How do you think that would be viewed within the industry?

Mr Shanahan—There is support for the true and fair view override. Michael Coleman from KPMG this afternoon will tell you the same thing. The Deloitte submission says something similar. As in the UK, a true and fair view override should be only in exceptional circumstances. You do not want to have a true and fair view override where every time you do a set of reports they say, 'We're different, this is one of those override situations.' It has got to be in rare and exceptional circumstances.

At the moment, auditors must sign that the financial statements comply with the accounting standards. I have quoted an example of leasing and, yes, it is possible under our standards to leave every lease off balance sheet. That is not a true and fair view. I have even given advice where I have said, 'This is a financing transaction, but you can leave it off balance sheet.' It was given to the government. They said, 'John, take the advice back, please. Delete that first sentence and give us the advice.' It didn't affect the accounting standards at all but they did not want to actually say that it is a financing transaction. That is my view of a lease. It is the Bureau of Stat's view of a lease. With a true and fair view override, you would be able to say, 'Well, if you end up with a ridiculous situation, then you can put it all right.'

Mr GRIFFIN—Given my flippant question earlier about the poverty of accountants out there, would you care to expand a bit more—as we did in the discussion we had outside—about why that is not the case? As I said to you outside, if I was being totally accurate, I would have said major firms.

Mr Shanahan—I agree with Tony Harrington from Pricewaterhouse that if you join a firm and you are told, 'There is a problem in that if you become an equity partner, you can be sued for all your assets because somebody in Western Australia made a bad call on an audit and our review procedures did not pick it up and turn it around.' As any professional, you would do the sensible thing and say, 'Can I quarantine myself from having personal assets available?' It is a problem when new partners come in.

Mr GRIFFIN—So it is a liability issue.

Mr Shanahan—It is a liability issue.

Mr GRIFFIN—It is a question of whether you have enough assets to survive that sort of action rather than poverty in a general sense.

Mr Shanahan—I still believe that we need to pay our auditors more. I think we undercharge for audits in this country. I believe if corporate Australia, the investment community, wants a

properly done quality audit, they need to pay more for it, and we need to expand what comes through in the audit.

Mr GRIFFIN—How do our prices over here compare to, say, the US?

Mr Shanahan—My experience is that our prices in Australia are comparatively lower than in the US. They have been prepared to pay more. At times, when you are doing international tenders, and you suddenly get a world wide fee quoted and you get the trickle down effect for what you are doing in Australia, you think, 'Gee, it is hardly worth being an auditor here in Australia for my share of the international fee.'

Mr CIOBO—Some of the testimonies we received dealt with proprietary companies and whether there was a need for those companies to be subjected to the same standards as publicly listed companies. I would be interested in your thoughts on that.

Mr Shanahan—I have no problem with the idea that disclosing entities, public companies and large proprietaries should all be audited. That is what we require at the moment to audit. There are only about 20,000 on that list in Australia. If you have a small proprietary company, which does not have external involvement or you have not borrowed funds under a prospectus, it does not require audit. A small proprietary company needs to keep accounting records but does not need to report or follow accounting standards or do anything. We are only looking at these 20,000 large proprietary public companies.

Where I think we have a bit of overkill is that there are about 8,000 public companies in this country which are your local RSLs and local regional sports clubs.They are companies limited by guarantee which, under a quirk of the law, makes them public companies. To hit them with a piece of two-by-four called the Corporations Law and accounting standards and full audits seems, as I say, an overkill. But I have no problem saying that large proprietary companies should be audited. I would like to see the grandfather exemption removed, because there are some large proprietary companies out there that are tightly held and, because they have been audited since about 1983, never have to tell anybody anything. I think that is a real wrinkle in our law.

Mr CIOBO—So what would be the threshold then?

Mr Shanahan—I think for large proprietary companies—defined as those with revenue of more than $10 million and assets of more than $5 million—those numbers need to be indexed every so often. At the moment the law does not do that.

Mr CIOBO—You make the comment that one of the greatest threats to auditor independence flows from the need to comply with standards rather than the notion of true and fair. You make reference in your submission as to what you think the greatest threat is.

Mr Shanahan—The greatest threat, I think, is the fear of losing the client, and the client threatening—

Mr CIOBO—That is right. So what do you see as the principal driver? If that is your greatest fear—that you are going to lose the client, and obviously that has an impact on revenue—what do you think is driving that? Is it just the revenue function?

Mr Shanahan—If you lose an audit client, it is done in a very polite way. The audit will go out to tender and you know you will not win the tender. It is commercially responsible to say, 'We have been getting good fees from this client. They have put it to tender. We want to keep it. We know them well. We will bid lower.' You have been doing a good audit, reasonably priced. You then suddenly lower your fee to try and keep the client and you lose it to a lower tender. You think, 'How is the next auditor going to do anything like a reasonable audit for that?'

The easy way to do it is not to lose the client. Where a client threatens to leave—I believe the people from Ernst & Young produced that sort of intimidation example as well—losing the client can have an impact on the firm's fee base. Any one of the audit firms is in business. We need to keep fees rolling in to pay our staff and to keep auditing, and to do the research to make sure our audit techniques are appropriate.

I am saying yes, I believe we should rotate the firms after five years. You know you would lose the fee after five years but then, if we all do the change at the same time, you will be able to tender and stay in the same industry. But the threat is: 'We will take the fees away unless you conform.'

I do investigations of defaulting auditors. It is remarkable: I find everything that needs to be found in the files. Walter Schultze, a former SEC chief accountant, said to me yesterday, 'Yes, John, it was the same thing there.' They found everything that needed to be found in the files. It was just at the partner level they would not make the call, saying, 'We are going to blow the whistle.' Why not? Because management says to you, 'If you blow the whistle, you know this is going to affect the public perception of the firm and also we are not going to be happy with you staying on as auditor.'

There is research on audit failure. The research shows that most audit failure happens in the first one or two years of an audit. You need to look at the cause of that. Is that because the outgoing auditor made a bold call and said, 'I will qualify,' so he gets flicked? The new auditor comes in; he is not going to qualify first year round. When he realises suddenly he should have qualified, then we have a failure situation. That is as good an explanation for the research results as saying, 'Oh, well, a new audit is always bad.'

Mr CIOBO—To paraphrase that, effectively what you are saying is that you have, as a result of the competitive marketplace for audit services, a cannibalisation of audit quality?

Mr Shanahan—No. I believe audits are done well. I am impressed by the quality of graduates we get from universities. The training programs across the firms are very good. I have not done an investigation yet where I have found the audit files themselves were deficient. I am concerned that the auditing standards actually give you very few options for reporting. It is hard for an auditor to 'warn' per se. Mr Long was saying to us, 'It is either black or white. You give a qualifier or you don't.' You can give an adverse opinion, 'The accounts do not give a true and fair view,' which is very rare, or you can say, 'They are all right except for a particular item,' or you could say, 'They are all right, but by the way, here is something you should look at

carefully.' Even the last HIH accounts had an emphasis matter. They were unqualified but if you read it carefully and could understand the code you would look further into it.

Mr CIOBO—It is cold comfort for us that it should be on the file and not signalled to the marketplace. That is of little impact really, isn't it—that it is all sitting on the file?

Mr Shanahan—I agree. I have been trying to find where the auditing standard says we have a duty to warn. I keep being told, 'No, that is a common-law duty to warn. It is not in the auditing standards per se.' I do not believe that the emphasis of matter which the auditing standards would say, 'There is how we would warn,' goes far enough.

Mr CIOBO—It sounds like you are suggesting that there needs to be greater flexibility for an audit partner to express an opinion that is not as commercially sensitive or marketplace sensitive as to qualify an opinion.

Mr Shanahan—I believe we should treat an emphasis of matter as an audit qualification and put it in front at the opinion paragraph, saying, 'Here is what we are worried about.' I believe we need to improve our audit reporting but, yes, as with the last series of questions to the Consumers Association, we do not expect the average investor to understand the accounts, the financial statements, and as auditors we also report in code.

Mr CIOBO—If your research shows that the greatest period is in the first or second year for there to be problems with regard to an audit, why doesn't peer review pick that up? If you can find anecdotal or perhaps actual evidence to indicate that, why isn't that currently being captured?

Mr Shanahan—The evidence comes from the auditing standards board, so it is their evidence. I have read the brief report of it because they said to me, 'John, you wouldn't want to rotate audit firms, you are putting yourself in this danger situation.' I believe one of the reasons an auditor was changed was because the auditor was making noises such as: 'I am going to have to start qualifying.' I have seen examples where an auditor has qualified, and his firm has rotated him off and put another one in.

Mr CIOBO—So perhaps independence is assured, or at least to a greater extent assured, through tenure?

Mr Shanahan—Yes, but I believe it should be a five-year tenure, because then you are not going to say, 'Oh great, I am here. I can't be sacked.' You would know after five years you will be looking for another audit to do, and I believe you would sell your next audit, and any other services, based on the quality of your auditing work. Yes, I believe we need to give the auditor tenure so he cannot be sacked for making a call which the company management does not like, but then you are not going to become so comfortable with the audit that you become part of management, in effect. That is why I picked a five-year period.

CHAIRMAN—In your submission to us, you said:

I believe that the Corporations Act should be amended so as to require all public companies to have an audit committee of the board of directors.

You know that you are in conflict with the Australian Stock Exchange, who have said they have no problem, in concept, with there being an independent audit committee—an audit committee of the board made up of independent members of the board—and that requiring that in very small, listed public companies would be an onerous requirement that might, indeed, cost them more than their profit. Could you comment?

Mr Shanahan—I am not sure I agree with the ASX. I think their response is that they say, effectively, the whole board acts as the audit committee. I accept that may be the reality. What I am saying is that I think large companies should have an audit committee and if you want to be a listed public company, if you want to play in that field, one of the requirements would be that you have an audit committee as well. If you have only got three directors and the three of you meet and say, 'Okay, this is going to be an audit committee,' what is the agenda for that audit committee? It is much more focused on analysing financial statements, the appointment of the auditor and financial reporting issues. Meeting as the audit committee, they are more focussed and directed on that than they would be if it were just another agenda item in a normal board meeting.

Senator MURRAY—But they are not independent.

Mr Shanahan—No, they would not be independent, but if you only have three directors, how are you going to get another set of independent people to come in?

CHAIRMAN—That is the point that ASX makes.

Senator MURRAY—Have a look at my corporate governance board proposal.

CHAIRMAN—Mr Shanahan, your paragraph 64 says:

By way of comparison, Australian Bureau of Statistics leasing data suggest that something in the order of 90 per cent of leases in Australia are finance leases i.e. they should be capitalised in the statement of financial position. AASB 1008 is clearly not achieving this at present.

I was wrong earlier this morning, with the first witness from PricewaterhouseCoopers: I paraphrased what you had said, and I said 80 per cent and I said finance leases, and I was corrected and told I was wrong and that I was talking about operating leases. Confusion reigns.

Mr Shanahan—A finance lease is on balance sheet, an operating lease is off balance sheet. The Bureau of Statistics suggests that 90 per cent should be on balance sheet finance leases.

CHAIRMAN—Oh, should be.

Mr Shanahan—Our accounting standard is very poorly written, in such a way that you can run rings around it. I wrote a book on leasing in 1981; I have given advice on declaring leases, operating leases, for a long time. I have given my speech to ASIC and the Accounting Standards Board. I can say, 'Listen, I can keep any lease off balance sheet.' Clearly, most leases are financing transactions. Our accounting standard is so badly drafted you can keep a lease off balance sheet. You need to change the standard, but in order to do that—and the AASB has to look at the economic consequences—there will be blood in the streets. The whole leasing

industry will fight it tooth and nail, but you can really only do it if we have a global rewrite of borrowing covenants. If you bring another asset and liability to the balance sheet, you will put firms in breach of borrowing covenants. So to change the standard we need to go more broadly and say, 'We need a rewrite of borrowing covenants as well, and then it will impact everybody across the board—let's get serious.'

CHAIRMAN—You will recall that, in the Commonwealth public sector, we addressed just this issue with the sale and leaseback of Dasfleet. A performance audit report qualified the operations of DOFA, and DOFA said, 'You're wrong.' Dick Humphry came in, did an independent inquiry and said that it could go either way. But the auditor still insisted that they were right, DOFA insisted that they were right and the two never got together. Is this unusual?

Mr Shanahan—I see people from the ANAO in the far right-hand corner there. They and I regularly cross words on just the interpretation of this standard. They refuse to admit that I am right and they are wrong—and vice versa—but you can debate this one. You can analyse the standard in such a way as to achieve your desired result. We are accountants; we are a service industry. We have a standard here and we will give you the result you want. My point is that the auditor has to sign off that you comply with accounting standards in a very technical sense, rather than saying what the true and fair position is. Truly, you are acquiring an asset and sometimes you have a liability to pay for it. Our standard does not achieve that.

CHAIRMAN—You were reported in the *Financial Review* on 5 July as saying:

> New accounting standards are long, complex and barely comprehensible. Even experienced accountants have difficulty with them.

Would you like to elaborate on that?

Mr Shanahan—My wife and I write a textbook on accounting standards. We started in 1987, and the first edition had 200 pages. The seventh edition, which is now about three years old, had 498 pages. The eighth edition, which we are about to bring out, is going to have 850 pages. We try to explain it in simple English with worked examples. That is the pace of development. Every new standard of the most recent ones is at least 100 pages long. We have a standard out now in exposure draft on director remuneration; it is 160 pages long. We have a standard on provision for contingencies; it is 80 pages long. The new tax standard is 150 pages long. I can do quite well out of trying to put these in English and explaining how they work, but I do not think we have principle based standards. It would be a fair comment to say that we have a lot of prescription in our principle based standards.

CHAIRMAN—You would agree that we are moving, albeit at some indescribable pace, towards incorporation of international accounting standards in our jurisdiction.

Mr Shanahan—Yes.

CHAIRMAN—Do you believe that is appropriate? Is it fast enough? Is it too slow?

Mr Shanahan—I believe it is appropriate to move to international standards. It is interesting that, over the last five years in particular, the Australian standard has become much closer to

and more harmonised with the international standards. We want a robust set of accounting standards we can use in Australia, and then we can send our financial statements overseas, to Europe, the UK or even the US, and not have to restate them. I think we are moving at about the right pace, but I think saying '1 January 2005' is a very optimistic viewpoint. I am intrigued that, at the moment, accounting standards have to be laid before both houses of parliament. As Senator Murray would know, the Senate disallowed two clauses of the Australian Accounting Standard in February 2000. I will be intrigued to see what happens when a house of parliament decides that it does not like an internationally developed international accounting standard which is about to fold into Australian law. I can live with international accounting standards from an accountant's viewpoint; whether parliament will happily live with it as well might be an interesting question.

Mr KING—It seems to me that this issue of independence is very important to you, and I can see why you say that. You have eight dot points in your submission. Listening to you, it seems to me that the five-year rotation point is at the heart of your submission. Is that correct?

Mr Shanahan—Yes. I think five-year rotation is the best way to achieve audit independence.

Mr KING—But might the public interest not see that as merely entrenching an established commercial interest, rather than opening up the profession to higher standards?

Mr Shanahan—I think that, if you had one of the 'big four' firms, in five years time you would find that you had the other three and the top several second-tier firms all wanting the work. If you are trying to audit a major multinational, you will be restricted to one of the large four. I accept that; it is a reality. If you are an Australian company, the second-tier firms and their networks are just as capable of providing a good quality audit. They may do it at a slightly lower price than the big four because they do not bear the same overheads. I believe there would be some real competition for those audits.

Mr KING—Dr Simon Longstaff of the St James Ethics Centre has suggested that the best guarantee of improved outcomes on this issue is a far stronger collegiate sense of ethics across the profession. It seems to me that the only way you are going to achieve that is through better training and a stronger corporate environment. What do you say about that?

Mr Shanahan—I believe a stronger corporate environment is clearly essential. Have the problems arisen in the longstanding, well-established household name businesses or the brand new dotcoms and high-techs, where some of the old accounting models—where you value firms on profits, not on sales per se—no longer apply? Over the last decade, we have changed some of our business approaches to revenue per se, not profit. In the good old days, you went back and said, 'Let's look for profit; debt versus equity.' Now, if you want a good debt versus equity ratio, you play games and reclassify a lot of debt as quasi-equity to try to blur those meanings. You spend a lot of time finding ways to shift risk off the balance sheet. If you hedge the position properly, you do not have the risk any more, it is the major bank or the major external financier. To fully understand the financial situation of the company you are looking at, you have to look beyond that particular company.

I think it is interesting that only now are we trying to bring in the proposed changes to our international standard on financial instruments—news of it arrived in the mail this morning. We

are going to say that they have to be recognised and measured here. We do not have those rules in Australia yet, and the proposals will cause some significant changes to Australian balance sheets. I think we have the right approach, but the application over the last five years or so has been somewhat lacking.

Senator MURRAY—You made a link between the borrowing covenant and the leasing issue in terms of accounting standards. I had not seen that before and it interested me. For us to examine that, we would need to understand better what you meant by that. Would you mind providing the committee with a brief summary of your case, on notice?

Mr Shanahan—I am happy to do that.

CHAIRMAN—That would be helpful. In response to my question about audit firms being companies and whether they are natural persons, you said that you were still working through that in your mind. If you reach a conclusion before we reach our conclusions and table a report, would you mind letting us have the value of your expertise?

Mr Shanahan—I believe that audits are done by the audit firm companies. I just find it odd that our regulatory procedure then picks out the individual who signed it and holds him to account.

CHAIRMAN—If you have further thoughts, we would appreciate your advice.

Mr Shanahan—I will do that.

CHAIRMAN—We thank you again for your very comprehensive submission, your views, your attendance today and your willingness to very openly and honestly answer our questions. We look forward to hearing from you further.

Mr Shanahan—It was my pleasure.

[12.20 p.m.]

CAMPBELL, Mr Gavin, Accounting and Financial Advisory Committee Member, Australian Institute of Company Directors

ELLIOTT, Mr Rob, National Policy Manager, Australian Institute of Company Directors

GRANT, Mr Stuart, Accounting and Financial Advisory Committee Member, Australian Institute of Company Directors

CHAIRMAN—We have received your submission, for which we thank you. Do you have a brief opening statement before we start to ask our penetrating questions?

Mr Elliott—We appreciate the opportunity and we understand the need for brevity in the opening statement; we would like to maximise time for questions. To set the scene very briefly, Stuart Grant and Gavin Campbell are both experienced company directors. Gavin is an ex-managing director of the Australian Stock Exchange. Stuart Grant has experience in a number of capacities, as a chartered accountant and as a senior regulator with ASIC, or ASC as it was at the time.

The Australian Institute of Company Directors is a peak body, organised to look after company directors as individuals not as companies. There are 16,500 of those company directors, large and small. The organisations cover all industries across Australia, large and small, private, public, not-for-profit sectors. Membership is individual not corporate.

Probably the most important thing we would like to introduce is the concept that the AICD is about promoting excellence in director performance and what we are not about is protecting poor director performance. With regard to promoting good practice rather than protecting poor practice in directorship, the institute's education and professional development has developed a number of publications. I understand you already have one of these. I will table the other, which is called *Fifty matters to be considered before signing a company's financial statements*. The final thing I would like to table is an AICD article published in the *Financial Review* on 25 June 2002 titled 'The auditing buck must stop with directors'. Having said those things, I would like to maximise the amount of time for questions.

CHAIRMAN—Do you have a copy of that article?

Mr Elliott—Yes, we will provide one.

CHAIRMAN—Thank you for that. I should declare that the four of us here at the moment have no conflict of interest; that is to say we have never been members of your institute.

Mr KING—So far as we know.

CHAIRMAN—I have not and you said you have not. In your submission, you stated:

A new financial reporting paradigm is needed, which emphasises substance over form and where the detailed approaches selected are based on effectiveness and have regard to the cost of their application.

You go on to support a new, principle based approach. But is it not true that we have in the past had an almost totally principle based approach rather than one that is at all rule based and that what we have today is a rule based approach with an override of 'true and fair'? Are you really saying you want to go back totally to principles and get rid of Australian standards and our movement to international standards?

Mr Elliott—The short answer is no, and I will let my colleagues elaborate.

CHAIRMAN—A bit more than 'no' might be helpful.

Mr Grant—Substance over form really means true and fair view in another form. As to the principles based approach, I think what we have at the moment in accounting standards is a mixture; it is a composite of principles combined with some prescription. The notion of a true and fair view is there but it is not an override—you mentioned an override, Mr Chairman. The predominant requirement is compliance with the rules which is embraced in accounting standards. There is a secondary requirement, which is true and fair view, which we believe is somewhat neglected because of the focus on the specific requirements, because they are so extensive.

The preference of the institute, which has been contained in its submissions for many years, is to revert to the requirement for a true and fair view being paramount—to comply with accounting standards but, nevertheless, to require that there be compliance with a true and fair view. In practice, this will mean additional disclosure, because 'true and fair' typically means more rather than less. The way the regime has moved, however, is that the true and fair view has tended to be only if you do not agree with the standard, so it is a one-sided assessment instead of an all-embracing assessment. As I say, we would like to see the more principles, the more all-embracing assessment. May I add that a true and fair view and substance over form are a more onerous test than any compliance with a set of rules.

CHAIRMAN—My understanding is that in Australia we have moved to continuous reporting and the Americans have stayed with quarterly reporting on a more detailed prescription. The Europeans vary, sometimes reporting half-yearly as well as yearly and sometimes more often. Would you support continuous audit of continuous reporting?

Mr Grant—My reaction is that that would not be desirable. It seems to be too onerous and perhaps too time consuming—too much delay. Furthermore, much of the continuous disclosure announcements, if they are valuable, should be in the form of projections, which are inherently not capable of traditional verification that an audit would normally apply. So we think that the regime of continuous disclosure is very good—the application of it can always be improved—but that an audit of it seems undesirable.

Mr Elliott—We have written to Senator Campbell with regard to a fundamental review of the continuous disclosure regime and how it works because, whilst we think it is very good and, relative to the rest of the world, excellent, that is not to say it is perfect. We pointed out some

particular areas in it which we think needed to be improved and we are pleased to see that CLERP 9 is going to be picking up a number of those issues.

CHAIRMAN—Would you mind sending us that information too.

Mr Elliott—Sure.

CHAIRMAN—I took a bit of exception to your media release that evidently appeared in the *Financial Review* on 25 June 2002 which started out by saying:

> Given the deafening debate on the independence of auditors and the role of audit committees, it is timely to remember that it is the directors of the board …

I would remind you that this committee's brief is far broader than the independence of auditors. We hope and expect to have a very important role to play in whatever position the Australian government ultimately takes on regulation versus self-regulation and recommendations we might make to independent companies and to independent auditors.

Mr Elliott—I take your point, Mr Chairman. In fact, the institute's business is in the wider range of corporate governance matters, and we understand that the independence of the audit, and the competence of the audit committee are just one part of the broader corporate governance regime of Australia. We see that as core business.

CHAIRMAN—One of the issues that we debate, and have continuously in these hearings, is the issue of auditor competence and how that might be judged. The Corporations Act requires that an auditor be a natural person, not a corporation. It says so, specifically. Yet, the big four, who deal with a lot of the directors that you represent, are all huge firms. They are not one man audit or accountancy firms with one auditor who happens to be one of the partners. How would you view changing the Corporations Act to require auditors to be corporations rather than natural persons?

Mr Grant—We actually discussed that, having read the transcript of earlier hearings of this committee.

Mr Campbell—I think the limited liability issue is important and probably can be handled in a number of ways. At this stage, I have no view whether incorporating auditors would be the best way of doing it, but it may be worth doing—one way or another. As for the wider aspects of incorporation, I do not know whether they would conflict with the day-to-day duties of an auditor or cause any difficulties or diminish the sense of personal liability that an auditor faces when he takes his pen to sign off an audit. I would have to leave that to my colleague.

CHAIRMAN—Would you object if say, regardless of whether it was compulsory or voluntary, an audit firm became a corporation, as I understand some are in some states in the United States? If it became a corporation, and was listed on the exchange, there would of course be a requirement for its financial operations to be audited. Would you be averse in such a situation to the audit firm also having a published performance audit performed on it relating to its independence and the quality of its work?

Mr Grant—Some interesting ifs in there. I think it sounds appealing in principle. I am not sure how effective it would be in practice. Also, I am not sure if there are measurable benefits from incorporating, as you are suggesting, as a possibility. The key to audit performance is for the audit partner or the executive group to make the tough calls when required. In my view, all the discussion about competency can be distilled down to that one issue: are they willing and able to make the tough calls? I am not sure about incorporation or peer review because those judgments that the audit team have to make are not capable of being fully documented. There is a high degree of instinct, subjectivity and experience that is brought to bear which, at the end of the day, lead the auditor to say, 'Yes I accept,' or 'No, I do not.' It is very difficult to second-guess that in hindsight.

Mr Elliott—It would be fair to say we would not automatically say, no, this is not a bad idea. It is something that we are all need to look at quite closely to ensure that those benefits actually did flow through and it would work practically.

CHAIRMAN—You might think about both those issues and come back to us.

Mr Campbell—Yes, it is worth looking at.

CHAIRMAN—The last respondent to this inquiry, who appeared just before you, has recommended very strongly that it be a requirement of the Corporations Act that the audit firms, not the individual audit partner, be changed every five years. He argues strongly that that would increase the quality of their public reporting, because they would have no fear that they were going to be sacked during that five years. They would make sure they did a better job because they would be reviewed by the new firm that came in after five years. Do you have a view on those views?

Mr Grant—Certainly the topic of rotation of audit firms has been the subject of a lot of discussion. I think what has not been fully canvassed is the practical and commercial difficulties that that gives rise to. There is a lot of expertise and a lot of knowledge that goes into an audit. An audit of, say, one of the big banks in Australia might involve 50 staff in that audit at the peak time or for quite a long period of time, and to suddenly say that is going to be removed from that firm, you have to ask: what are you going to do with those people, what are you going to do with that expertise? It is never going to be a neat fit that they are going to get another job that precisely fills the spot. So there are significant commercial difficulties with that. It seems to me that there might be other aspects of the audit role that could be brought to bear that sufficiently enhance the security of tenure of the auditor without going to a fairly extreme practice of complete withdrawal of one firm from the audit and replacement with another. Just as an aside, Mr Chairman, rotation of audit firms was introduced in Italy in about 1975 and the Italians got around it by switching the partners from firm to firm.

CHAIRMAN—This committee has heard that some have suggested that perhaps the majority of Australian companies view audit as simply an expense rather than adding value to their operations. Would you care to comment?

Mr Campbell—In my particular case I never had that view. I always saw comfort in the auditor and the importance of making sure that the auditor had direct access to the board and to me as a director.

CHAIRMAN—Would you then support public performance auditing?

Mr Campbell—Of the company or the auditor?

CHAIRMAN—Of the company. The earlier question was a performance audit of the auditor, but let us go back to the crux of the question, a performance audit of the company to give a true and fair view of the company's operations.

Mr Campbell—In my personal experience the nearest analogy I can get to is the preparation of a prospectus or an IPO, an initial public offering. I did that when I was a director of Optus—Cable & Wireless Optus as it became. In fact, I was chairman of the due diligence committee. I will just give you some numbers. The cost of the audit in the year prior to that listing year was about $1 million. The estimated cost of preparing the company for listing was put in the prospectus at about $50 million, and that figure did not include some costs met by the two major partners who were pushing this concept and had special considerations, and it did not include the opportunity cost of the massive diversion of senior management time from making a buck for the shareholders. I might say it was the third time Optus had started the listing process; so probably they got some streamlining in the third round. If that is in broad terms a valid analogy—you can pick holes around the edges—one has to be prepared for a very significant increase in costs.

I think a lot of the debate is going to concern where the benefit-cost balance lies in what is going to be a diminishing returns curve. Personally, I thought the requirements for an IPO were excessive in terms of the consequential costs and diversion of key people's time, but that is in a climate when you only do it every now and then; you do not do it every year, much less every quarter if it ever comes to that. So I think there is a fair comment that there can be more quality injected with more effort and more money into auditing processes, including possibly expanding them to cover non-traditional areas, but there has to be a cost consequence and a re-balancing of benefits and costs.

CHAIRMAN—You would understand, Mr Campbell, that this committee, which has a strong role with respect to audit for the Commonwealth, deals almost entirely with performance audits of Commonwealth entities. From time to time, we do take on inquiries which do not, and this is a good example of one where we believe we know more about the audit function than any other committee in the parliament, so we decided to inquire into it publicly rather than privately. You would be aware of our interest in performance audits?

Mr Campbell—Yes.

CHAIRMAN—I think I can say on behalf of everyone on this committee that we believe very strongly that performance audits add value.

Mr Campbell—Yes. Where you do not have the alternative of a market setting its own discipline on performance, measurable in terms of profit and loss. I think you may have little alternative.

CHAIRMAN—Okay, we accept your point.

Senator MURRAY—These remarks I am about to make result from a six-year tenure which I have had on the Joint Committee on Corporations and Securities, now the Joint Committee on Corporations and Financial Services. That committee has oversight of ASIC. In my capacity as a member of that committee, I have periodically explored the issue of best practice election of directors. Does the institute have a set of guidelines as to the way in which company constitutions should develop the best processes for electing directors and some alternative models for the types of boards which might be seen as providing the best balance of capabilities and skills?

Mr Elliott—As you would expect from an organisation that considers its core business to be corporate governance, yes, almost everything we do touches upon corporate governance. Many of those issues that you have asked about are covered in a wide range of products and services that we provide, including the company director course. Over 2,000 members go through this course each year. There are a number of other purpose-built courses, including the role of the chairman, the selection of the board and developing a good corporate governance manual and process within your board. These are specific courses and there are subset modules of larger courses. There is a range of publications which touch on a number of those issues. Probably the most recent one is on the succession, selection and performance of directors, called 'The 21st century board', which we released at the end of last year. There is a wide range of publications and courses that touch on those issues.

Senator MURRAY—This committee will plainly have to take a view as to the health, if you like, of directors as a body throughout the publicly listed companies. Could I ask you on notice, firstly, to give us a summary of what your institute considers best practice process within company constitutions for the election of directors; secondly, what you consider to be a range of good models for board structures, depending on size, risk and all those sorts of things; and, thirdly, what balance of skills and abilities your institute believes are ideal for good corporate governance in that sense. All those are best put on notice.

Mr Campbell—There could well be a potential conflict between what might be logically and demonstrably best practice and, if you like, the almost sovereign right of shareholders who own a company to pick the directors they want. I think there seems to be at times no end to the silliness of people in charge of companies. But the shareholders who own the company have the right to pick their directors unless there are extremes of criminality or whatever to exclude them.

Senator MURRAY—I take that point. The problem that was exposed in an inquiry into this was that the shareholders who often come in after the event are confronted with a constitution and a process which allows for rigging. It is only in a number, a minority perhaps, of companies that that occurs. Really, it is the reform process that I am interested in.

Mr Campbell—I accept that, where that is an issue, it should be looked at.

Mr Elliott—To make a point on that, when we talk about competency of the audit, we are not just talking about competency of auditors. We are also talking about and are quite concerned about the competency of directors in the process. That is very important. We are in no way saying that this is a one-sided debate. And the point is made in our—

Senator MURRAY—I clearly understood that.

Mr Elliott—Our role is to try and improve those directors.

Senator MURRAY—I am trying to move with some pace because of the time. The second area is audit committees. In those companies with excessive executive or managerial dominance, sometimes combined with excessive control or dominance by a financial interest, it seems to me in those situations that the audit committee of such a board will be the creature of that board and will not be an independent committee. The independence of non-executive directors is an absolutely vital issue and that really relates in part to the last question. In those companies with best practice, I do not think you have to worry about it too much. And HIH and those people are kind of worst practice if you want to make a judgment at this stage.

The issue of appointing auditors and making them independent, I believe, requires there to be an independent process of appointment. One model that I have contemplated, which is not mandated—I do not believe it should be mandated—but it is a model that is available is the corporate governance board model, which, as you know, is elected by one vote per shareholder, not one vote per share. It has a very limited remit and does not interfere with main board operation. It is very cheap. It covers constitutional amendments, running meetings, supervising the election of directors, remuneration issues for directors and management, and appointment of key advisers such as auditors and valuers. So it has a very limited remit, a very limited job. Providing it is not mandated, I presume your organisation would have no objection to the view that, if a company wants to set itself up with such a system, with a main operating board doing what it normally does and a corporate governance board, you would have no in-principle objection to that, would you?

Mr Elliott—Absolutely not. In fact, it can do that right now and there are some companies that we know about—for example, Mr Shann Turnbull has companies and has in the past set up companies with this structure. There is nothing to stop or prohibit that and the institute sees itself in the governance debate as providing a smorgasbord of opportunities, not mandating any in particular, suggesting what we consider to be best practice, but basically having a debate and being a forum for the debate. As long as it is not mandated, and you made that point.

Senator MURRAY—I assumed that would be your response. The reason I raised that was that a previous witness from PricewaterhouseCoopers, when asked the question whether he would oppose an independent non-executive director being elected on the basis of one vote one shareholder, as a concept he said that he thought it was wrong because he thought it would not represent the economic interest—in other words, the controlling shareholders. What is your reaction to that view?

Mr Elliott—I think you have two different votes there, don't you? You would have one vote under the existing structure for the board of directors, and no-one is proposing that that change, and your suggested corporate governance advisory board model has a separate vote for that purpose. That would be something which the constitution would have to have built into it to make it quite clear that those are two separate votes under two different voting mechanisms for two different bodies. As long as it is not mandated, if it works for the company at the time, it should be looked at.

Senator MURRAY—Thank you.

Mr GRIFFIN—I want to take you back to the proposal about five-year rotations of audit companies. First off, I am interested in your concept of 'suddenly', given, in effect, a company would have five years notice of the fact that it would be getting rotated. Do you really consider that to be suddenly, as you said earlier, an issue for change within the company? Following on from that, you seemed to suggest that there was a commercial imperative from a company's point of view, particularly for large audits, with respect to them actually having a commercial relationship which would make it difficult for them if they lost that particular audit. Does that have implications for compromise with respect to their actual operation, which would seem to be the logical suggestion? If there is a commercial concern from the company's point of view, then that could have an implication for them actually performing their duties versus actually maintaining that commercial relationship. I am also interested in your comments regarding Italy and the circumstances there. Has that since been changed, or is it still a situation of playing pass the partner?

Mr Grant—I am not sure if I can remember all your three questions.

Mr GRIFFIN—The first one was define 'suddenly', the second one was commercial versus compromise in respect of relationships of auditors, and the third one was the Italian experience.

Mr Grant—On the five-year period sudden cut-off, my feeling, and certainly the view of the Institute of Company Directors, has been that rotation of audit firms is not necessary, as I summarised before. Even if it were to be telegraphed by being a fixed and rigid period, it would still happen that precipitously that knowledge that had been built up would be, in effect, lost. When I mentioned commercial it was not the commercial relationship that I was commenting upon but, rather, the commercial position of the auditor. One of the ingredients of auditor independence is that they are paid reasonably well. The best way to be totally independent, of course, is not to be paid at all, but that is not so practical.

Mr GRIFFIN—We tried that with politics a long time ago.

Mr Grant—That was really mentioned as an aside; it is not a predominant reason. But the knowledge and skill that an audit team brings to bear develops substantially. Furthermore, there is a significant cost to the company and, therefore, to the shareholders in making that change through just the process of change. Also, the new team of auditors coming in has to be, if you like, retrained on all the company's procedures and so on, which is a significant allocation of company staff time. These are more practical issues than philosophical, as you are probably well aware, but nevertheless they are significant. I believe the case is yet to be presented that really indicates there would be significant benefit in light of the costs. I also have a concern that there might be a temptation to recommend it as a bandaid fix, when in fact it does not deal with the core issues of independence and competence at all. As to Italy, I believe it has changed. I am a little bit out of touch with it, but I believe that in Italy now they do not require—I believe, but I am not absolutely sure.

Mr GRIFFIN—If you could check that and get back to the committee, that would be great.

Mr Grant—Okay, I will see if I can find that out.

Mr Elliott—I think there is also the practicality of the big five becoming the big four. Given that, for large listed companies, there will be a certain size of audit firm which is required and a certain skill base, and conflicts of interest, there are some practicality issues in rotating regularly. We are not saying it is impossible, but there are some issues there.

Mr KING—The public interest concerns the failure of auditors to warn the commercial community and shareholders of problems found on file, it seems to me. I was wondering whether or not you wish to comment on that problem in the face of the overmighty executive, and on whether the answer to that problem is a more detailed regulatory regime for auditors, or better education and training for directors, or both.

Mr Elliott—Possibly both, but I would probably defer to either of my colleagues who have plenty of first-hand experience of that from both sides—both the auditor and the corporate side. My gut feeling is that—

Mr KING—HIH and Enron seem to be pretty good examples.

Mr Elliott—Absolutely, and I think you do not have to be a rocket scientist to figure out perception is reality in a lot of these cases. What gets kept and what does not is pretty crucial for confidence and, after all, the markets rely on confidence and integrity.

Mr Grant—It is never as simple as it appears after the event. You are right, however, in that I understand that the issues that have become problems in HIH and, let's say, in Enron were known to the audit team at least partially. In practice, it is never typically black and white. In the HIH situation, for example, I believe a significant issue there—and far be it for me to prejudge the outcome, but this is my impression from media reports—was that the auditors were deliberately misled by the withholding of information with side deals. There is no amount of audit that can really detect that until it is too late. When those side agreements start to be called upon they will be identified and, all of a sudden, the auditor will realise that there has been a misrepresentation, but that could be two years later. So while the auditors were aware of the issues they were profoundly misled—to use somebody else's phrase—by withholding of information.

Furthermore, in that industry the problems of measurement are enormous. Normally for a corporation the problems of measurement relate to assets, but in an insurance company the issues of measurement relate to liabilities: have you got them all and have you measured them correctly? And there is no right answer. You can flick your assumptions by one decimal point or one percentage point and your outcome could be tens or hundreds of millions different in your assessment of the need for outstanding claims. So there is a huge amount of estimation, a high degree of sophistication and, typically, the company and the industry have more expertise than the auditor does . You would certainly hope they do because they work in it every day, whereas the auditor does not; so the auditor has, inherently, a degree of hesitation in being adamant when it is a grey area because the industry knowledge contained through the executives is superior to his. He will seek expert advice, of course, but nevertheless he has to be cautious, to make sure he is on firm ground, if he takes a stand.

That is a fairly longwinded response, but I am just trying to give you a flavour of the issues not being as simple as they might appear after the event. It now appears that the WorldCom ex-

ecutive who capitalised those costs, which now everybody thinks clearly were expenses, argued passionately and believed he had a good case to argue that they were capital. The CFO from WorldCom—Mr Sullivan, I think his name was—believed that he was doing the right thing. In hindsight, it appears that he was erroneous. We have had this with Southern Cross Airlines: they capitalised training costs for pilots for the new aircraft. Is that right or not? It is highly debatable. The aircraft were not flying yet, so clearly those costs were not attributable to revenue today. They carried them forward. Debate: should they or should they not? Bond Corporation capitalised advertising costs when they owned Swan Brewery.

Senator MURRAY—Start-up costs are another one.

Mr Grant—That is right. Many mining companies and the like capitalise those sorts of start-up costs, or removal of overburden: it does not generate revenue in itself but it is necessary to get to the revenue product.

Senator MURRAY—And then you depreciate it over 15 years.

Mr Grant—That is right. But the fundamental issue in all accounting is: what is a today cost versus what is a tomorrow cost which you incurred today, and that is going to be never ending.

Mr Campbell—I add one bit of more upbeat news, which I am sure the committee is already aware of, and that is that under Australian law and accounting practice some of Enron's techniques of getting doubtful things off the balance sheet would not be law and I am sure would not have got past their auditors.

Mr Grant—Yes, would not have been permitted.

Mr KING—I was very impressed with your comments about the issues about ethics and training, and Simon Longstaff has been talking about this a little bit too. The cri de coeur from some members of the commercial community has been to suggest that audits have proved worthless to the commercial community but very expensive to the companies involved. I would suggest that one solution would be to make them optional and leave it up to people to judge for themselves.

Mr Grant—I think there is some merit in that. I would never invest in a company that was not audited.

Mr KING—Yes, that is the point.

Mr Elliott—Getting back to some of the points about wider governance, good corporate governance is a jigsaw puzzle. It is about a whole range of things as well as disclosure. The market is actually pretty good at working these things out as long as it is a well-informed market and it has the will and the power to act. I would not count it out but I know where I would put my money; it would be in an audited company.

Mr KING—Yes.

CHAIRMAN—I would like to follow up on what Mr Grant had to say about this reporting process. It has been put to us that, under the current Australian accounting standards, something like 90 per cent of leases in the corporate sector are publicly reported as finance leases—therefore, they are off the balance sheet—when in fact probably the majority of them are operating leases. You could sell off your capital, sell all your buildings, sell a big swag of your assets, move all that off balance sheet as lease costs and show a good profit every year until all of a sudden the whole Taj Mahal came tumbling down. It is not a very good example, is it, Mr Grant?

Mr Grant—I think you had it around the wrong way: finance leases are on the balance sheet and operating leases are off—but that is by the way. I do think your comment would not in fact be the case. For example, Qantas might have a leverage lease for a jumbo. If it is a finance lease, the aircraft will be on its balance sheet and it will be charging depreciation and interest but if it is an operating lease then it will just be a lease cost, which is also based on depreciation and interest. The fundamental profit and loss cost is not much different whether you are accounting for a finance lease or an operating lease; it is the presentation of your indebtedness that is the difference. You could be highly geared if you had a finance lease; if you did not record it, it would not be so readily revealed that you were highly geared. I think the concern is more in the balance sheet focus.

Mr CIOBO—I have two questions I would like you to take on notice and get back to the committee on, if you could. The first is your views on whether or not CEOs or CFOs should be personally liable for the financial statements that they make. The second question refers to comments attributed to your Queensland branch president, John Massey, in the *Australian* on 2 May 2002. He stated that he felt some directors were taking on too many directorships and, as a consequence, were perhaps not 'giving the value to shareholders that they should'. I would be keen for your comments on that, on notice.

We have received testimony that has indicated that one of the principal drivers diminishing the quality of an audit and the scope and role of an audit flows from, as has been phrased by other members of this committee, the mighty executive having undue influence and perhaps putting audits out for tender. What is the AICD's view of directors seeking to cover up bad news, and what is your view as to whether or not this is one of the key drivers? Should there be jail terms if this is an ongoing problem—which many have testified it is—as some sort of disincentive to prevent it in the future?

Mr Grant—On the tender side of it: needless to say, in the present market economy it would be a bit difficult to imagine that there should not be an entitlement for a company to put its audit out to tender. I am using those words because I think it has some dangerously concerning aspects. In practice, my experience with audit tenders is that it is somewhat demeaning for the auditor, because the auditor is there to protect the shareholders' interests, not the company's, and yet the company is seeking a fashion parade from these auditors to be seduced as to who is going to be the best for the company and not necessarily for the shareholder. There is also an inevitable tendency to look to the cost. Once again, as a shareholder, my inclination would be to pick the highest price, not the lowest, because I would be more comfortable about getting a quality audit. That is not consistent with the objective of a corporation to keep its costs to a minimum, though, so you have a bit of a dichotomy. As I say, there are some concerns with the tender process.

Mr CIOBO—And what about the role that directors play? What was put to the committee was that there was a reluctance by auditors to qualify an audit opinion, for example, if it meant that it was a loss of a revenue stream for them and that that was a power that directors had over an audit firm. From this committee's perspective, what is your response to whether or not directors partake in such activity? Obviously you cannot speak for each and every director. I accept that, but as a general observation what are your comments in response to that testimony?

Mr Grant—In another role I have been an auditor for many years too and my experience in 30 years of auditing was that I never experienced that. Sure, you have debate; sure, you have vigorous debate. People get snaky. I have been physically threatened in my role as an auditor. So it is not all beer and skittles. In fact, my partners had knocks on the door at midnight on one occasion with physical threats to their wellbeing. I am pleased to say that that seldom occurs, but it has occurred.

Senator MURRAY—Are they still in business?

Mr Grant—Have you heard of Nugan Hand?

Senator MURRAY—Okay.

Mr Grant—It can always happen; it is always a possibility if you have got directors who are not ideal. Another observation, just touching on tenders, is that I have a hypothesis that there can be a little bit of a nexus between a company seeking an audit tender and its subsequent difficulties or failure. Qintex, Bond Corporation, Westmex and OT Lempriere changed auditors and went broke within a year or two. Southern Cross Airlines is another. I have a concern about the tender process because to my mind it seems to focusing on the wrong issues. They tend to be trying to squeeze down the audit fee, which represents less than one-tenth of 1 per cent of the revenues of the organisation, when they should be focusing on strategic issues that are much more important. In other words, they are focusing on the petty cash.

Mr Campbell—One thing the Enron disaster has shown the world and emphasised is the disaster to an auditor that can come out of loss of credibility, if you like. My observation is that auditors have always been acutely aware of exactly that point, that their credibility in the marketplace is their biggest single asset.

Mr KING—Wasn't that the result of an overweening confidence amongst those who audited and those who governed the company rather than any consciousness of their obligations?

Mr Campbell—I was not a member of the jury that decided part of that issue, but I think it was a lot more than just confidence.

CHAIRMAN—Senator Murray has a question he would like to put on notice to you. We have to take a break now or we do not get to eat.

Senator MURRAY—I am a supporter of compulsory voting in the democratic system. I do not think you can apply that in the shareholder system. However, because I am talking about maximising shareholder participation, I want to ask you on notice if you could give some thought to this proposition. Should sophisticated investors—namely, those who manage and

control unit trusts on behalf of other shareholders, those sorts of people—be obliged to vote in all company voting situations and should they be prohibited from giving proxies? In other words, should they have to make a decision about the matters, as a duty of care for the investors?

Mr Elliott—There is a style of approach to that.

Senator MURRAY—I would be obliged if you could give us a response on notice.

Mr Grant—I would like to add a short comment. This is a little anecdote following Mr Ciobo's comments or questions. My observation in the last decade since we had the excesses of the 1980s and so-called creative accounting is that directors have been far more diligent and far more independent in their actions than they were before. An example of that is that I was talking to a partner in a second tier firm that does a number of public company audits that have tended to be smaller ones. He related the story that on four occasions they had had disagreements with management over an accounting issue. They went to the board and on four out of four the board agreed with the audit firm and said to management, 'Fix it.' They took the stand and they overrode the management view after due consideration. I think that is an anecdote worth noting, just to demonstrate that I think boards today are much more rigorous and much more independent minded than they were a decade ago.

CHAIRMAN—Gentlemen, thank you very much once again for your submission and for coming here. We look forward to receipt of the further information that you have promised.

Proceedings suspended from 1.10 p.m. to 2.00 p.m.

[2.00 p.m.]

HULLAH, Mr Nicholas Peter, Partner in charge of the Professional Standards Review, Deloitte Touche Tohmatsu

WYLIE, Mr Robert Harvey, Senior Partner, Deloitte Touche Tohmatsu

CHAIRMAN—I welcome the representatives from Deloitte Touche Tohmatsu who are appearing at today's hearing. We have received your submission, for which we thank you. I am bound to ask you if you would like to make an opening statement. If the answer is yes, please make it extremely brief because we have lots of questions, which we think are more important than the opening statements.

Mr Wylie—I have some brief notes which highlight some issues that were not in our recent submission.

CHAIRMAN—Could you make that very quick—no more than two minutes, please.

Mr Wylie—Certainly, I will be as brief as I possibly can. Thank you for the opportunity to address the committee today. Can I say from the outset that Deloitte Touche Tohmatsu believes a strengthening of the audit framework in Australia is actually long overdue. We agree that it is important to take steps to restore the faith in the financial statements of Australian corporations. Firstly, we believe that the Corporations Law should be amended to provide tougher penalties for misleading auditors. In Australia, it should be a criminal offence for management or the directors to mislead an auditor by either the omission of information or the provision of false information.

Secondly, Deloitte strongly believes this committee should recommend that the scope of the audit of corporations be extended. For example, we advocate extending the scope of the audit and the audit report to cover risk management procedures and internal accounting controls, as well as key performance indicators other than earnings per share. Complementing this measure will need to be a reform of the professional negligence liability provisions of the auditing profession to deal with the expanded responsibility of the auditors. Of course, a tougher audit with a wider scope will cost companies more, and some chief financial officers may blanch at the additional cost. If it is wider and it enhances the confidence of shareholders, then so be it. Deloitte believes that the role of the audit committee within companies should be substantially toughened. Typically, for example, one of management's key performance indicators is to cut costs in their organisation. They may resort to a bare bones audit purely to keep costs down.

Non-executive directors must be given a more active role in overseeing the audit committee and ensuring that the audit function is accorded its true importance. The audit committee is the logical forum for the non-executive directors to take the lead in the interdependent relationship between auditors, management and the board. In this regard, directors should choose the auditor rather than rely on management's recommendation; decide the scope of the audit and negotiate the audit fee; and approve the provision of other known auditor services in lieu of management.

Deloitte also believes that this committee should use this inquiry to examine the area of share price manipulation. Those managing companies now have the real prospect of making themselves seriously wealthy through generous share and option schemes. This prospect has created an overemphasis on managing the share price and the drivers of share price. We believe that boards should review the way they remunerate senior executives so that executives are only rewarded for actual wealth accumulated by the companies they are managing rather than simply reaching a target share price on a fixed date.

Finally, Deloitte believes that Australia can learn from the spate of corporate collapses here and overseas and implement reform to help prevent a recurrence of the financial disasters. Deloitte believes that Australia should establish a body to investigate companies that have collapsed. Our global firm has recommended a similar organisation in the United States. To put this in an aviation context, the Australian body would be akin to a bureau of air safety investigation which examines aircraft crashes and makes recommendations on how future errors can be avoided. This body's focus should be to examine why companies have collapsed and provide a forthright direction on how a similar collapse can be prevented in the future. That concludes my opening address.

CHAIRMAN—Thank you. Just before we were about to break for lunch, I noted to several of my colleagues that there seems to be a little unanimity of view among those responding to this inquiry as to how to handle each of the issues and no unanimity of view as to what the issues are. We are going to have some difficulty coming to resolution, as I suspect the Treasurer ultimately will.

I will ask you a question that I have asked everyone who has appeared before this inquiry, and I will get it out of the way now. It concerns the Corporations Act requiring that an auditor be a 'natural person'. Your company is a huge corporation without being incorporated. What is your view of auditors being incorporated companies versus natural persons?

Mr Wylie—In line with our submission on the professional negligence issue, we would support the concept of limited liability, and incorporation could be a very good vehicle for achieving that.

CHAIRMAN—If you were to become a listed corporation, then your firm would be subject to audit. How would you also view a requirement that there be a performance audit of your independent functions?

Mr Wylie—Listed companies in the professional services that we are in are not a particularly satisfactory solution. You only have to look at some of the recent listings of consulting firms to see that it does not work particularly well. I am not sure how the audit of an entity's financial statements would actually add anything to the quality of the services that they are delivering. In regard to the processes we have in place right now to satisfy the quality and the integrity of the services that we deliver, there is a very comprehensive process in place which encompasses internal quality assurance processes, peer reviews, reviews by the Institute of Chartered Accountants. My colleague Nicholas Hullah is responsible for what we call the quality and integrity processes within our firm. So if you want a detailed description of all of those processes, he would be able to provide you with that.

CHAIRMAN—If you could send that to us, we would appreciate it.

Mr Hullah—I am happy to provide you with that in written form if that is more useful for you.

CHAIRMAN—That would be very helpful indeed because your submission has raised quite a large number of questions that I think we will want answered. One issue you raised said that the scope of the audit should be expanded to cover governance, risk management and internal control aspects relevant to shareholders and that appreciation of the company should be reported in plain English. You are, in effect, recommending or proposing that we have performance audits of publicly listed companies. Can you tell us how you balance this conflict experienced by the auditor when completing his performance audit? On one hand, the auditor wants to report fairly, truly, openly and honestly what he believes to be the case and, on the other hand, the auditor is frightened to death that in doing so the company shares will go down and the audit firm will lose the work.

Mr Wylie—I would not see what we are proposing as a performance audit. I think it is a natural extension of the work that auditors already do in the area of internal controls and in risk management because, as you would be aware now, modern audits are risk based. The other point I would make—as we said in our written submission and as I also said in my opening remarks—is that without some extended liability protection, it would be impossible for the profession to extend the scope of its audit into the areas that we are suggesting.

CHAIRMAN—I will move on. Some commentators seem to be unaware that a true and fair value override already exists in the Corporations Law. Would you like to expand on that? We seem to have a different view about whether auditors are reporting on adherence to the Australian accounting standards—whether they are Australian or international—versus the requirement to report a true and fair view of the state of the accounts of the company; that is, the balance sheet and the profit and loss statement. Can you expand on your comment? We certainly have a difference of view from those responding to this.

Mr Wylie—I can only give you my view, which is that, in Australia, we collectively—the auditors and the preparers of accounts—are required to have those accounts prepared in accordance with Australian accounting standards, but should there be a view that that alone does not give a true and fair view, then additional information should be provided in the notes to the financial statements.

CHAIRMAN—But is that clear in examination of both the Corporations Act and the auditing standards?

Mr Wylie—I can only say that that is my understanding. I believe it is clear.

Mr Hullah—I think it is quite clear. The Corporations Act requires that the financial statements be prepared in accordance with accounting standards but, if it does not provide a true and fair view, then there is a requirement to provide additional information to provide that true and fair view. But your first point is that you must comply with the accounting standards. That permits comparability of financial statements from one company to another and it does remove the capacity of preparers of financial statements to prepare accounts according to what they

believe to be true and fair, because they have first got to provide them according to the accounting standards.

CHAIRMAN—I will read from the Corporations Act. I have already read this once today:

> The financial statements and notes for a financial year must give a true and fair view of:
>
> (a) the financial position and performance of the company, registered scheme or disclosing entity; and
>
> (b) if consolidated financial statements are required-the financial position and performance of the consolidated entity.
>
> This section does not affect the obligation under section 296 for a financial report to comply with accounting standards.

I am sorry, but I do not know exactly what that means. There appear to be differing views amongst the accounting profession, the auditing profession, the companies and, indeed, individuals who are shareholders as to what it means.

Mr Wylie—In that case, it ought to be clarified. I do not think that this is really the issue because, at the end of the day, in countries where the true and fair override still exists, it is also stated that the necessity to move away from accounting standards in order to show a true and fair view should be very rare.

CHAIRMAN—This will lead us, I would think, naturally into the issue of: what do you report and where do you report it? If you report only a note on the balance sheet, there may be some question in your mind about whether the company has been accurately expensing those items which should be expensed or put into the capital account and those items which should be capitalised and depreciated. If there is some question in your mind, my understanding is that generally, in the Australian context, we have a propensity to provide that as a very quiet little note rather than a bold statement on the balance sheet that will wind up in shareholders' hands and give them perhaps cause to ask questions if not cause for concern.

Mr KING—The problem, Mr Chairman, seems to be that the act obliges the auditors to 'give a true and fair view', but there is no requirement for any statement to that effect on the accounts. All you have to provide is that the accounts reflect the Australian accounting standards. Is that the sum of the position?

Mr Wylie—The auditor's report does use the words 'true and fair'. But, as I stated before, in Australia you are required to prepare the accounts in accordance with Australian accounting standards.

CHAIRMAN—I have now moved on from that; I am now talking about the report.

Mr Wylie—The annual report?

CHAIRMAN—Absolutely. There is no other place that I am aware of that you as auditors report to me as a shareholder.

Mr Wylie—That is correct. I would like to point out a couple of things. First of all, the financial statements must be read as a whole. You must not just look at the balance sheet, the profit and loss account and the cash flow statement; you need to look at all of the notes as well to get a full comprehension of the financial statements. The other thing is that important accounting practices and policies are required to be stated up front in the notes to the financial statements. They are usually in note 1. So by reading that you should be able to understand how companies are preparing and compiling their accounts or understand the important accounting standards that are being applied in preparing the accounts.

CHAIRMAN—There are dogsbodies that are doing all the legwork. They are doing the auditing and accounting work on the ground to check and see what the company is actually doing. They are testing various hypotheses, including stock and valuation and capitalisation—all those things. It has been said to us that if you went back and examined their audit files—and I am not talking about partner files—of a company that has collapsed but with a clean set of books, inevitably you will find absolute evidence that the auditor found that things were going bad, that there were very questionable practices or that something was wrong. Yet at partner level there have been examples where a partner has signed off, notwithstanding that he had been advised of this. How do we get a better disclosure regime?

Mr Wylie—I am not sure that I understand what sort of information you want disclosed that is not already disclosed.

CHAIRMAN—Are you trying to tell me that, if we put an internal auditor through your firm and they examined the audit work of companies for the last 10 or 12 years, they would find no examples of questionable accounting practices or accounting practices that perhaps should have been disclosed to the shareholder, to the board of directors, to the owners of the company? Yet such statements never wound up in the annual report. You are confident that will never happen?

Mr Wylie—The processes that we go through to satisfy ourselves that the company is complying with its stated accounting standards, policies and practices—and let us assume that its stated practices are in accordance with Australian accounting standards—and complying with the Australian accounting standards are very rigorous. They include several levels of review, and within that process you can often find differences of opinion at various levels within the organisation, even at partner level. Our processes require us, at the end of the day, to refer all of these grey or questionable areas to our national technical group. The group has the final say, not the partner signing the accounts. That is part of our quality assurance procedures.

CHAIRMAN—Professor Houghton has recommended that every audit firm have an internal board or group that examines the 'independence' issues for that firm. Do you agree with that?

Mr Wylie—Personally, I am very attracted to that process, and we are looking at it. The question is this: would the shareholders be attracted to that? The whole point of that recommendation is to provide more transparency around the procedures that audit firms have, and I think that is good. Will the shareholders believe us? That is the only question. Otherwise, I am attracted to that recommendation.

CHAIRMAN—How about if it was external?

Mr Wylie—There already are external processes of review around our quality control processes. Apparently, the shareholders do not see much value in that. So, if this helps, we would be in favour of it.

CHAIRMAN—The ASX says that independent audit committees for publicly listed companies are a great idea but would be destructive of businesses that are too small to be able to afford to have a number of outside directors. How do you respond to that criticism when you recommend that audit committees be mandatory?

Mr Wylie—I think you will find that something like 97 per cent or 98 per cent of the capital value of the Australian Stock Exchange or companies representing that sort of proportion already have audit committees. So I am not so much concerned about whether it is an audit committee or whether it is the full board. My point is that it should be the non-executive directors who drive the process.

CHAIRMAN—What happens if there are no non-executive directors?

Mr Wylie—Then the shareholder should consider whether they should be investing in that company.

CHAIRMAN—I am sure they will.

Mr Wylie—Good. It is their decision.

CHAIRMAN—Don't they do that every day?

Senator MURRAY—No, they do not, and that is the problem: they are unsophisticated. Before we go down that particular borough, you are a partnership, aren't you?

Mr Wylie—We are.

Senator MURRAY—What national laws govern partnerships?

Mr Wylie—That is a good question. I do not know that I can name the statute for you. I will get back to you on that.

Senator MURRAY—I deliberately asked you that because Corporations Law governs companies, but there is no national law governing professional service companies. If the device to get you audited is in fact to push you into the Corporations Law, through incorporation, perhaps there are other mechanisms which could be used. Do you think it is time for COAG to put together a national professional services law?

Mr Wylie—I really had not considered that issue so I cannot give you a considered answer. I am still not sure why you want a financial statements audit of the auditing firms and what you see that would do in terms of improving the quality of audits.

Senator MURRAY—It has been a line of questioning the chairman has been pursuing, but there is also the issue of consistency and standards. My understanding is that professional firms such as yours—lawyers, accountants, valuers and all those sorts of firms—are governed under state laws, which vary. I am an extreme critic of much of our federal system because of the inconsistency in rights and obligations that apply to Australians and Australian organisations. If we now have national laws to govern companies and their responsibilities and duties under law and to cover financial institutions—which, finally, two years ago, we got after 100 years of trying—perhaps it is time to bring all professional associations under laws which establish their duties and responsibilities and how they are to be governed, in the same way that you do with corporations but, obviously, respecting the different structure.

Mr Wylie—I do not disagree with you, but I fail to see what that would do to affect the quality of the services we deliver. You are talking about governing the firm from a management perspective and auditing the financial statements of audit firms. I have no objection in principle to it, but I fail to see what difference it would make.

Senator MURRAY—Different propositions are being put to the committee. I am not chasing this particular one, I might say. As far as making you into a publicly listed company, I can see some difficulties with it. But the proposition you put up is that either oversight boards, which is a PricewaterhouseCoopers approach, or a reformed version of peer review or some structural changes are necessary to assure people that the processes of audit companies themselves are subject to proper oversight. The committee eventually will come to a view as to what they think that should be. I am merely suggesting that to try and force partnerships into Corporations Law in order to gather up some of the corporate governance mechanisms which are in Corporations Law might not automatically be the best way to go. It may be better to have a separate national body of law agreed to govern professional services companies. That is all. I will leave it at that.

The next issue relates to your remark about tougher penalties for misleading auditors. What you are referring to there is that, if you ask a question and you as an auditor are misled or lied to, there should be a tough penalty on the executive or that person responsible. I agree with that. However, there is a different area of interest, and that is when you have not asked the question and a whistleblower might be needed to bring the matter forward to you. There is no specific protection for whistleblowers in this country. There is common law protection in certain circumstances. Do you think that whistleblowing protective devices should be inserted so that people within companies who come forward to auditors or to any regulatory body should be protected from being victimised as a result of their actions?

Mr Wylie—I have no particular view about regulation in that regard. It is very hard to regulate that sort of thing. What do you call ‘victimisation’?

Senator MURRAY—The difficulty is that confidentiality agreements are often used to clamp down on individuals who might otherwise come forward and say to you that a contract has been structured in such a way that it is rorting the company or that an issue is highly improper. In other committees in other places, private sector whistleblowers have outlined these very real problems in their lives. Surely you want a device to encourage whistleblowing into the right ears which, to me, would seem to be the external auditors, ASIC or someone of that kind.

Mr Wylie—That seems reasonable. I really do not have much of a view on the subject. I have not considered it greatly.

Senator MURRAY—The last question I have is about audit committees. You put a great deal of store by them in your submission. My understanding is that the ASX were actually quite critical of the view that they could be a save-all provision. It is quite clear to me, from both the evidence I have seen and my general judgment of publicly listed companies, that if those who are the worst performers have excessive management control or if they have excessive control by a particular financial interest, the audit committee is useless because it is a creature of a distorted and corrupted board. Surely you need to find a device whereby the non-executive independent directors are genuinely independent.

Mr Wylie—You would be familiar with the Blue Ribbon Committee recommendations in the US in that regard. Again, I come back to the fact that it is very hard to legislate against bad judgment and corrupt practice. I am not sure that we should believe that boards are generally corrupt.

Senator MURRAY—I did not say that; I said the worst examples.

Mr Wylie—The worst examples, perhaps, yes. I believe that the mechanisms in place already to appoint directors are adequate. I think shareholders have the opportunity to have their say with regard to the appointment of directors. I am not sure that there is another mechanism that makes better sense. At the end of the day, the quality of the directors on boards is really important. We believe that directors are the key to this issue. For that reason we have put a lot of emphasis, as you have said, on the role of the non-executive directors with regard to the appointment of the auditor, the remuneration of the auditor and the determination of the scope of the audit, as well as the issue of what other services the auditor provides. We believe that if directors step up to that, as we all need to step up, we will have a reasonably workable framework.

Senator MURRAY—My assumption is that the assumption of most people is that the process for electing directors is a good one. In another committee I have seen academic evidence which compares provisions within company constitutions. It compares the actual process of putting up directors and looks at the way in which they have laid out the kind of information that is put out as allowing for boards to be rigged—in other words, for them to be elected in a manner which ensures that the choice of the board gets on top. I think it is an assumption that in every case in publicly listed companies the company constitution guarantees the best process for electing directors. Have you ever as a company actually examined on a comparative basis various company constitutions, to establish which is best practice for the election of directors and for guaranteeing the best sort of board?

Mr Wylie—I am not aware of specific research that our firm has done, but I think you are alluding to the European or the German model, where there is a sort of advisory committee.

Senator MURRAY—No, I am not. It is an Australian case.

Mr Wylie—We have not done research within Australia on that concept, no.

Senator MURRAY—Thank you.

Mr KING—Thank you for your detailed submission. You seem to be prescribing the approach of broader responsibilities and powers for auditors as the way forward in dealing with the over-mighty director and the rogue executive. As the public, communal price for that, we deal with the problem—which has arisen in other areas—of addressing the liability level of auditors and possibly caps and so on. Would you care to frame a standard of care that you think is appropriate for auditors to be judged by in the conduct of their work?

Mr Wylie—I am not sure that I would want to do that right here and now, but I would be happy to respond to that in writing.

Mr KING—There are several possibilities. You could have the common law duty of care, you could try something which no reasonable auditor would do or you could try a level of recklessness or even fraud. There are other possibilities in between. When you made that submission, did you have in mind any of those possible standards?

Mr Wylie—I am not sure that we necessarily were envisaging any change in the existing standards. We simply believe that the audit scope ought to cover these other areas.

Mr KING—I am now talking about civil liability. If you are going to impose greater standards and responsibilities in accordance with one perception of community expectations, you are going to expose yourself to greater levels of liability in respect of that work. But you have argued for both a reduction in that exposure and capping. I am asking you: where will you set the threshold in terms of the standard?

Mr Wylie—I am not sure that I am able to respond to that right now.

Mr KING—A duty of care.

Mr Hullah—In relation to that liability issue, our strong belief is that there has to be a substitution of the joint and several liability with proportionate liability. That is the foremost reform that is necessary.

Mr KING—Proportionate with what?

Mr Hullah—Proportionate with the amount of damage that we cause. As things stand at the moment under joint and several liability, if a loss occurs and we are judged to be partly responsible and the other party—

Mr KING—Contributed.

Mr Hullah—We contributed—there might be contributory negligence from the company itself, its directors and so on, but because they have do not have the deep pockets that we have through our professional indemnity insurance, we are potentially liable for 100 per cent of the blame. We believe very strongly that that is inequitable.

Mr KING—So you would not have a problem with the continuation of the standard of care that currently exists, or do you just want to see a pro rata allocation of liability in quantum?

Mr Hullah—We think that also the New South Wales system, under the professional services act, of a cap which is determined according, perhaps, to the level of remuneration is a reasonable reform as well. But we are not arguing for a change in the laws in terms of our responsibility and our duty of care to the shareholders.

Mr CIOBO—I am interested, Mr Wylie, in what you, from Deloitte's perspective, see as the principal threats to a quality audit.

Mr Wylie—More and more as financial instruments and as company structures and commercial transactions become more complex, our major threat is our ability to have the quality and variety of people and experience that we need to have in our audit team to audit the sorts of complex organisations we come across today.

Mr CIOBO—I take it from that answer that you would rate undue influence, for lack of a better term, by the management or directors of a company on the auditor as being below that.

Mr Wylie—I would say that, yes, it is definitely below that. I am not suggesting it does not happen but I am suggesting that the No. 1 issue is having good quality people who can do a good quality audit. That is the major threat for us today.

Mr CIOBO—I am interested in the latter aspect that I raised—about undue influence. We have had testimony from others that has indicated that that is a very real factor. I am interested that, from your perspective, it is not as high as others have claimed. In that respect, I am just wondering what your reaction would be to, for example, whether or not tenure of the auditor provides a safeguarding against the exercise of undue influence or whether you perhaps believe there is another mechanism that might help circumvent undue influence.

Mr Wylie—I think the tenure issue is an important one. It is very good to see that in Australia there are quite significant protections which make it very difficult for a company to dismiss an auditor, particularly when there is a dispute. That sort of protection does not exist in other countries, such as the US, for example, so that is good. I think we should continue to see that. So, yes, tenure is an important issue.

Mr CIOBO—In summary, would you say that the current safeguards are adequate or does there need to be a further strengthening?

Mr Wylie—I think this is an important reason why I would like to see the non-executive directors take a more active role in the relationship with the auditor, rather than management. I think that will also contribute significantly to this issue of undue influence.

Mr CIOBO—I am just trying to get my mind around whether or not there is a general perception in the commercial marketplace about which comes first, in terms of the cart or the horse: is it the board or is it the CEO et cetera? I take it that your feeling—to paraphrase what you just said—would be that the board is the most appropriate body responsible for oversight of the auditor's role.

Mr Wylie—Yes.

Mr CIOBO—So would it be worth while, given that the CEO signs off on financial statements, to attach liability to that? It has been suggested to us that perhaps that could even involve jail sentences for fraudulent declarations. Would that be something you would support?

Mr Wylie—I think that is very similar to our recommendation with regard to giving an auditor false information, so yes.

CHAIRMAN—You have stated in your submission:

- Deloitte supports updating audit independence standards but does not support the Corporations Act being amended to incorporate a requirement that the auditor the independent; ...

Could you tell us why?

Mr Wylie—We believe that the auditing standards, particularly the new F1, which is in line with the IFAC standards, are appropriate. We are now consistent in Australia, having adopted F1, and Deloitte have met made the decision to adopt F1 early, so we are world class in terms of those standards.

CHAIRMAN—What negative impact would changing the Corporations Act have on you?

Mr Wylie—There is already something in the Corporations Act. Again, I cannot quote you the particular area, but there is already a statement—

CHAIRMAN—You said you do not support the Corporations Act 'being amended to incorporate a requirement that the auditor be independent'. I just do not understand why you are so against it—I am having difficulty.

Mr Wylie—I do not think it is the biggest issue that we have in our submission.

Mr Hullah—Mr Chairman, could I just add to that because I have been partly involved with that. We just do not believe that putting those words into the Corporations Act is going to materially help it. They are going to the questions of interpretation. We think the interpretation of independence is there in F1 and in the professional standards, so putting it—

CHAIRMAN—What you are saying is it is not a big deal?

Mr Hullah—It is not a big deal.

CHAIRMAN—Thank you. We have had put to this committee that it should be a requirement of the Corporations Law that the whole audit firm, not the partner or the natural person but the audit firm, be rotated every five years. Your response to that recommendation?

Mr Wylie—We do not support that recommendation for a number of reasons. First of all, by the admission of people who have been promoting that idea, the first two years of the auditor's role in a new audit are quite inefficient. But also there is research to show that those first two

years are quite ineffective, because in fact it has been shown that there is an increase in the undiscovered management fraud during those first two years. Could you imagine, for example, the automotive manufacturing industry accepting a new law which would require them to change their production processes to build in 40 per cent inefficiency and also an increase in the defect rate? It does not make any sense.

CHAIRMAN—Would you mind sending us that research you have quoted?

Mr Wylie—Certainly.

Senator MURRAY—Just to add to that: are you against rotation altogether or is it the five years that bothers you? If it was seven or longer, would you agree?

Mr Wylie—We are against rotation of audit firms. We do have already within our firm a requirement for audit partners to be rotated every five years.

CHAIRMAN—It won't do Andersens much good, will it! You have come on very strongly on this issue of compulsory audit committees made up of independent members of the board. Is my understanding correct, from what I have read in our press, that Enron, WorldCom and Xerox all had independent audit committees?

Senator MURRAY—Not independent.

Mr Wylie—I am not sure of my facts but I would have thought they all had audit committees.

Senator MURRAY—Yes, that is right.

CHAIRMAN—Thank you very much for your submission and for coming with your honest and frank answers today. We would appreciate responses to the questions that we have left on notice. We intend to wind this inquiry up so we can report in late September, or early October at the latest, because we intend to be very much a part of the CLERP 9 process. We appreciate your cooperation.

Mr KING—Mr Wylie, in responding to the chairman could you indicate what the cap is that you think the legal liability should have? You mentioned it in your report and I thought you backed away from it in your response to a question from me. As I understand it, you do advocate a cap, amongst other things, and I would like to know what you say it is.

Mr Wylie—We will put that in. We do advocate a cap but we believe proportionate liability is more important.

Mr KING—I see that.

CHAIRMAN—Thank you very much again.

[2.47 p.m.]

McDONALD, Mr Robert, Senior Vice Chair, International Board, Institute of Internal Auditors—Australia

McROSTIE, Mr Christopher, Executive Director, Institute of Internal Auditors—Australia

MIDDLETON, Mr William, National President, Institute of Internal Auditors—Australia

CHAIRMAN—Welcome. Thank you for your submission, which we have received and read. When we reopened after lunch, I said that, from our inquiry so far, there appears to be no unanimity of view about resolution of any of the issues. In fact, there is no unanimity of view about what the issues are. You raised some new issues that we have not comprehensively discussed before, so we thank you for that. Do you have a very brief opening statement before we go to our penetrating questions?

Mr McRostie—We do, and I would like to ask our Senior Vice Chair to make the statement.

CHAIRMAN—A very brief statement, please.

Mr McDonald—The Institute of Internal Auditors has been in existence world wide for 61 years. We have over 77,000 members throughout the world in over 120 countries. We have a designation certified internal auditor, which is a four-part examination. We have over 36,000 CIAs world wide. The institute has a true set of international standards for the professional practice of internal auditing, one of the few bodies in the world to have that worldwide recognition.

I have just returned from Washington DC from the 61st international conference of the institute. We had nearly 1,500 participants from 76 countries represented, which was a record in terms of country positions. I have a position paper that I would like to table from IIA headquarters in terms of the position on internal auditing and corporate governance processes post Enron and others.

Mr KING—That is hot off the press from the United States.

Mr McDonald—It is a document in progress. It is labelled 'draft' so that we can table it for those organisations. It has been presented to the Securities and Exchange Commission and a number of congressional committees in the US.

CHAIRMAN—At the risk of being a little bit flippant, I would advise you that the committee is 89 years old. In your submission, you note that there is a marked trend toward the outsourcing of internal audit function, with much of the work being picked up by firms that also provide external audit and other consulting services. You say that external auditing and internal auditing are significantly different in purpose, objective and required skill sets. Would you expand on that for us?

Mr McDonald—Yes. The role of external audit is primarily to look at financial statements to attest that they are a true and fair representation of the operations of the organisation and that the organisation is still able to operate as a going concern. The role of internal audit should be to look at the entire gamut of the organisation, from the strategic level right through to the business level and down to the operational level in all aspects. In my view, about 30 per cent of internal auditing should be looking at compliance—auditing of financial statements and financial reporting—but 70 per cent of the time should be looking at the risk areas of the organisation: things like legislative compliance, the risk assessment and risk management structure of the organisation and governance structures—liaising directly with the audit committee, for example.

CHAIRMAN—Who should the internal audit committee report to in a public company?

Mr McDonald—To the board through the audit committee and, administratively, to the chief executive officer and not the chief financial officer.

CHAIRMAN—What mechanism then does the CFO have available to her or him to ensure themself that the internal operation of their financial accumulation system is working properly?

Mr McDonald—That should be a combined effort of management and audit committee. The internal audit unit should be providing a specific annual work plan with a three- to five-year strategic plan. The plan should be made up through a risk assessment process with adequate consultation with senior management, particularly the CFO and the CEO, and the plan should then be signed off by the audit committee. So, at the end of a day, the CFO is also reporting to the audit committee through the CEO.

CHAIRMAN—One of the major purposes for this inquiry—and indeed other private inquiries—has been to tease out how we should go about assuring the public that, when they read a financial statement which is signed off by an auditor, they are getting reasonable advice from the directors and reasonable advice from the auditor who says, 'The directors were pretty right,' when they invest their money in that publicly owned company? Isn't there a conflict of interest between internal and external audit in that respect?

Mr McDonald—No, the internal audit area and the issue that we have been talking about—the reporting mechanism through the CEO to the audit committee—is certainly one about independence. If you have the internal auditor sitting under the chief financial officer, there is a real potential conflict of interest because of those issues about, 'Don't tell me about those accounting practices or the interpretation of those standards.' The audit committee needs to be hearing those directly from the chief audit executive. That is the issue about setting up the transparency.

CHAIRMAN—Mr McDonald, aren't you proposing that we overregulate the private sector when we tell companies how they have to structure their operations internally? I would have thought that was a bit beyond the pale, quite frankly.

Mr Middleton—From our point of view, a number of things have to come together in the corporate governance structure. We see that the audit committee, as part of the board committee, needs to made up of only independent directors. There are a few planks to this. You need an audit committee made up of independent directors, and it should be mandatory that there be an

internal auditor who reports to that audit committee. The annual report should include a report on the activities of the audit committee, the activities of the internal auditor, the status of internal control and perhaps the status of risk management. The fourth part would be the external audit—that is, if they were in a position where they were providing only external audit activities, as against internal audit and other consultancy activities. With that full group of things being mandatory, being managed internally and operating in publicly listed companies, it is not that onerous; it is just a matter of establishing the regime that would then given a lot of independence to the audit committee, a lot of independence with the decisions that are being made and a lot of independence to the scrutiny that comes from the internal and external auditors. So it is putting some meat behind the guidelines. There are guidelines on all of these issues, but if it is structured properly internally, I think that would tend to give good coverage for your stakeholders and the public at large.

CHAIRMAN—If I were to ask Dick Humphry, representing the Australian Stock Exchange, how he viewed your proposal, do you think he would view it positively?

Mr Middleton—Absolutely. I do not know if that view has been put forward. We are not representing any group apart from, I guess, internal auditors. We have worked with a lot of other agencies. We have put out guidelines on audit committees—I do not know whether they have been tabled—and we have worked with other groups in that. Our whole aim is to promote the role of internal audit—that is understandable—but we have no vested interest in that, apart from looking after our members. In putting this proposal forward, we believe, and our members would believe, that this sort of independent scrutiny, internal to the organisation—and external, with the external audit—helps put together a package of reform that is easy to implement and would offer that degree of independence that I think the public is looking for.

Senator MURRAY—I note that the acronym for the company independent auditor is CIA! If you want to control someone, you have the power to hire and fire. Reporting to the board is one thing, but if the power to hire and fire remains with management you still have somebody who is subject to control. Would you be suggesting that, as well as reporting to the board, the board have the power to hire and fire the internal auditor, so that the chief internal auditor is fully an officer of the board and not of management?

Mr McDonald—There is a particular issue on that aspect in the institute's standards. It is our stance that the audit committee should be instrumental in or part of the process for the hire, fire and remuneration for the chief audit executive, not for the auditors who work within the team—that is the CAE's job. Certainly the audit committee—not the direct board but rather the audit committee—should be part of the selecting and firing process.

Senator MURRAY—Whistleblowing. We had a witness earlier who gave us a moment of amusement by recounting the times when there was knocking on the door late at night and threatening behaviour. He was an external auditor and his firm were external auditors. I would think if you are an internal auditor the chances of intimidation are increased with a thuggish management. I am not suggesting that is the norm in Australian companies, but I am suggesting that it does happen sometimes. Do you believe the process of internal governance, standards and the willingness to expose wrongdoing would be improved if the Commonwealth introduced some whistleblowing provisions to cover the private sector to protect people who inform internal and external auditors of concerns?

Mr Middleton—The whole issue of whistleblowing is very difficult to manage. I know that internally in the New South Wales government there is legislation, the Protected Disclosures Act, to protect whistleblowers in the state government sphere. From my experience, whilst that does happen and it can be encouraged, there is no real protection for those people ultimately, if they want to maintain their anonymity. At the end of the day, that tends not to be able to be done. You do your best, but their anonymity can never be guaranteed. So for a while, perhaps, it may be a deterrent and people would report but, unless action was taken to protect the anonymity of the whistleblowers, it would probably come to nothing in the longer term. People already have the power to write to their local member. They write to companies and the regulatory authorities. It is a matter of what they do with it that becomes a problem. Although anything is better than nothing, I do not think it would be the be-all and end-all.

Senator MURRAY—I suspect from your answer—do not take this critically—that you probably have not read enough about it or looked at it enough, because the public sector whistleblowing acts which are in existence not only punish people who victimise a whistleblower but provide means for compensation. You recognise that if you cross that boundary you are in trouble, and sometimes people lose their livelihoods. I will leave it at that.

The other issue I want to raise with you concerns non-executive directors. Under item 4, page 6, you said that the audit committee should be comprised of non-executive directors only. I have hardly ever come across a non-executive director who does not get onto the board as a result of either the dominant management interest or the dominant financial interest. In other words, they are not independent. They might be people of great standing and integrity, but they are not independent. The only process that I have ever been able to come up with which delivers a truly independent non-executive director is if someone is elected on the basis of one vote per shareholder, not one vote per share. How do you ensure that the audit committee is not the creature of the dominant financial interest or the dominant management interest on a board?

Mr Middleton—I do not know how you would ensure it. These issues I think are related to the tone at the top and the ethics of the whole organisation. I would imagine that most organisations would know who would be a good independent director and would appoint that person. If that independent director has their own ethical standards et cetera and has the fortitude to do the job that they are supposed to do, most of the problems in an organisation would be solved. However, there are those that are there for their own benefit and it does not matter what rules you put in place, they will do it for their own benefit.

Senator MURRAY—This committee has to attend not to the bulk who are operating well but, as with all law, look at the minority who do not. Therefore, we are trying to ensure they are independent as well as non-executive. The non-executive directors issue has always been developed with a view to independence. Now, I accept that there are more independent executive directors. I am putting the proposition to you that they are never, in our Australian situation, except in rare circumstances, truly independent because they get on there as a result of the dominant financial interest or the dominant management interest. Would you be averse to a company adopting a system, if they so choose—because there is great resistance to it, I might say—of electing truly independent non-executive directors through the process of one vote per shareholder? In other words, the financial interests could not dominate that appointment.

Mr Middleton—I think that would certainly be a very positive step.

Mr McDonald—Yes. At the end of the day, I think we tend to forget about the issues and the individual shareholders. A lot of the instances that we have seen over the past few years are not really about the failures of our systems and governments; they are really about individuals' need to gain more for themselves and forgetting about the shareholder interests. So I would certainly look to your solution as one method of doing that.

Mr CIOBO—It has been suggested to the committee that there are examples of directors being unable to perform their duties adequately because they have spread themselves too thin. I an interested in your comments on that. Secondly, do you perceive that an internal auditor may have a role in assisting to determine whether a director is able to fulfil their responsibilities?

Mr McDonald—It is certainly an issue for me. I am asked to speak at a number of conferences around the world, and one of the issues that I raise with folk is the role of the internal auditor as the educator of the audit committee and also the corporate conscience for the audit committee. That is, who are the people who have been selected to be on the audit committee? Are they doing their job? When they come to an audit committee meeting, are they coming prepared? That is, have they preread all the material that is provided for them so that they can have a meaningful input? Do they attend regularly? There are other internal issues, like how long does the audit committee meeting go for? If it only meets three times a year for an hour, it is a waste of time. They should be meeting several times a year and devoting the time necessary to get through the agenda. So, yes, I certainly see the role of the audit committee as looking at the qualifications of those members. I would suggest that you do not want an audit committee that is made up purely of accountants, economists or engineers. You would want an audit committee that has financial and financial statement expertise; depending on the industry, you would want some expertise from the industry as well; and then you would want some folk who have no idea, so that they can ask, 'What does this mean?'

Mr CIOBO—You have confined your comments there to the audit committee. Can it be applied more broadly as well?

Mr McDonald—It can be applied up to the board. If you are looking at a good governance process, at the end of the day, I believe so.

Mr CIOBO—In your submission, you contend that internal auditing should be recognised as a separate profession and that internal auditors should be registered. How would you see that working in conjunction with the professional accountancy bodies? How would you see the development of internal auditing standards? Should they be enforceable in the same way that external auditors' standards are?

Mr McDonald—I think a couple of us probably need to answer this question. Firstly, we have our standards for the professional practice of internal auditing, which are international and which the CIA examinations are based upon. So that is not an issue. In terms of the accounting body, as I said earlier in my testimony, the role of the internal auditor is different—and must be different—from the pure role of the external auditor, who is focused directly on the financial aspects of the organisation. Internal auditing must go beyond 'tick and flick' compliance and extend the scope to all aspects of the organisation. In terms of registration, Chris?

Mr McRostie—We took the position with registration that internal auditors—the senior internal auditor or chief audit officer—need to sign off on their work. I think that is one way of saying, 'This person is qualified to do that.' If they are providing information back to the audit committee, that signing off is a significant indication that that has been done and complied with, and a recognition that it has been done with a registered or qualified person. I guess it is taking a view similar to the registered external auditor approach, that you have someone who is clearly qualified in that area.

Mr CIOBO—Sure; they are signing off on it. My final question is with regard to CEOs and CFOs signing off on financial statements. What is your position with regard to the attachment of liability to that process and the suggestion that there should even be jail terms associated with misleading statements to that effect?

Mr McDonald—It is something that we have not had in the past which may perhaps have made a difference.

Mr CIOBO—That is well phrased.

CHAIRMAN—In your submission you said:

We suggest that one of the Board's—

that is, the Auditor Independence Supervisory Board, as in the Ramsay recommendation—

first activities should be to clearly state that external auditors cannot provide any other services to their audit clients.

I cannot recall—and I am sure that the inquiry secretary will correct me if I am wrong—a single auditor, major audit firm, the Institute of Company Directors, company director or other independent person recommending anything other than that we do not do that. They say that we will destroy audit quality by removing the ability of audit firms to do anything other than provide financial audits. How do you respond to that? Does it make you feel lonely?

Mr McRostie—No, it does not. We have picked up on what our international organisation has also been reporting on in terms of that independence and distancing between what the audit firms are doing. We are not saying that people cannot undertake those particular tasks, but the institute in Australia and in its international relationships is saying that, if audit firms are doing the external audit, that is all they should be doing. We are saying that if they want to do internal consultancies that is fine, but not to try to get the two mixed up together.

CHAIRMAN—That is not knee-jerk?

Mr McRostie—No, I have been with the organisation for five years, and that has been the view of the board during that time. It is not a response to the current situation; it has been that separation.

CHAIRMAN—A response to Bond or Skase?

Mr McRostie—It may have been in the past.

Mr McDonald—May I make a point of clarification? We are not saying as a blanket statement that auditing firms should not provide other services. We are saying that, if a firm is providing the external audit services for the XYZ company, it should not provide those additional services to the XYZ company. It does not preclude them from offering those services to the ABC company, which it has no other external duties with.

Mr KING—Mr Middleton spoke of the ideal management structure of publicly listed companies that would address these questions that are before us as including the board, the management team and the internal and external audit processes with the internal audit committee. I was wondering where in that structure the accountant fits, or are you equating the accountant with the internal auditor?

Mr Middleton—No, I am certainly not equating the accountant with the internal auditor. The accountant has to do what the accountant has to do, and I guess he would be reporting to the chief executive officer, producing the financial statements that they sign off. There is certainly no crossing over. I do not think many accountants report to the board. The chief financial officer will present the financial statements et cetera, but we are looking at internal audit being totally separate from the financial arm of the organisation.

Mr KING—The OECD convention on the prevention of bribery just published speaks, in relation to internal auditing, of the need for a publicly available management report that attests to the existence of that fourfold structure that you just mentioned. What do you think of that proposal?

Mr Middleton—Part of the proposal said that in the annual report you should be reporting the operations of the audit committee, the internal auditor and the external auditor and reporting also on risk management. I would have seen the scope and the status of internal audit, and what it has been doing, as part of that process. As far as the financial side is concerned, at the moment you have the chief finance officer and the CEO signing off on the accounts.

Mr KING—I think the convention is addressing a different issue. It seeks a statement by the management of the company on a regular basis—annual or six-monthly, I am not sure which—saying that the internal management of the company in those four tiers that I just mentioned do exist and are working effectively. It might not sound particularly onerous, but the fact that it is a public statement appears to be central to the proposals of the OECD convention that I just mentioned. That is a response to the US problems in relation to Enron and so on, and to the problems in other OECD countries.

Mr Middleton—I am not sure what the question is, though.

Mr KING—I want to know whether you think it is a good idea or not.

Mr McRostie—We have probably alluded to that in talking about annual reports and saying that we are recommending that companies should report on a number of those issues that you have talked about. I guess the comment from the OECD is bringing it forward to a half-yearly basis. We have looked at that issue of the internal audit function being reported in the annual report on a regular basis regarding what is actually happening within the company in terms of the internal audit function, the control functions et cetera.

CHAIRMAN—Are you recommending that you do that?

Mr McDonald—Can I say that there is a best practice. Quite a number of Queensland government departments report that way on an annual basis in their annual reports—that is, they make a report about the governance structure of the organisation, risk management, the role and activities of the audit committee and the role and activities of the internal audit unit.

Mr KING—I have one final question relating to risk. I think it was you, Mr McDonald, who said that it is your view that 70 per cent of the work of the internal auditor should be focused on risk assessment. I have had to address reports of public GBEs and other bodies dealing with this issue, and I have sometimes found them rather impenetrable. What do you mean by the word 'risk' in this context?

Mr McDonald—I did not mean spending 70 per cent of your time doing a risk assessment but rather doing a risk assessment of the organisation and spending that 70 per cent of the work on the riskiest elements within the organisation—for example, workplace health and safety. Perhaps in a chemical producing organisation there would need to be a lot of focus on environmental protection and workplace health and safety issues. So an internal audit should not go through an organisation and just say, 'Let's audit the payroll and the expenditures and the revenues for the year.' What they should be doing is a risk assessment with management, identifying, say, the top 10 or 20 risks that the organisation faces and then putting in the audit resources to ensure that those risks are not occurring, that they are in fact well addressed and that they have been mitigated where possible.

CHAIRMAN—Mr McDonald, what you are really proposing is that internal auditors perform performance audits and that they be reported as part of the reporting structure to shareholders. Once upon a time, I was managing director of a publicly owned company. If you had put that to me, I would have thought that you were away with the fairies. There is no way known that I, nor can I imagine the Institute of Company Directors or the American Stock Exchange or anybody around, would agree with you that there would be an internal audit function that did performance audits that wound up being reported in the annual report.

Mr McDonald—If we are after transparency about what the organisation is doing to address its operations and if we want it to provide good reporting mechanisms to the audit committee, the board and the shareholders, that is certainly one mechanism. Canada is in fact requiring all of its government agencies' internal audits to publish their audit reports on the web.

CHAIRMAN—Mate, we examine 60 performance audits a year of Commonwealth places, so we know a little about performance auditing, believe it or not. In fact, I think we know quite a lot, and we understand the difference between the public sector and the private sector. I cannot imagine that if I were employed as an internal auditor of company XYZ and in a performance audit I say, 'This is risky bloody outfit because they do no risk assessment and they just fly off the handle making investment decisions without due diligence,' and I put that in the annual report that I would still have a job tomorrow. I cannot imagine that I could have. Words escape me!

Mr McDonald—I am not suggesting that you put in the results of all of the audits but rather the areas that have been covered—that is, a broad summary of the operations of internal audit, not down to specifics.

Senator MURRAY—The essence of the Chairman's remarks are not that the internal auditor should not examine risk areas but that for a performance audit to be valid, independent and objective, it has to be external. That is the view that we have developed over time. How do you react to that?

Mr McDonald—I guess it is an issue of definition of the term, and the role of, internal audit. Performance audit is not a term that I would have chosen to use, because I understand that that is more than what a lot of internal audits do in reality. In my comment about workplace health and safety and environmental protection, for example, there are a number of aspects to that. The first one is legislative compliance. Secondly, there are the things that the organisation has in place to assess the risk for those things. Then there are the issues of whether we are complying et cetera. So it is not a performance audit in terms of the full-blown method that is in your mind.

CHAIRMAN—I would stand to be corrected, but my view is that this committee's understanding is that all those things you have just said are defined by the term 'performance audit', and I think Mr Barrett would back me up. There is one other thing you could respond to. Deloitte has said that they have external research to prove conclusively that forced auditor rotation and lack of provision of external services has had no effect whatsoever on audit outcomes. If you could provide us with some research to indicate that it would be more helpful that auditors not be allowed to do that, we would appreciate receiving it.

Mr Middleton—I thought I saw an article in the last couple of days about that, saying that there was evidence either side of it. We can certainly see what we can provide.

CHAIRMAN—We would appreciate it. We appreciate your attendance. We are going to try to report in late September, early October, so that we are relevant to CLERP 9, and we intend to be relevant. Thank you very much.

[3.22 p.m.]

COLEMAN, Mr Michael John, National Managing Partner, Risk and Regulation, KPMG

MAXSTED, Mr Lindsay Philip, Chief Executive Officer, KPMG

CHAIRMAN—I welcome representatives of KPMG appearing before today's hearing. Do you have any comments to make on the capacity in which you appear?

Mr Coleman—I am the National Managing Partner, Risk and Regulation, KPMG.

CHAIRMAN—And Commonwealth internal auditor.

Mr Coleman—Independent auditor for the ANAO, actually.

CHAIRMAN—For the Prime Minister, with the acquiescence of this committee, I might remind you.

Mr Coleman—That is correct, and I remind you all that you actually examined me very forcefully at the time when you first actually asked me to take on that role.

CHAIRMAN—As I recall, the last time we met across this table—in exactly the same seats, I believe—I had every member of the committee here.

Mr Coleman—We were actually up at New South Wales parliament.

CHAIRMAN—My recollection was that we were in this room. That is neither here nor there.

Mr Coleman—We will go back to the record, if you like.

CHAIRMAN—We even had overseas PAC representatives here watching it all. Thank you for your submission. If you have an opening statement, could you make it very brief, because we would like to ask lots of questions.

Mr Maxsted—I would be pleased to take them. This really goes to the heart of the headings in our submission of 3 June. KPMG, as you would hope, have some very strong views on virtually all the subject matter which is the subject of your brief. In relation to audit independence, we are very forceful in our own organisation in relation to independence. We have embraced F1 in terms of the profession's self-regulation of independence. As you will know from our response to government, we agree with Ian Ramsay on each of his recommendations, and KMPG think, in the context of audit independence, that that deals with the majority, if not each, of the independence issues.

We hope our submission also takes you to other aspects which we think are critical to why we are where we are today in these discussions. The first is that we think the regulatory framework can be improved because we think it is a little bit fragmented at the moment. We really think the item of 'truth and fairness in the accounts' is being understated as a secondary proposition behind 'compliance with accounting standards'. We think that is important in the context of getting things right. We noted from listening to the previous discussion about performance audits and financial reporting models that we are not quite there, but we really do think that the accounts themselves and the reports that go around the accounts could have much better information in them. To the extent to which there needs to be regulation to encourage that, we would be supportive of it. We think the audit report would need to be tailored to take into account that there would be greater information in those accounts. We have a hobbyhorse—and there was a question earlier in the afternoon in relation to this—that, if we are going to extend what we audit, which we think is necessary to get greater confidence in the community, then we have issues with the unlimited liability of practising this profession in that framework. That concludes our introductory remarks.

CHAIRMAN—Thank you for that, Mr Maxsted. The Corporations Act requires that you be natural persons, not a corporation—in fact, it requires that you cannot be a corporation—so you are hit with unlimited liability. Moreover, we get no opportunity to test the quality of your services externally. I have to ask you, since I have asked everybody else—how would you view the Corporations Act being revised so that auditing firms must be corporations?

Mr Coleman—Lindsay and I have had a chat about this; we have seen the previous transcripts. As a firm, we have no objection to operating as a corporation. In fact, within the KPMG world, there are a number of places where KPMG acts as a corporation, including in the United Kingdom, where there is an organisation called KPMG Audit PLC that does audits. That is allowed under the UK corporations law because of changes that occurred in the United Kingdom in 1989. We see no problem with operating as a corporation.

Senator MURRAY—Was it Cadbury who initiated that?

Mr Coleman—No, it was EU directives that led to that. KPMG, in Germany and France, also act through corporations—so there is no fundamental reason why you should not be able to act as a corporation. To the extent that your question extends to audit firms being publicly listed companies, I think that that in itself causes problems. The major issue that the Australian Stock Exchange has had since it became a publicly listed company is that it has a share price which is reflective of its own results. If one of the things that we are concerned about is the degree to which an auditor might be influenced by commercial activities then, once you become a publicly listed company, as long as you have external shareholders who are looking to your results, I think that you introduce a whole new framework and a different concept of the way in which an auditor should operate. I see that there is great advantage in being incorporated, but I am uncomfortable—

Mr KING—Are these commercially sensitive issues that you are raising?

Mr Coleman—No, it is more that if one of the concerns that has been expressed is that an auditor has a commercial responsibility to its client—the organisation that it audits—and if the belief is that the auditor may not be as independent or as forthright with a client as he should be,

then, if he is a publicly listed company, he has even more encouragement to pursue a client from the purely commercial aspect of whether or not he can retain that client.

Mr Maxsted—It depends, Michael, on what the pressure point is for a listed company. If you say that part of the issue we face today is because it is all based on short-term share price, you can see how that interest could override the very independence of the decision. In other words, the decision could be, 'I need to qualify this account. What will that do? I will lose this account, therefore ...' That is the issue you get into, I think. If the better view is that in the listed company you should have more objectives than just your short-term share price, then you should make the same decision as the auditor would in our firm at the moment in a partnership. They would say, 'No, the better long-term view is "I must qualify", and whatever comes out of that, comes out of that.'

CHAIRMAN—Since you have read part of the transcript, what do you think of Professor Houghton's idea of there being an independent oversight board for each major audit firm?

Mr Coleman—We have actually had some discussions with Professor Houghton and we see the value of what he is suggesting. We do think that it is a very useful suggestion for the way in which we may move forward.

CHAIRMAN—What do you think about John Shanahan's recommendation that there be a required rotation of audit firm—not partner—every five years?

Mr Coleman—John and I have known each other for a long time and I am very aware of the view that he has. I am not certain that the rotation of audit firm is actually going to give us the benefits that we really think it may. As it stands at the moment KPMG and, I think, most of the other four firms practice a process of audit partner rotation, where you achieve the dual objective of keeping some understanding of the corporate history between the auditor and the business being audited, as well as providing a fresh set of eyes by having the partner rotating rather than the whole firm. I am not entirely certain what rotating the firm is actually going to achieve, short of perhaps giving a completely different set of eyes to the way things are done.

Mr Maxsted—I will even be a bit stronger than Michael. I think what Shanahan says is wrong because it does a number of things: it underemphasises the importance of the knowledge of the corporate to get the answer right; it assumes that one person can come in and replace the incumbent auditor and within a matter of minutes, days or weeks, have all of the knowledge and get to the heart of the issues within that company; and it assumes that resources are all the same, so that KPMG's resources are the same as XYZ's and everyone else's so you can just switch from one to the other and the level of competence within your team is at the same level overnight. In a former life before becoming CEO of KPMG I did a number of large insolvencies in this country. One of the ways many of those names—and you mentioned a couple earlier in terms of Bond, Skase, Goldberg and whatever—went as long as they did is because they had a divide and conquer regime: they would have a different auditor from the tax people, different balance statements for different companies and they would have trusts interposed in relation to companies. If one plays around with the continuity of that external review, one does so with great peril.

CHAIRMAN—As you well know, we just interviewed CIA and they recommended that audit firms not be allowed to do any other work for a client if they are doing an external audit. What are your views on that?

Mr Coleman—No.

CHAIRMAN—That is pretty simple.

Mr Maxsted—That recommendation is also wrong because, again, it assumes you can do a high-quality audit without full knowledge of what is going on in the organisation and that the external audit in itself can give you that full knowledge. In terms of the major acquisition of an entity, the knowledge that one gains by being involved in the due diligence of that is irreplaceable. Taxation is a major part of liabilities on balance sheets and results for the year and, again, the knowledge which is gained by having the auditor and his firm work together to work through those issues is irreplaceable.

CHAIRMAN—Can this extension not lead to complacency? Is it not possible that an audit firm becomes so used to a public company with a large store room and stock in the store that moves in and out—and some of the stock sits there for a million years—that it misses the forest for the trees and the fact that none of it is worth a cent? Would you like to tell me that that does not happen?

Mr Maxsted—I cannot say that does not happen. Clearly there would be some work going on by liquidators and administrators at the moment to try to prove that that did happen, but I think there are other issues. The rotation of the personnel is really important and that is where we say we protect ourselves from that circumstance: by having more than just one auditor sign off, by having a review partner look at all the key issues coldly, by having the rotation of auditors and by having people coming through the organisation—not only at the partner or sign-off level but different audit managers on the jobs. We say that we can refresh in that environment and not fall into that pitfall that you just described.

CHAIRMAN—Do I recall, Mr Coleman, when we interviewed you at Australia's historic first public hearing into the appointment of an independent auditor, you described that your firm had a firewall between external audit and other consultancy services for clients?

Mr Coleman—Indeed, and in fact since then we have actually sold our consulting firm, but that does not mean that you do not have other services that you might provide to an audit client. I think there is a very practical example. KPMG audits a large number of the major banks in Australia. As a result of that, one of the specialty areas we have is treasury risk management. You cannot audit a bank unless you have a good level of understanding of the treasury products that they are undertaking. So we actually have a separate independent group that we call treasury and risk management that we use to actually assist us with the audit of banks. That particular organisation is so well regarded that, in fact, many of those banks use them to provide other services; indeed, helping them to deal with issues such as their treasury reviews for internal audit services.

If we were precluded from providing that service to our external audit clients, we would not be able to generate the quality staff that we have in that particular area that enable us to actually

do the work that we have to do in the first place. So you cannot properly do an audit unless you have quality people to do it and quality people who actually understand the business.

Senator MURRAY—I want to explore performance audits briefly with you. Financial assurance audits as they are sometimes called are different from performance audits which focus on risk areas and outcomes.

Mr Coleman—Efficiency and effectiveness.

Senator MURRAY—Yes. The question I have asked at previous hearings is as follows. I am not at all of the mind that the law should mandate performance audits, but I am toying with a view which I would like to hear your reaction to—and this would have market effects. In certain circumstances—and perhaps criteria would need to be developed—people like ASX, ASIC or APRA should be able to request for the publicly listed company a performance audit if they feel that there is market concern or if they themselves are nervous about some circumstances.

Mr Coleman—There is an example of a performance audit in the form that you describe in the banks. When it was the Reserve Bank of Australia and now APRA, APRA actually have the ability to request all of the external auditors to perform a specified procedures review and APRA does that review annually. What happens under that particular set of circumstances is that APRA usually picks a particular area of activity. It might be something to do with credit risk or it might be treasury activity, or something like that, and they will have the organisation engage their external auditor to carry out that review. As it stands at the moment, that particular review is not publicly reported. It is reported to the board and then the board on-passes the report to APRA. So I do not think there is anything that would preclude a regulator from requesting an organisation to do that.

Senator MURRAY—There is certainly nothing that precludes them requesting it. What I am after, in fact, is the view that the law should allow them to require to do it; not as a mandated regular occurrence but only where certain criteria trigger that requirement. Then the next question is: if that is desirable, should it be public because of the market effects? My feeling at the moment, but I would like to hear your view, is that it should be public because you need to inform the investing public. What is your reaction?

Mr Maxsted—It is very difficult, isn't it? I have not followed the APRA example before, but you can see why that is as far as the legislation has gone in terms of the impact on just one particular organisation of having that as a public finding. Off the top of my head, maybe the better method is for the regulator to make the request for the review to be done, to be provided to the board and to the regulator and then, at that stage, a decision can be taken by the regulator as to what they do with that report. Clearly, one outcome of that might be to make it public.

Senator MURRAY—Could you both perhaps give some more thought to that issue of performance audits and how they should be triggered? There is absolutely nothing in the law to prevent it happening right now on a voluntary basis, but that is not the issue for us. The issue is when it should be triggered or provoked into happening and whether it should be public. If you could give it a bit more thought and write back to us, I would appreciate it.

Mr Coleman—A performance audit, specifically, as set out in the auditing standards—without getting too precise about it—is, typically, an audit that is related to determining the efficiency and the effectiveness of a particular operation. Typically, the report from a performance audit is a long-form report. That means it does not necessarily have a specified structure; it is really a matter of reporting to somebody about the effects. I am not entirely sure what type of performance audit you might be anticipating in the case of a public company.

Senator MURRAY—Frankly, I would like you to explore it a little more for us—to help us. As you are well aware from your official position, the ANAO, for instance, have developed a convention on how they examine a company and they are capable, as you know, of applying that to a business regime which they are entitled to audit, such as Telstra. Over and above the accounting standards, there is an expanded convention which has emerged in the public sector to deal with performance audits. Specifically, I mentioned the word 'outcomes'. Because of the way in which the financial statements of the Commonwealth have been changed to deal with the whole accrual introduction—

Mr Coleman—And devolution.

Senator MURRAY—That is right. Because of that, it is outcome orientated, which is shorthand for saying efficiency and effectiveness. 'Here is the money you spend. What is the outcome, and is it efficient and effective?' I would like you to not have a narrow view. Obviously, it has to attend to risk, to projections and to the health of an organisation, and I would envisage a regulator only being triggered when, in an HIH type situation, they are getting market signals and they are not sure themselves what to do.

Mr Maxsted—It is interesting, because underperformance is a difficult issue to regulate, but I would say the market should determine that. It is the whole skill of the chase in terms of which companies are performing above or under expectation or whatever in their sectors. The issue that always impacts us is when the underperformance is so chronic that it gets to the stage where you cannot pay your debts as and when they fall due and, therefore, you get into an insolvency situation. If you were more efficient, your share price would be $2.50 as opposed to $1.50. I do not think we are in that territory—and I certainly would not say KPMG is in that territory—but there is a role for performance auditors to ask: 'Why is this company leveraged as low as it is when its competitors are so and so?'

Senator MURRAY—I need your thoughts about it because I cannot accept anymore the market as the regulator. The scale impact is so great that, when you arrive at a situation such as an HIH, it is such a market shock that, ideally, if you are going to have that shock, have it earlier, if you know what I mean—have the signals and the triggers emerge earlier. The regulator needs provocative devices.

Mr Coleman—It is unlikely that we will necessarily answer all your questions, I am sure, because it is a fairly broad brief. Can I have some idea of when you might want that by?

CHAIRMAN—We intend to report by the end of September or early October. We must, if we are going to be relevant to CLERP 9, and we intend to be relevant.

Mr Coleman—I am certain you would not want our response on 30 September, presumably.

CHAIRMAN—It would probably be just a tad late.

Mr Maxsted—So over the next six weeks or so?

CHAIRMAN—Something reasonable like that. It would be appropriate if you negotiated that with the inquiry secretary.

Senator MURRAY—My last point, because I have taken a bit of time on this, is on the question of human nature. Earlier today I had an interaction with Mr Harrington from PricewaterhouseCoopers. To paint it a little unfairly—it is easier to do it that way—he was almost distancing himself as far as possible from Arthur Andersen as a partnership in terms of their practices and implying that that sort of thing could never happen to them, but in the same breath he was saying to us that that huge group signs off a thousand audits a day. My knowledge of human nature is that it is impossible to have any organisation or any system anywhere that prevents somebody somewhere doing something so dishonest and so wrong that your whole corporation or your whole organisation can end up stained by it. Behind my observation is this question: do you believe that the focus on auditors is overdone? In other words, do you believe that the responsibility in this area lies with a number of bodies, boards, internal auditors, management, regulators, accounting standards et cetera? If you do, do you have any ranking as to which is the most important to address in that scale?

Mr Coleman—There were a number of parties in there. I believe that one of the features of the current environment is that there has been far too much focus placed on the auditor and far too much focus placed on independence.

Mr Maxsted—For good reason, we think.

Mr Coleman—I agree with the general observation of Senator Murray firstly that the whole issue is to do with the exercise of corporate governance generally. By corporate governance I mean boards and executives—not just the board; the whole organisation. Certainly the culture within an organisation is very significant and you need to be confident that some of these things are dealt with. I find it very interesting when you actually read some of the things that Warren Buffet says. Warren Buffet says that he examines an organisation very well from the financial statements and that he makes sure that he understands what the business is all about and what the management is all about before he decides to invest in an organisation. So all of those issues related to corporate governance are very important. The issue of the regulator is very important as well. It depends on which regulator you are talking about. There are some entities—insurance companies and banks—that have their own specific regulator. That regulator obviously has a pretty good understanding of that particular business.

Senator MURRAY—Extremely underresourced at the time, I might say.

Mr Coleman—They probably are, and one of the features of life—again, it is human nature, I suppose—is that when things are going along swimmingly then everybody presumes that everything is going swimmingly and therefore those types of areas are perhaps underresourced. It is only when things start to change, when economic cycles turn, that you tend to have the type of debate and argument that we are having here. In the scheme of things—and Nick Hullah spoke to us earlier today about proportional liability versus joint and several liability—it seems

to me that all of those bodies have a role to play. Probably the most significant role, though, is the role of corporate governance—the role of the board in conjunction with management to try and make sure that they instil in an organisation the right sort of culture to drive it to act ethically and appropriately.

Mr Maxsted—I agree with that. I do not think, Senator, that you can rank them. I think everyone has a role to play, but the board certainly has a major role; the audit committee thereof does; management does; and we, as auditors, do. Quite clearly, as you say, human nature comes into all of these things, and each of those groups in different cases will make mistakes. Some mistakes will be deliberate, so it is up to the other persons to try and correct them. I would not try to rank them, but there is certainly a role for everyone. That is why we say that there has been an overemphasis on audit. That is not to walk away from our responsibilities but to know where they fit in. We do think there is an overemphasis on independence because we believe—and you will have heard this through your inquiry—that it is all about quality, not independence. Independence goes to the heart of quality: it is part of it, but it is not the main game.

Mr KING—On corporate governance, the recent OECD convention on combating bribery in this context advocates a publicly available management statement in respect of the four-tiered checks and balances management structure that is normally put in place by a well-run company. I wondered whether you had a view on that, whether you thought it was a good idea or not in respect of publicly listed companies.

Mr Coleman—Unfortunately, I am not entirely sure of what the four tiers are.

Mr KING—The board, the management, the internal and the external management reporting to an internal audit committee.

Mr Maxsted—We would say that is the right thing to do and it is best practice for corporates to do it. We agree that the internal auditor must report into the audit committee—that is his role. If you look at some of the larger companies which have failed even here in Australia, some of those have purported to have good governance in terms of saying, 'We have an audit committee and we do those sorts of things.' Therefore the mere encouragement, either encouragement by way of best practice or encouragement by legislation, means that unless you get to the heart of the good governance practices then obviously you do get situations where people make those statements and the reality is that they are just not doing that.

Mr KING—On the audit role, I was wondering whether your view is that the price of audit truth is no liability at all.

Mr Coleman—It depends on whether or not you are talking about the liability we incur or the liability that the organisation incurs.

Mr KING—The liability that you incur to those who claim to have been harmed by your misrepresentations.

Mr Coleman—Interestingly, in the majority of cases where there are claims against auditors, typically the courts have acknowledged, in those very limited number of circumstances where in fact the claim has gone all the way to a point where liability has been identified and agreed, that

the auditor's liability is very tiny. Even if an audit has been negligent the actual causal relationship between the auditor's negligence and the loss is minimal. That is one of the reasons why as a profession we do feel that the concept of joint and several liability is quite inappropriate because the auditor is the one who actually bears all of the loss for that breakdown in an organisation.

Mr KING—So you would agree with Mr Hullah on that point?

Mr Coleman—Yes.

Mr KING—What about the capping?

Mr Coleman—Again, I was here to listen to what Mr Hullah had to say, and capping is just a way of trying to limit the total liability that may be attributed to the auditor—the actual monetary liability. Picking up again on the question that I heard you ask Mr Hullah, yes, the auditor would still carry out his activities with all due care and all due diligence. In no way, shape or form would we be suggesting that the auditor reduces the level of care, but we are saying that the level of monetary responsibility that attaches to the auditor if something goes wrong should be capped because the size of the claims at the moment can be extraordinary.

Mr KING—You would argue for a greater level of professionalism, and I think you have actually said so in your comments, and at the same time for the removal of the legal burden if you get it wrong.

Mr Coleman—That is right.

Mr CIOBO—I am interested in KPMG's view, and I have asked this question of other witnesses, on the greatest threat or threats to a quality audit?

Mr Coleman—I suppose you had a couple of interesting answers as well. I think that the lack of good corporate governance is probably the most significant threat.

Mr CIOBO—Threat from where?

Mr Maxsted—From our clients' side.

Mr Coleman—Yes, from our clients' side. In my experience—and I have been plying this trade for in excess of 30 years—the best audits are the audits where there is a good level of cooperation between the organisation as a whole and the auditor, where the organisation itself is actually prepared to discuss issues with the auditor rather than leaving it to the auditor to find—it is not as though we are all Inspector Clouseau. If the organisation itself actually has the right sorts of processes and procedures to identify issues and brings them to the auditor and discusses those issues with the auditor with the approach of actually making sure that the marketplace is properly informed about those sorts of things, that is the strongest environment that an auditor can work in. I feel the biggest threat is an environment where the organisation itself is attempting to try to hide things, to not be open and free with the auditor.

Mr Maxsted—That is the biggest threat from the clients' side. From our own side—from KPMG's internal resourcing side—it is that very point of resourcing, and I made the point earlier in relation to a five- or seven-year rotation of audits. You have to have the expertise within the organisation to be able to deliver the audit. If we set ourselves up in an environment where we cannot encourage highly intelligent and hardworking people through the organisation, that is not respected in any way because, no matter how good a job they do, in five years time or seven years time they are told, 'I am sorry, you can't keep it; you have to go and do something else,' and/or we limit the amount of other things that we offer to the people coming through the system. That is a very big issue for us.

CHAIRMAN—Mr Maxsted, you have broached an issue that I was going to make further inquiries on—that is, the five-year rotation. So I will leave that for the moment. In terms of promoting that friendship or open communication channel between management and an auditor, does that go to the heart of also jeopardising the independence? How do you maintain something that potentially could be at conflict?

Mr Coleman—When I was a young boy I was in the cadets and at one course I went to I was told that when you are an officer you need to be fair, firm but never friendly. It is very important for you not to be too friendly. It is very important for you to be aware of the relationship. You obviously need to be able to be in an environment where you can sensibly and realistically talk to the client about the issues, but you should not be in a position where you are so close that your judgment could be impaired.

CHAIRMAN—So would you see tenure of the auditor as being a way of safeguarding fairness?

Mr Coleman—I think so. In fact, I am somewhat amazed that we are having this debate, because it was not all that long ago that the Corporations Law was changed to actually make it more difficult for an auditor in Australia to be removed. That was largely because at the time it was considered that the best way of making sure that the auditor had a position of strength was to make it more difficult for them to be removed.

CHAIRMAN—So are those safeguards adequate now?

Mr Coleman—I certainly think that those safeguards are very adequate. I think that if you go one step further and you think about the top 200 companies in Australia most of whom have audit committees, you see that an environment that enables an audit committee to sit between the auditor and management provides a whole new focus that perhaps was not even there 10 or 15 years ago.

CHAIRMAN—That all sounds good, but how do you account for the HIH and the OneTel situations? Is it because the scope of the audit is built around compliance more than providing a true and fair overview? If the safeguards that we currently have are adequate, if they are designed to ensure a certain degree of scrutiny without getting too friendly, how do those events take place?

Mr Maxsted—Part of the answer goes to what I was going to say before; that is, that the protection in terms of the friendliness is the role of the audit committee and the board. A firm

like ours understands that we have to work with management to get the right answers but, at the end of the day, we are accountable to shareholders through boards and audit committees. I think that is really important. It has heightened awareness over the last six or 12 months. It has always been there in good companies and good firms like ours, but I think we are even more conscious today than perhaps we were 12 or 24 months ago.

In answer to your question on HIH and OneTel, obviously neither Michael nor I could comment on those specific examples. It seems to me that it is about a few things. There is the timing aspect, and that comes down to how often auditors report. You can clearly get a situation, particularly with a start-up company, where the position of the company is very different six months or nine months after one has reported. In a situation where there is fraud or deceptive behaviour on one side, you can see how that is not picked up straight away, and that might happen in a short timeframe just after you sign a report or just thereafter. My third point would be that it comes back to the quality of the audit. Sometimes you just do not have the people with the depth of knowledge in some of these situations where very complex transactions are involved. You absolutely need the depth of knowledge, otherwise things just get missed.

Mr Coleman—We have spoken about OneTel and HIH, and with OneTel there was not an audit. At the time that OneTel failed the audit report was reasonably old.

Mr KING—Have you read Barry's book *Rich Kids*?

Mr Coleman—No, I have not.

Mr KING—It is instructive.

Mr Coleman—I would like to make a positive statement about Andersen. If you have actually seen the final audit report that Andersen did on HIH, it had an emphasis of matter attached to the audit opinion. The emphasis of matter was directing people to the uncertainty around the big area that finally took HIH down. In both those cases I think that the auditor did a pretty good job. The problem was that, particularly in the case of HIH, the marketplace took absolutely no notice of the fact that there was an emphasis—

Mr CIOBO—You are saying that the signals were there but the market—

Mr Coleman—Yes, the emphasis of matter opinion was there.

CHAIRMAN—Isn't the emphasis of matter reporting pretty blessed obscure with respect to the majority of shareholders? We might have something significant to say about that.

Mr Coleman—It is actually one area that has caused me a little bit of grief—and Mr Shanahan has heard me say this. There was a time when we prepared an audit report and under those circumstances our opinion would have been what we would call a 'subject to' opinion. In complying with international auditing standards it was considered that a subject to opinion was not strong enough, that the auditor was not making a decision. Therefore the international auditing standards, which we adopt in Australia, changed the focus to this thing called an emphasis of matter. One of the things I would really like to see happen is a return to the 'subject to' style of opinion when we have a significant uncertainty. Another issue, of course, as Lindsay

mentioned, is the whole issue of 'true and fair'. In Australia, the Corporations Law was changed in 1991 to require, firstly, compliance with accounting standards and, secondly, a true and fair opinion. I believe that if 'true and fair' was returned to the primacy position that it was previously in, an auditor has another very strong tool, because an auditor then has to say to the board of directors or to the management, 'I'm sorry but the actual accounts, even though they may comply with accounting standards, are still not right. I don't believe that they are right.' I would really like to see the true and fair override reintroduced.

CHAIRMAN—That was the next to last question I was going to ask you because you have stated:

... the true and fair override in Corporations Law is effectively of secondary importance to the requirement to comply with the accounting standards and the status of this override deserves further debate;

I put down, 'Really?' We have had some discussion today, some debate and some disagreement about whether the override exists or does not exist. As I read the Corporations Act, section 297, 'True and fair view', at the end of it, it says:

This section does not affect the obligation under section 296 for a financial report to comply with the accounting standards.

How then can it be an override?

Mr Coleman—It is not an override at the moment but it used to be.

CHAIRMAN—I have some difficulty with that set of words but my opinion is not universally shared; that is obvious.

Mr Coleman—If you have five minutes I can talk to you about it, otherwise we can—

CHAIRMAN—No, we do not have another five minutes, unfortunately. If you want to write to us, we would appreciate that.

Mr Coleman—Another question that I have heard Mr Ciobo ask was the question as to whether or not directors and management should be subject to liability. I believe that under the Australian Corporations Law they are, because directors have to sign a statement stating that the accounts are true and fair and that they believe that the accounts—

Mr CIOBO—Directors.

Mr Coleman—and, of course, typically that includes the CEO. There was an interesting point in our Corporations Law where the chief financial officer used to sign the accounts and say that he thought that they were true and fair. Again, that was something that was removed from our Corporations Law, I think, about 10 or 12 years ago. It is interesting that what comes around goes around.

CHAIRMAN—In your report, you also said:

Retrospective analysis of performance must give way to real time reporting.

I have asked many witnesses to this inquiry so far whether, because we have continuous reporting and that difference in concept from most of the other jurisdictions around the world, it is time that we had continuous auditing of continuous reporting. If I recall correctly—and I would not want to impugn anyone—the ASX and the Institute of Company Directors were not overly enthralled with that idea. You seem to be quite in favour of continuous auditing of continuous disclosure.

Mr Coleman—It is important to remember that the financial statements that we have today are historically based, with information prepared at a point in time. KPMG believes that as the world is changing—we have the Internet and different types of organisations are able to report their results more quickly—there needs to be an environment that allows that to happen. This is perhaps not necessarily the best example, but when Cisco first started to move into the stratospheric end of their share value, they used to put their daily sales figures on their web site. That was one of the things that enabled them to generate continuing shareholder information—some might suggest hype—about the nature of their particular business. If you are putting that sort of information on the web site daily, it would be useful if that information was in some way subject to audit and in some way subject to assurance that that information was appropriate and reasonable. We think that the reporting framework needs to be revisited. A fellow called Fra Luca Pacioli wrote the first book about historical cost accounting in 1396, so it is probably about time for us to change.

Senator MURRAY—It is a book I have never read.

Mr Coleman—It is written in Latin too. He was a mathematician. It is definitely time for us to start looking at different ways of doing things, and that might be through a form of continuous auditing. In many ways, most of us are indulging in a form of continuous auditing. If you think about these very large global organisations that need to report to the stock exchange within five or 10 days of a period end, you actually have to be in there and understand what the systems are all the time and you need to be continuously auditing those sorts of organisations in any event.

CHAIRMAN—You need to live there, don't you?

Mr Coleman—In the really big ones, you must. So within that environment there need to be different ways of dealing with these things. The trouble is, as long as we have the liability environment that we have today, the auditors are going to be more inclined to try to deal with what we know than to actually have boundaries and frameworks around what we do.

CHAIRMAN—Would continuous reporting and continuous auditing of continuous reporting, in your view, represent world's best practice?

Mr Coleman—I do not think that we are there yet.

CHAIRMAN—I mean if we had it.

Mr Coleman—It is an area that needs proper investigation to make sure that we are reporting information that the stock market wants and understands. If we can add some veracity to that information by providing a continuous audit, that would be tremendous.

Mr Maxsted—I think it is dangerous to say a straight yes to that question. In theory, the answer is yes, but you need to know the detail about what you are reporting on.

Resolved (on motion by **Mr Ciobo**):

That the following submissions be received as evidence: *Review of independent auditing by registered company auditors*, authorised publication No. 46, by Graeme Dean; and an additional submission from the Australian Consumers Association, No. 47, dated 8 July.

CHAIRMAN—Is it the wish of the committee that *Fiftymatters to be considered before signing a company's financial statements*, presented by the Australian Institute of Company Directors, and *Position of internal auditing and corporate governance processes*, presented by the Institute of Internal Auditors, be taken as evidence and included in the committee's record as exhibits 13 and 14 respectively? There being no objection, it is so ordered.

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

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

CHAIRMAN—I thank the witnesses for attending. Thank you to the media who have been with us here all day, and thank you to our colleagues from the institute, independent auditors and officers from the ANAO. Thank you to my colleagues and our staff and, particularly, thank you to Hansard for a long, hard day. I declare the public hearing closed.

Committee adjourned at 4.10 p.m.