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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Friday, 26 July 2002

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

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

Terms of reference for the inquiry:

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

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

WITNESSES

Committee met at 10.03 a.m.

CHAIRMAN—The Joint Committee of Public Accounts and Audit will 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. This is the fourth and final in a series of public hearings. There is intense public interest and rigorous debate in the public arena concerning the independence of auditors in corporate governance. In addition to our review, responses to the Ramsay report are to be considered by the government. The Treasurer recently announced a review of the auditing and accounting framework. The HIH royal commission continues to investigate the HIH collapse. Auditors, directors and management are very much under the spotlight. As we are witnessing in the United States, poor corporate governance and auditing leads to a decline in investor confidence, with significant economic consequences. In the course of the inquiry, many ideas have been thrown up for consideration. We now have the golden opportunity to get things right.

The committee will begin by hearing from Professor Ramsay. The Ramsay report has generated intense debate, and we will explore the various responses to his report. The committee will then hear from the Australian Securities and Investments Commission. We are interested in investigating what needs to be done to improve the regulatory environment and enhance the role of ASIC. The committee will then take evidence from the Australian Accounting Standards Board to discuss the question of adequacy of accounting standards and the ramification of adopting international standards.

In the afternoon the committee will take evidence from a number of individuals who are involved in various ways with the issue of audit independence. Mr Graeme Macmillan has extensive experience both in Australia and internationally. Professor Houghton has been a very active participant in this inquiry and has presented some interesting ideas to the committee. Mr Mark Leibler is a respected member of the legal profession and will discuss the legal aspects of auditor independence within the current regulatory environment.

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

[10.05 a.m.]

RAMSAY, Professor Ian Malcolm (Private capacity)

CHAIRMAN—Welcome, Professor Ramsay. We did not ask you for a separate submission, because we have, and have read thoroughly, your report, which was prepared for Joe Hockey. Would you by any chance have a brief opening statement?

Prof. Ramsay—Yes, I do. First let me say that I welcome this opportunity to appear before the committee. The inquiry is both timely and important, given both local and international developments. We know that auditors are an important corporate governance mechanism, and it is vital that their independence is not compromised. To mention just one significant international development, we only need to look at today's *Financial Review* to see that the leaders of both Houses in the US Congress have agreed on the passage of the Public Company Accounting Reform and Investor Protection Act 2002 that, among other things, establishes a public company accounting oversight board, mandates audit partner rotation and sees a stronger role for audit committees of companies.

Underpinning the recommendations contained in my report, which was delivered to the federal government last October, is the key principle that ensuring the independence of company auditors involves a multipronged approach. There must be a focus upon, firstly, audit firms—for example, ensuring they have appropriate internal procedures to deal with conflicts and that there are appropriate restrictions on relationships between audit firms and clients that can jeopardise independence, as I note in my report. Secondly, there must be a focus upon audit clients. The recommendations in my report include an enhanced role for audit committees and improved disclosure of non-audit services. In this respect, I regard it as a desirable development that the Auditing and Assurance Standards Board announced on 27 May this year that it would, following the recommendations in my report, provide guidance to the marketplace on enhanced disclosure of non-audit services. Thirdly, there must be a focus upon professional accounting associations. In my report, I called upon the professional associations to move quickly to update their ethical requirements in this area, and they have recently revised their ethical rules. Finally, there should be a focus upon disciplinary bodies, and I made recommendations in my report for the improved operation of the Companies Auditors and Liquidators Disciplinary Board.

I note that there are other issues that warrant attention; may I conclude by mentioning one. The increased focus in the United States on disclosure of what might be termed 'critical accounting policies' in the reports of companies is a welcome development, in my view. As noted by the United States Securities and Exchange Commission:

> … critical accounting policies are those that are both most important to the portrayal of a company's financial condition and results, and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

In brief, I believe there is a need to improve accounting disclosure. I would be pleased to discuss these and related issues with you.

CHAIRMAN—Thank you very much. You made a series of recommendations in your report to the government. Have you changed your mind about any of them or do all your recommendations still stand?

Prof. Ramsay—In my view, the report has stood the test of time. I do note that some commentators have said that, since my report was given to the government last October, there have been of course some very prominent corporate collapses—to mention two, Enron and WorldCom—but I do not believe that those particular collapses would lead me to change the recommendations in my report. However, I think one of the very valuable tasks this committee is engaged in is to move beyond those recommendations, to focus upon issues to do with accounting standards. If I were to revisit some issues in the report, though, with the benefit of developments in the period since October and with the benefit also of having read the submissions to this particular committee, there might be two things that I would further reflect upon.

Firstly, I would certainly further reflect upon the recommendations contained in Professor Keith Houghton's submission. That submission focuses upon audit firms themselves and, in that sense, sits with the philosophy in my report that you need a multipronged approach. I regard his submission as a very helpful contribution to making specific recommendations that can enhance auditor independence.

Another issue that I think may be worth revisiting is that of the length of audit partner rotation. In my report I made a recommendation that the period be seven years. I am advised that the period in the new act that has just been approved by the leaders of both houses in Congress is five years. I have not had confirmation on that, but I would be interested to think further about the appropriate period. Certainly, when I was doing my report it was put to me that the period should be somewhere between five and seven years. So that would be an issue that I would give further thought to, Mr Chairman.

CHAIRMAN—Thank you. One of the major points in your report was for the establishment of an auditor independence supervisory board. You have just discussed one of the issues that Professor Houghton put on the table; that is, that the audit firms themselves create an independence group or board or committee—whatever you want to call it—and that it, with internal controls, decides independently of the audit partners assigned to a particular audit function whether or not the audit firm is undertaking its responsibilities in a clear and ethical manner and whether or not it is acting independently of the company that it is auditing, notwithstanding any consulting work or the level of audit fees or all of these other issues that may come into play. Do you think that one or the other is our choice, or do we need both?

Prof. Ramsay—I have a view on that, Mr Chairman. I do not think the two are inconsistent. I think that what Professor Houghton has suggested is a timely and considered recommendation focused upon, in the first instance, the large audit firms, but I understand he also wants the professional associations to set up some sort of similar body that would assist second-, third-, fourth-tier firms, et cetera. I do not view that recommendation as being inconsistent with the need for some sort of public accountability body. I do see a sharp difference between that and what the private firms do themselves to enhance their credibility, to improve their internal processes for dealing with conflicts. I regard that as important, but I have always maintained

that there is a public interest in having public accountability. So, in that sense, I think it is appropriate to have both.

CHAIRMAN—You just mentioned the disciplinary board and you also mentioned in that reply the accounting bodies themselves, the associations—the unions, if you will—of the profession. It has come to my attention that, while CALDB has found a number of instances where auditors or accountants have done the wrong thing, the profession itself has not disciplined anyone for 10 years. What do we do about that?

Prof. Ramsay—It seems to me that one might think about a public accountability body. I am aware of the argument that the professional bodies have not been as effective as one might want in disciplining their members. I am also aware of the argument that the CALDB is limited to what ASIC brings before it. I will deal with two issues. I would note with regard to CALDB that, in my view, there are some improvements that should have been undertaken a number of years ago. Its proceedings need to be more transparent. After all, you are taking away someone's livelihood, potentially. The proceedings should be more transparent and, frankly, it needs more members to operate effectively. Coming to the professional bodies, though, and disciplinary processes, again it is a multipronged approach. I have no problem with the professional bodies having an important role in discipline. I actually think that is appropriate.

At the same I think we do need some public accountability outside of the professional bodies. That is what we have in Australia. We have a two-pronged approach. Professional associations discipline members; CALDB plays a role. That approach is probably an appropriate one, but it needs to be more effective. The professional associations should be more transparent about their disciplinary proceedings and do more to demonstrate to the public that they are fulfilling their mandate; but at the same time CALDB's proceedings must be made more transparent.

CHAIRMAN—We received a submission yesterday from Mark Leibler. We have just authorised it for publication, so nobody else has seen it. He largely argues that the Corporations Act requires that the accounts of a company be in conformance with the accounting standards. He accepts that the accounts of a company must also reflect a true and fair view of the value of the company, its profit and loss statement and its cash flow statements. He argues that they are not mutually exclusive, that in fact both are legal requirements. I am informed that you have read the transcripts of our inquiry.

Prof. Ramsay—Yes, that is correct.

CHAIRMAN—We have had it argued to us by some people that the true and fair view in their understanding no longer applies if there is a major conflict. Perhaps they should put in a note. Perhaps it becomes an emphasis of matter—which I believe I commented on in colourful language in this morning's *Financial Review*—which no-one ever reads and nobody really understands anyway; at least I certainly do not. Mr Leibler agues that both are required. What is your view?

Prof. Ramsay—In my view both are required under the Corporations Act. There is a requirement both to comply with the accounting standards and to ensure that they are presented in a true and fair view. Where the debate lies is a question of emphasis. Many people take the view that, if you comply with the standards but that does not present a true and fair view, then

what is required is, as you say, Mr Chairman, a note in the accounts. That is specifically provided for in the legislation. That then leads on to the debate about whether in fact we should return to the true and fair override to ensure that the true and fair view takes precedence over compliance with the accounting standards in certain circumstances. To sum up, I have no doubt that both are legal requirements.

CHAIRMAN—From my reading of the newspaper reports of what is going on in the United States, I believe they have no true and fair override any longer. I think that is right. In reading particularly about WorldCom, Enron and—was it Rank Xerox?

Prof. Ramsay—Yes, they restated their earnings also.

CHAIRMAN—It just seems to me from what I have read is that there is an outright blatant attempt to move expense to the capital account, which should be as illegal as holy hell. I would have thought there would be no way you could get away with that, but they have managed to use the black letter law of the accounting standards to do that. My understanding is that in 1998 we moved away from the true and fair view to adherence with accounting standards because there was some misuse of the true and fair view. Some accountants who have appeared before us disagree with you that both are legal requirements and they disagree with Mr Leibler that both are legal requirements. They say that they must adhere to the accounting standards. Should we modify the Corporations Act to make it clear that both are absolutely required?

Prof. Ramsay—Let me say two things. First, just to reiterate, both are in the Corporations Act as a requirement. If there is inconsistency that compliance with the accounting standards does not present a true and fair view, the act says that an appropriate note must be prepared. What seems to be the big issue, though, is whether you return to the true and fair override—almost as a type of principles approach, if you like. I believe you have correctly stated, Mr Chairman, that we in Australia have and that those in the United States have not, and I think they have paid somewhat of a price for perhaps relying on accounting standards that are too detailed. Someone was telling me about the accounting standards on derivatives that are in excess of 800 pages in the United States, for example.

As for the true and fair view override, may I offer a view on that; I know you have taken many submissions on it. I think it is something that is worthy of very serious consideration. However, once you go down that path, you need to ensure that your accounting bodies and all of your corporate governance mechanisms are working pretty well so that we do not have a return to what occurred in the 1980s, when the true and fair override was abused by a number of companies and their professional advisers. The principles approach, the true and fair view override approach, relies on the integrity of those who prepare the accounts and those who advise.

Senator MURRAY—Professor Ramsay, for the record, I should record the fact that I stated immediately after your report came out that I would support those recommendations but, you might recall, that I thought they should go further. The reason I supported them is that I did think they advanced the issue at hand, which is better performing markets, more honest and accountable systems and a greater chance of lessening untoward risk resulting from present structures. I will put that declaration aside before we proceed further.

I want to return to what is a fundamental theme throughout much of the discourse, and that is the word 'independent'. It is a fact that the solutions to the problem facing us have many threads. But in many of those threads the word 'independent' is part of the deemed solution, with the implication that if people are not subject to financial, personal or other pressure, they will act in a better way than they do at present. Independence most often results when you have proper processes and criteria for appointment, security of tenure and proper processes and criteria for termination with regard to boards, committees, the appointments of auditors or valuers, or for any other situation. In any circumstance where the appointment is subject to the direct control or influence or the patronage of the controlling financial interest or controlling management's interest, I think you have a problem. Do you have a view as to whether the very basis on which a committee like this should start is to establish up front what the criteria for independence should be and use that as a reference point wherever it pops up in terms of boards, audit committees or accountability mechanisms and accounting standards creation, et cetera?

Prof. Ramsay—I think it could be helpful to endeavour to define 'independence'. In some circumstances what we mean by independence might differ according to the particular context. The focus of my report was on company auditors. But independence might mean something a little different, perhaps at the margins, if we think about the concept of independent directors, and I will elaborate on that for 30 seconds.

There is a debate that has occurred in a number of countries about whether a director can be independent if he or she is appointed by a major shareholder of the company. Is that person then independent or not? It may be that there are some different issues that crop us as we think about independence in the context of analysts, independent directors or company auditors. But that does not take away from the point you are making, Senator, which is that it may be useful if not essential to endeavour to define independence in this context.

Senator MURRAY—You would be aware, but many might not, that people such as Dr Turnbull and I are interested in exploring the option of creating the potential for independence to be available to boards through the process of a one vote, one shareholder process as well as the existing system of one vote, one share. I will put that aside for the minute. If we move on from that brief discussion we have had and look at the issue of audit committees, I see a difficulty, because if audit committees are subordinate to a board in which all the directors are subject to the direct appointment or the patronage of the controlling financial interest or management, then the audit committee is simply their creature. You have read the transcripts, I am sure, and the submissions. An interesting view was put by Richard Humphrey of the ASX, and I happen to agree with it, that the audit committee is a kind of overrated mechanism that people are turning to. Those are not his words, that is my paraphrase. What did you think of his remarks? Do you recall them?

Prof. Ramsay—I do and I read his opening statement. I think there has been some misrepresentation of one of the recommendations in my report, particularly in some of the commentary outside of this committee. I have never said that the problem is solved by an audit committee, and not for one moment do I suggest that that is your comment, but the comment has been made outside of this committee. Indeed, the precise words in my report are that a well functioning, well structured audit committee can play an important role in ensuring the independence of company auditors. I do not think anyone has doubted that except Mr Turnbull who, I think, has a view that I quite disagree with in many respects, and I would be happy to

elaborate. My report was about processes: how can you put in place evolving processes—not a static recommendation but an evolving process to ensure auditors' independence. That goes to things like public accountability through the independent supervisory board, but it also sees an important role, but not an exclusive role, for audit committees.

As I understand some things that have been said about the report, they talk about 'Ramsay says appoint audit committees—problem solved.' That wasn't it at all. Sure, I recommended that listed companies should have audit committees, but I also recommended that they be properly constituted; and I thought I worked hard, although people did not get to the appendix, and endeavoured to say that it must be well functioning. And I thought I had prepared rather helpful guidance as to what a well-structured audit committee should be doing in terms of a mandate. So it was about process.

One of the pleasing things that has come out of the report is that most of our largest listed companies have been rethinking the role of their audit committees. Are they properly supported? Are they properly resourced by the company? At the end of the day, I think that focusing on the audit committee is appropriate: ensuring that it is properly resourced, properly constituted and that it has a mandate that is continually reviewed.

I have one final comment, and that is that I read something—it might have been something from the ASX—that One.Tel, Harris Scarfe and HIH all had audit committees. No doubt they did have audit committees, but a colleague of mine has done research to demonstrate that they did not have independent committees, and that is the test. If we burrow down a little bit, I believe my recommendation still stands, Senator.

Senator MURRAY—That is an interesting remark. It takes us full circle, back to defining in context what independence should be and what it means. My reading of the American publicly listed corporate board structure is that, frequently, the chief executive and the chairman coincide. That is not as frequent an occurrence in Australia, but it has occurred. Is it your view that the committee should consider recommending a mandatory separation of the two roles so that the chair of a publicly listed committee could never be a member of the executive?

Prof. Ramsay—My view is that, in most companies, it is probably best practice for the roles to be separated. However, I do not hold the view that that is appropriate for something to be mandated. I do believe in having some flexibility in corporate governance practices—that they need to be adapted to suit particular circumstances. In relation to that issue, I think that most people would say that it is desirable to separate the roles—certainly this is reflected in the Investment and Financial Services Association guidelines, which are generally regarded as the main guidance in this area in Australia—but I would not want to see that in legislation, for example.

Senator WATSON—A number of critics have suggested that perhaps some of your recommendations were a little too restrictive, in that the whole focus seemed to be on auditors and audit independence, et cetera. Is this due to your terms of reference? If not, why did you not give more recognition to the many problems that arise before the auditor starts examining the financial accounts? I know that you gave some attention to audit committees—which is right and proper—but if items are not on the balance sheet, for example, it is very hard to blame an auditor. Would you like to comment on that?

Prof. Ramsay—My terms of reference were specifically limited to the issue of ensuring the independence of company auditors. So, in that context, it was not part of my mandate to review the very important area of the adequacy of Australian accounting standards.

Senator WATSON—Mr Maurice Newman, who is Chairman of the Australian Stock Exchange, has recently written that, 'It is hard to escape the conclusion that corruption in corporate America is endemic and will take many years to clean up at incalculable cost.' Is Australia any different in terms of the potential for this to happen here? Or do you see that there is a mere handful of recalcitrant people who intertwine themselves in a number of public corporate structures?

Prof. Ramsay—First, if the quotation was that corruption is endemic in the United States or in United States companies, as someone who practised in the United States for several years, I would refute that. I think that we have seen some shocking instances of corruption, but I fail to see any evidence of endemic corruption in the United States. I appreciate that you are only quoting someone else there. Coming to Australia, I think I would take exactly the same view. As to whether there is systematic restating—

Senator WATSON—It is my view that it is restricted to a handful of recalcitrants who are permeating through a number of companies.

Prof. Ramsay—To be frank, I would agree with that. At the moment, I think we are seeing several notable company collapses. We are seeing appropriate investigation and, if appropriate, prosecution of the individuals involved. I think that, at the same time, it is appropriate that we are rethinking some of our corporate governance framework and mechanisms. I would also say that the ASIC surveillance that has recently been announced seems to me to be an appropriate step for the securities commission to take to ensure that audited financial statements are accurate.

Senator WATSON—Do you favour the licensing of company directors? If so, why?

Prof. Ramsay—No, I do not. I have had a chance to think about this. I believe strongly that directors should be properly educated about their responsibilities and that companies should provide appropriate resources to ensure that their directors can fulfil their ever-demanding legal, ethical and other obligations. However, I am not convinced that licensing of directors, however that might be achieved, is the desirable step in the short term. That would fit in, it seems to me, with the answer that I have just given that, if at the moment what we are seeing is a few notable corporate collapses, I am not sure that something as perhaps heavy-handed as saying that all directors must receive a licence is an appropriate step forward. But I am encouraged by the evidence that we see that the training courses and educational programs for directors are being oversubscribed at the moment. It tells us, it seems to me, that Australian company directors are taking their obligations seriously and do want to be educated about them.

Senator WATSON—Yes. As a parliamentarian, I just get a bit worried that we are overemphasising the need for reform of the auditing profession. Do you not see that the auditing profession is perhaps being a little more maligned than it should be simply because it is the last group in a long line, and people with deep pockets and those who have an ability to fund a

bailout, such as auditors, naturally have a big focus on them and, indirectly, it does come back and maybe puts an unfair light on some of their so-called practices or standards?

Prof. Ramsay—There are two things. Firstly, let me say that it is appropriate for us to continually place auditors under public scrutiny.

Senator WATSON—There is no question about that. That is not in question.

Prof. Ramsay—Yes. Secondly, is there an unfair tainting of the profession? My answer to that would be, I think, yes. Let me give you a specific example. Some months ago I opened an issue of *BusinessWeek* and the cover page had on it 'Accountant's shame.' I think there is a danger that the profession itself will be tainted in a way that will not be in the interests of Australian society or of the economy. I understand, but you might want to take evidence from others, that enrolments for accounting courses around Australia are falling. I do not regard that as desirable because I have always maintained the view that accounting and auditing are core corporate governance mechanisms. We need to ensure that the people who take them up are charged with the highest standards of honesty, integrity and competence. I do have a concern that, at least in the views of some commentators, there is an unfair tainting of the entire profession.

Senator WATSON—Yes. That is important to have on the public record, Professor Ramsay. We come back to this question about the application of accounting standards and true and fair. In a sense, wouldn't you say that where people have gone wrong is that there has not been a strict application of the two limbs of the requirement, firstly, to the adherence to the standards and, secondly, if it does not adhere to those standards, further supplementary information be provided to ensure that there is a true and fair view? If you take that interpretation, why has it all gone wrong and why are people suddenly wanting to change it round the other way?

I put to you that if you so prescribe the accounting standards in the first place and come back to a true and fair view, that is also going to obscure some of the results for some people. In accounting, of course, you cannot have a standard that is one size fits all. There has to be an element of flexibility in order that there be a true and fair view. Not all applications and not all environments in which businesses operate are identical. Therefore, you must allow the scope for companies to flourish, to trade and to make a profit. I put it to you that we have to be very careful. If we simply reverse the situation and do not get a proper recognition of both limbs, we are not going to improve the situation at all.

Prof. Ramsay—I would agree that there must be—to use your precise words—a proper recognition of both limbs of the requirement, both compliance with accounting standards and that they must present a true and fair view.

Senator WATSON—Do you believe there should be professional qualifications for chief financial officers of corporations—that they should be a member of a recognised accountancy body?

Prof. Ramsay—For our listed companies, yes, I think that that would be an appropriate step. I do not regard that necessarily as licensing, but it is interesting to see what is going on overseas. The SEC, as members know, has recently said that CEOs and CFOs must, in a sense,

publicly attest to the accuracy of financial statements. So we are seeing an increased focus upon CFOs, and quite rightly. After all, we only need to recall the name Scott Sullivan, CFO of Worldcom, to realise that the influence of an individual can have devastating consequences for 17,000 employees. I think it is useful, as part of the general inquiry into governance issues, to ask whether CFOs of companies are appropriately qualified, and whether they have the appropriate resources. To the extent to which professional bodies can assist, I think that would be useful.

Senator WATSON—Perhaps an unfair criticism of the profession has been that, in eight years, there have been very few disciplinary actions taken. Perhaps some of that discipline may not have been as transparent as a number of people may have wished. But do you think it is not surprising that there have been so few, given that ASIC itself has brought relatively few cases for prosecution, and also that there have been so few references from the Australian Stock Exchange, the ASX, regarding their concerns about practices in terms of those that are on the public register?

Prof. Ramsay—It is difficult for me to comment—

Senator WATSON—Why focus on the accounting profession in saying, 'They haven't done their job,' when ASIC has produced so few cases of the need for disciplinary action or prosecution—and neither have all the other bodies around the country who have some say in this? I feel that the profession is being unduly tainted and somebody, apart from the profession, has got to stand up for them.

Prof. Ramsay—It is difficult for me to comment upon whether the professional associations or ASIC itself has brought enough disciplinary actions. It is really not something that I have investigated. But I would say this, repeating something I said earlier, I do think that those charged with disciplinary powers could do more to demonstrate to the public whether or not they are fulfilling their mandate. I include in that CALDB and the professional bodies.

Senator WATSON—In a sense, you could accuse lawyers of a lack of transparency in their disciplinary actions. They do not necessarily herald them across the front pages, particularly if it has not been heralded across the front pages by an ASIC or another regulatory body. Why are you suddenly focussing on accountants—that they should have been so transparent—when there have not been a great number of demonstrable accounts of significant lapses? You will always have some—that is human nature.

Prof. Ramsay—I think professional legal bodies should do more to demonstrate that they are fulfilling their mandate for discipline. After all, it seems to me, it is a privilege for parliament to delegate to professional bodies the right to discipline. But, I think it is impossible for me to conclude whether or not that mandate is being fulfilled. With that privilege being delegated to them comes the obligation to demonstrate back to parliament and to the public generally that the mandate is being fulfilled in terms of discipline.

Mr KING—Professor, you acknowledge that a proposal of Houghton's—was it a gloss or an improvement—you might take up as an addition to your report. I was just a bit concerned about how that would dovetail with your recommendation about the supervisory board. You are really adding two further layers of supervision to the conduct of auditors if you do that; firstly, through

an external board of the type you propose and, secondly, from over the heads of the auditors themselves from within the firm as proposed by Houghton. Why wouldn't it be a better approach, having regard to the fact that we already have the auditors disciplinary board there, to beef up that board and ensure that we have a better, more comprehensive and, dare I say, more effective disciplinary body in the name of the auditors and liquidators board? What do you think about that?

Prof. Ramsay—I think there is some merit in thinking that we need not have an excessive number of public bodies regulating auditors. That is a perfectly appropriate objective. I am not sure, though, that CALDB is an appropriate body to take on the development of ethical standards. At the moment it is effectively a part-time body. It is a very small body. I met with them as part of the consultation process. They are focussed exclusively upon discipline. I am open to the idea that it might be possible to reshape an existing body to take over some of the public accountability tasks that I wanted for the auditors independent supervisory board. I severely doubt that CALDB would be that particular body. Its whole philosophy at the moment is quite different.

I reiterate that nothing I have read in Professor Houghton's submission is inconsistent with also ensuring that there is public accountability in terms of auditors' independence. We all appreciate that the big four audit firms, particularly, are at the moment under enormous pressure to prove to the public and the marketplace that their internal procedures are adequate. We have seen PWC set up a board. We have seen KPMG go down this path, although it is a little unclear to me what their mandate is because it appears to be mostly internal. So there is a question about the constitution of these bodies, but they are essentially bodies focused upon the internal audit firms. It is understandably so. That is important both in terms of substance, ensuring that there are appropriate procedures, and in terms of appearance. But nothing in that is inconsistent with a public accountability framework also.

Mr KING—Whether we take your approach to have an independent supervisory board or Houghton's approach to have a self-appointed regulatory board or stay with the beefed up CLDB, it would be better to have one and not three regulatory bodies, wouldn't it?

Prof. Ramsay—I do not think we can have one. I really think that at the end of the day we need the individual firms to set up transparent processes.

Mr KING—That is a different question.

Prof. Ramsay—I thought you said that you could have one dealing with all of them. My view is that if Professor Houghton's proposals, which are focused upon the individual firms, are adopted, that is not inconsistent with a public body.

Mr KING—There is a public perception that the current system, the principal arm of which is self-regulation, has fallen down because—dare we say it?—of a low standard of ethics in the profession. Do you agree with that?

Prof. Ramsay—I have seen no evidence that there has been a general decline in ethics in the accounting profession. We have seen individual instances, both here and overseas, where individuals have failed to adhere to ethical standards and to the law.

Mr KING—Another explanation may be that there is just an impossible conflict of interest, even if it is only an apparent conflict of interest between audit firms conducting their procedures in accordance with the highest professional standards and also conducting non-audit procedures in relation to the same businesses. Presumably from your report you do not agree with that proposition.

Prof. Ramsay—I think that some non-audit services can certainly compromise the independence of an audit. In my report, what I believed was the appropriate solution was, firstly, to more clearly identify the sorts of non-audit services that can jeopardise the independence of an audit and, secondly, to enhance transparency in this area. Shareholders do not know how their funds are being used in terms of non-audit services, so you need to carefully explain that to shareholders and to unbundle them. That was the solution that I put forward in the report, and I still adhere to that.

Senator WATSON—Where is the proof?

Prof. Ramsay—The proof of what, Senator?

Senator WATSON—That is easily said—that there are not these Chinese walls. I say: show us the proof.

Prof. Ramsay—Perhaps I should elaborate further. Most people would agree that there are certain non-audit services that compromise the independence of an audit.

Senator WATSON—But where is the proof for that? That is the question I am asking. It is easy to make these assertions but where is the proof?

Prof. Ramsay—Can I ask you this question, Senator?

Senator WATSON—No, I am asking you the questions. It is a serious allegation that you are making.

Prof. Ramsay—I think there is a profound misunderstanding here, Senator.

Senator WATSON—There is this perception. I keep asking: where is the proof of that perception?

Prof. Ramsay—I think we may have a misunderstanding here that I should endeavour to clarify. There are some global standards on non-audit services. Everyone around the world—IFAC, SEC—agrees, for example, that it is inappropriate for an external auditor to review all internal work if the external auditor has done all of that, including things such as valuations. There would be uniform agreement that that non-audit service is inappropriate. All I was doing in my report was endeavouring to say that we need, as much as possible, to identify those non-audit services that may impair the independence of the external auditor.

Mr KING—You have made some suggestions about section 324 on this point, although I am not convinced that your proposals are really going to enhance the process beyond where it

currently stands. Another proposition put forward, in order to put commercial value back into the audit process so that businesses do not feel as if it really is a tremendous and unnecessary business expense to go about doing an audit, is to enhance or put value back into the audit role. Instead of making it merely a rerun of the accounting process, we should make it a comprehensive and value added service with opinions on assessments of financial viability, corporate governance and risk management. What do you say about that? If that occurred, there would be a very legitimate reason for hiving off non-audit functions from audit professional functions.

Prof. Ramsay—I can reply to that by saying that I think it is appropriate to rethink what is the classic role of the auditor. But I would also add that companies are free to negotiate with their auditor, to use your words, to enhance the classic role of the auditor. So I have no problem with that, and I think it is appropriate for us to be thinking about whether, in some circumstances, the role of the auditor should be expanded. Of course, the audit firms themselves would immediately reply that that should be reflected in an increase in fees and perhaps the response to that is, 'Let the market determine.'

Mr KING—There has been a suggestion in OECD countries recently in a draft convention that has been put forward that, in order to solve this problem of corporate governance and failing audit confidence, management should have an obligation on a periodic basis—I would suggest six months—to publicly report and clearly state to both the board and the relevant listing and corporate governance authorities that the internal management mechanisms for reviewing the health and status of the audit processes within a company, both internal and external, are working sufficiently and precisely how they are working. What do you say about that proposition as a means of preventing corporate fraud?

Prof. Ramsay—It seems to me that, to the extent to which that is aimed at more disclosure to shareholders, creditors and the marketplace about the internal mechanisms within a company to ensure that you have an accurate—

Mr KING—Internal and external.

Prof. Ramsay—Part of my report indeed was focused heavily upon the need for enhanced disclosure. I think that those sorts of ideas are well worth considering. I have no doubt at all that disclosure is a real issue here on a number of levels.

Mr KING—Finally, I want to ask you about options. If the accounting standards should be changed to deal with the options issued to management, is it an accounting issue or should it be dealt with in a more direct and blunt fashion?

Prof. Ramsay—I can respond to that. I think they clearly should be expensed. It is an accounting issue but the minute we say that it is a political issue because the accounting standard setting process is to a large degree politically driven.

Mr KING—That is why I am asking you.

Prof. Ramsay—If it is not something that can be achieved through the accounting standards setting process—and I would hope that it can be—I think that it may be something for

parliament to form a view on. But, in my view—and I see that there is growing consensus for this around the world—options should be expensed.

CHAIRMAN—Professor Ramsay, we are very late but I am intrigued by one thing: if we were to allow our accounting companies to have limited rather than unlimited liability and if we required them to do some form of performance audit in addition to financial audit—that is, risk analysis or corporate governance issues, like we do in the public sector and like the Auditor-General does—do you see that as a possibility for enhancing the auditor's role and for enhancing the degree of information which we give to the public about the state of a company's affairs?

Prof. Ramsay—In certain circumstances it may enhance confidence in information to have the auditor do the performance audits, but I am not sure that one would mandate that. We appreciate that there are some sharp differences between the public sector and the private sector. There are some disciplines in the private sector that may not always exist to the same degree in the public sector. I would be hesitant perhaps to mandate that. It seems to me that to extend the role in that substantial fashion would be a fairly substantial change to our current understanding.

CHAIRMAN—Thank you very much. We could go on and on—I would love to—but we have other respondents whom we must talk to.

Prof. Ramsay—I understand.

CHAIRMAN—Professor Ramsay, if we have further questions, would you mind if we address them to you in writing before we bring down the report?

Prof. Ramsay—I would be pleased to answer them.

CHAIRMAN—Thank you very much. As has been reported in the press, we will attempt to bring down a report in late September or early October, so that we are relevant to CLERP 9 and so that the Treasurer and others who have interests in this matter have a chance to take account of our views as well as yours.

Prof. Ramsay—Thank you, Mr Chairman.

[11.00 a.m.]

NIVEN, Mr Douglas David, Deputy Chief Accountant, Australian Securities and Investments Commission

RODGERS, Mr Malcolm James, Executive Director, Policy and Markets Regulation, Australian Securities and Investments Commission

CHAIRMAN—Welcome, gentlemen. Would you, by any chance, have a brief opening statement?

Mr Rodgers—I would like to, if I could take the opportunity, Chairman.

CHAIRMAN—Could you please make it as brief as possible. We have lots of questions.

Mr Rodgers—I will. I do propose to table the statement. The committee has ASIC's submission. That submission reflects views that were first expressed by ASIC's chairman in a speech given on 15 May this year. In that speech Mr Knott reflected on the causes of and issues arising from recent corporate failures in Australia. He did draw attention in that to the apparent failure of accounting and audit processes to maintain public confidence in the availability of timely and accurate financial reports. At the same time he stressed that the issues were complex and that he shared wholeheartedly the caution expressed by many about knee-jerk responses.

Mr Knott argued that the debate about these complex issues should begin from consideration of first principles and noted that ASIC had an important role in contributing to the debate but that we did not intend to be dogmatic or inflexible about positions—I might note, particularly in the light of the government's announcements that it will be dealing with these issues in the context of the recently announced CLERP 9.

Mr Knott, in that context, proposed 10 measures that are reflected in our submission to the committee. I must take the opportunity to clarify a couple of aspects which do not appear to be fully understood, at least to judge by the way that they have been reflected publicly, including in submissions to this committee. Firstly, I will deal with the rotation of audit firms. In ASIC's view, rotation of audit firms is correct in principle. This is because there will always be a threat to the integrity of the audit process by continuing long-term relationships between an auditee company and an audit firm. In our view, that threat cannot be adequately addressed by rotation of partners alone.

At the same time—and this is the point I want to stress—we are fully aware that there are substantial practical obstacles to the adoption of a universal requirement for firm rotation but we do think that discussion ought to start with recognition of the high-level principle that firm rotation is needed to ensure long-term integrity of the audit process. We have noted that this principle might be reflected in a number of ways, including by giving shareholders a voice if a company proposes to depart from that general principle.

In Mr Knott's speech and in our submission to the committee, reference is made to the relationship between compliance with accounting standards and the obligation for financial reports to portray a true and fair view of a reporting entity's financial position. Neither Mr Knott nor ASIC should be taken to be advocating a return to the 1980s position where directors could choose to depart from accounting standards by forming a subjective view that the result would not have been true and fair.

However, we see the need for emerging international standards, and ASIC is an advocate of international standards being fully embraced for Australian purposes. We see the need for those standards to strike a more appropriate balance between two potentially conflicting approaches. We see the need for more emphasis on standards that contain principles requiring a focus on the substance of transactions and less emphasis on detailed rules to be applied regardless of whether the result is a proper reflection of the economic substance of a transaction. There is some evidence from recent events in the United States, especially Enron, that overemphasis on detailed rules may be contributing to current problems.

Accordingly, ASIC's support for the true and fair override should be construed as aiming at ensuring that accounting standards are applied to the substance of a transaction, not its form. We do not support the use of such an override in a way that might interfere with the uniform application of agreed accounting standards to the substance of transactions.

I would like to touch very briefly on the views which I understand Mr Leibler has made known to you in a submission. It would perhaps be helpful to make a couple of observations about them. As I understand it, Mr Leibler asserts there is a fundamental misunderstanding about the law. In particular, he maintains that the accounting profession and, implicitly, ASIC, give a primacy to the accounting standards that is not justified by the text of the law.

In our view, there is some confusion in this view between what I call legal primacy and practical primacy. Under the Corporations Act, the application of the accounting standards determines the numbers in the balance sheet and the profit and loss account, which are at the heart of a financial report. The notes explain, and they can add, new information but they do not override or negate the information contained in the financial statements. Whether the financial statements and notes give a true and fair view cannot be determined until after the entity has prepared financial statements and notes in compliance with the accounting standards. Whether the financial statements give a true and fair view is to be decided in the light of the statements and notes prepared in accordance with the standards. We do not see the law, and we do not think the law is to be read, as a general invitation to boards and auditors to rewrite the accounting standards when they prepare notes to the accounts. We have taken advice on this view and we are proposing to make a submission to the committee on it.

I will make one final point. We respectfully disagree with Mr Leibler's view about our enforcement approach to this. In particular, under section 344, which is the section which creates the relevant contravention, there is no breach of the law simply because the financial statements do not comply with either the accounting standard requirement or the true and fair requirement. What must be shown is that directors did not take all reasonable steps to comply and that their failure to do so has caused the breach of 297. It is not enough for ASIC merely to assert that a different result would have been arrived at. Thank you for your indulgence, Chairman.

CHAIRMAN—Thank you, Mr Rodgers. It is my view that it is almost impossible to have a corporate collapse without somebody—and probably lots of people—knowing that it is going to happen. I have talked to lots of accountants and auditors about this view. I have not found anybody who disagrees with it. Certainly, the creditors of a company that is in difficulty know the company is in difficulty because they are not being paid, and it is inevitable. Unless the auditor is purely incompetent, he is bound to know that the CFO, the CEO or somebody in the operational side of the company is trying to shift expense into the capital account. It is impossible to do an audit and not pick it up. If the company is trying to hide behind the black letter law of the accounting standard and the accounts do not reflect a true and fair view, I am confused about how we flag to the public that there is a problem. Section 297 states:

The financial statements and notes for a financial year must give a true and fair view ...

It goes on to say:

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

Then it says:

Note: If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under paragraph 295(3)(c).

That paragraph says:

(3) The notes to financial statements are:

(c) Any other information necessary to give a true and fair view.

But that may be buried so far down the list in such fine print that any reasonable observer—for example, a shareholder who is not an accountant and is not an auditor—is never going to pick it up and never know that this company is headed for deep dark trouble. How do we revise the language in the Corporations Act so that Mr Liebler's view is more adequately expressed? That is that the accounts must comply with the accounting standards but that they also must reflect the true and fair view of the company's financial position.

Mr Rodgers—I think our response to that, and we have made the point in our submission to the committee, is that to the extent that there is a disconnect between a particular standard and its ability to produce a true and fair view of a particular transaction, then under the current law the first focus should be on the standard itself. The law requires a process which says that the numbers are determined and—I am talking about the numerical part of a financial report; the balance sheet, the profit and loss, the cash flow statements—must be derived by the application of the accounting standards. The numbers cannot be changed by any other process, including an examination of a true and fair view. What the current scheme in the law does is say that, although you must produce the numbers in that way, you may explain or add notes if you think that the numbers do not amount to a true and fair view. We have said that the direction in which the accounting standard should go is to express principles which are capable of application and are more likely to result in a true and fair view, than become extraordinarily detailed rules that recent history suggests do not always produce that result.

CHAIRMAN—Your point No. 5 says:

Audit and consultancy services should not be provided to the same clients.

Have you read transcripts of these hearings?

Mr Rodgers—Yes, but I do not pretend to have a comprehensive knowledge of them.

CHAIRMAN—Professor Houghton, the first off the mark actually, the first respondent we interviewed, said, 'Imagine a large company XYZ in an audit market with only four large suppliers.' I think it is easy for us to imagine that—that is with a scale to undertake the audit. Firm A is the auditor and the audit fee is $1 million; firm B provides tax services for local and foreign subsidiaries of the company for a fee of $2 million; firm C provides internal audit services to the company for $2 million; and firm D provides information technology and internal control consultancies for a fee of $1.5 million. When we go to rotate the companies what have we achieved, Mr Rodgers?

Mr Rodgers—I think the view that we are articulating is that real value needs to be placed on the independence of auditors. That is for the reason that there is huge public reliance on the audit process. Looking at these things, you would say that to maintain the integrity of that process—that part that people rely on—you really do need to be extremely diligent in making sure that it is not threatened by any conflict and that it is seen not to be threatened by the potential for conflict. In relation to auditors we say that the starting point should be that full independence could be achieved by rotation but we may not be able to get there for the practical reasons that you suggest.

On the provision of non-audit services, we say that there is such a deep potential for conflict in those arrangements that, while we would not want to end up with the position of saying that audit firms should not supply consultancy services, we would say that there should be separation of those services at the level of the auditing firm so that firms choose an auditor. It is a limited market to choose who else might provide consultancy services, but it should not create that large potential for continuing conflict as would getting the services from the same firm.

CHAIRMAN—Someone said to me—it was probably Mr Alfredson—that when Arthur Andersen put his signature on the bottom of an audit he put his entire integrity on the line. It was like signing off that he was a gentleman. He said, 'This represents a true and fair view of the value of this company, and I stand responsible for that statement.' It is patently obvious to the most casual observer that auditors, certainly in the United States, seem to have forgotten that. I would have to say that, in terms of Enron, One.Tel, Harris Scarfe and HIH, it would appear that, since they had clean books, there must be something wrong here as well. Isn't there another way we can go about ensuring the integrity and quality of the profession without having to regulate what they do and for whom?

Mr Rodgers—That may be so. Our primary point here is in the debate about how that might be achieved. A very high level of focus should be on those independence questions, and that may well lead, as we say in the case of audit and non-audit services, to another way to achieve the same result with the same high level of confidence. Our response on this is based on the idea that there is a real threat, particularly because of events in the US but also because of the

Australian events that you mentioned, to public confidence in this process, and something needs to be done to restore that level of public confidence.

CHAIRMAN—You heard our discussion with Professor Ramsay, and you have obviously read his report. You know that Professor Houghton has proposed that we have independence groups within the accountancy firms themselves that are independent and report to some higher authority so that there is no possibility, or a highly unlikely possibility, of a partner who is responsible for the audit of a public company getting into bed with the company or agreeing to let the company get away with accounting practices that are less than open and do not represent a true and fair view of the operations of the company. On top of that, Professor Ramsay proposes an oversight board. Do you agree with both proposals, one or the other?

Mr Rodgers—We would not want to be taken as having formed a concrete view, particularly on what ought to be reflected in the legislation, other than to say that we have argued in the submission that the auditing standards should be reviewed. We have argued that they should have the force of law, and we have argued that our role in policing compliance with those standards should be parallel with what we already have in relation to accounting standards. To that extent, we are saying that there is a case for the way in which auditors are treated in the law to run on a closer parallel to the way that accounting standards and the conduct of accountancy is dealt with in the law. That does suggest an argument that there needs to be some form of external oversight body. I pick up the point that Professor Ramsay makes that we need to think separately about the standard setting process which, in the accounting context, belongs to the Australian Accounting Standards Board—and the role of that board is recognised in the statute—and then police compliance because they may sit with different bodies.

Senator MURRAY—It seems to me accounting standards and the true and fair view could be in conflict. Take the case of expensing executive and board options. Professor Ramsay, I think, reflected what is a growing uniform view that options should be expensed. The accounting standards at present permit them not to be expensed, which may mean—judging by some of the estimates I have seen from America—that profitability could be overstated by up to 13 per cent. A true and fair view, now, could say that accounts which comply with the law and accounting standards rightly do not have to be expense options, but still do not represent a true and fair view because they have overstated the profitability by 13 per cent. How do you resolve that sort of issue, where the two may be contradictory or contrary? Would you consider past affirmations by the major audit companies that Australian companies were presenting true and fair views of their situations were not true because their options were not expensed?

Mr Rodgers—I am not sure that we would want to be drawn into that proposition in its strong terms. Let me put it another way. It is certainly open to boards and to auditors to form that view and reflect that view in the notes to the accounts; they may explain the way that they have chosen to treat. From the regulators point of view, if we were to assert that directors who did not do that had failed to comply with their obligations under the law then the opening remarks that I made about the way in which the enforcement provisions of the law work would come into play. We would have to prove a contravention, even a civil contravention, of the law that what the directors had failed to do was to take all reasonable steps to comply with either or both the accounting standards and the requirement for them to come to a view about whether there was a true and fair view. As we have heard, views may differ about what is the appropriate treatment or whether one treatment is, in all cases, to be regarded as the true and fair view and

all results that do not end up with that result are, therefore, untrue and unfair. The practical way to resolve these issues in the kind of environment that we operate in at the moment is for these debates to be had, first of all, in the accounting standards context.

Senator MURRAY—But take it back to its essence. The idea of comfort words like 'true and fair view' is that for an unsophisticated investor with some amounts of money, they should be comforted by it. They might now say, 'Well, I hear this debate about expensing options. That is perfectly reasonable, they should have been expensed. And yet I was told it was a true and fair view of the company's accounts and, in fact, they have overstated their profitability by 13 per cent, so it was not a true and fair view.' I do not mean this rudely, but I think you are dodging the question. The words, and I would suspect that is behind the intent of Mr Leibler's submission, have to have ordinary and understood meaning to ordinary people.

Mr Rodgers—I do not think we are taking issue on that point with Mr Leibler's view of what the law says. What we are trying to do is to say that the scheme as a whole was expressly designed in 1991, which was the time at which compliance with the accounting standards became mandatory for all purposes. That removed the 1980s position that allowed directors effectively to override the results that would be produced by application of the standard. In 1991 it said, 'Whatever process you go through, the numbers—

Senator MURRAY—That is then. We have now got a problem. Tell me about now. Do you agree with the proposition that we have got to ensure that the words mean what they say?

Mr Rodgers—I agree with that proposition on its face. I think the difficulty here is to think through how that would play out in practice.

Senator MURRAY—I understand.

Mr Rodgers—I think it would be a very heavy burden generally to require every board of directors having in front of them a set of accounts produced in accordance with the standard to start from the proposition that an entirely separate inquiry was required that may well end up with them saying, 'Well, we think this standard doesn't result or can't result in a true and fair view and therefore we have to override the standard on every occasion.' I agree that there are clear examples where the fact that there is not a standard may give real meaning to what the true and fair inquiry is directed towards. It may be that, for example, some accounting standards allow alternative treatments. They allow a company to say, 'We will use this treatment or that treatment,' and you would expect the obligation of directors to ensure that the financial reports properly reflect a true and fair view. Perhaps one of the touchstones that the law requires of directors in that circumstance is to ask which of the two alternative treatments will result in something which is either true or fair absolutely or at least more true and more fair than the alternative treatment.

Senator MURRAY—Let me put an extreme proposition to you just to make the point so that we can see the dangers of the argument that we are conducting and also the issue of independence. This extreme proposition applies. The men and women who populate our boards, our senior executives and our audit companies are extremely clever and capable people on average. I think that is a reasonable remark to make, on my experience. They all knew that options should be expensed. However, they all knew that it was in their self-interest for it not to

be expensed. Because nobody was independent in this chain of people, because the controlling financial interests and controlling managerial interests controlled the boards who controlled the appointment of auditors, they all said, 'Right, it is in our self-interest to turn a blind eye to this,' and they signed things off as a true and fair view when they knew very well that it was not. I put that as an extreme proposition just to make a case for argument for someone who might see things from that perspective. Personally I am highly doubtful that that was the environment. But you can see then that, if we are to address this issue of what I see as a contradiction between the necessarily subjective issue of true and fair and the accounting standards themselves which have some subjectivity but are more objective and the issue of independence, you have to ensure that the two issues of true and fair and accounting standards come closer to Mr Leibler's proposition of resolving the difficulties and also come closer to my proposition that you cannot have independence where the controlling financial interest and the controlling management interest have the ability to either directly appoint or to exercise patronage over every member of the board.

Mr Rodgers—On the first point, I think what you say lies behind our suggestion that, as we move towards international accounting standards, we need to get the balance right between rules in accounting standards, the degree and detail of those rules, and the very legitimate expectation that the application of the rules should result in financial reports which are reliable, except in unusual cases. In other words, what the standards setting process should be directed towards is the production, in almost all instances, of accounts that are reliable, credible and comparable. So only in exceptional cases would you then need to say, 'What does an inquiry based on true and fair result in that might be different from those?'

Mr Niven—While I understand that your questions are in the general context, you have used the example of the options issued to executives or directors—

Senator MURRAY—As an illustration.

Mr Niven—On that particular matter, we are of the view that there should be an accounting standard that requires the expensing of those options. I think we should be clear on that point. The International Accounting Standards Board and the Australian Accounting Standards Board have this particular subject on their agendas.

Senator MURRAY—But you would agree that there is nothing to stop all those companies producing their year end accounts right now from expensing options?

Mr Niven—There is nothing to prevent them from expensing options under the accounting standards as they stand at the moment; that is true.

Senator WATSON—Doesn't it really come back to good accounting practice in terms of short-termism vis-a-vis the long-term result? We have to get some sense and balance back into this debate. Perhaps we should have some words such as 'intent'; as Mr Liebler would know, in tax law intent is pretty important vis-a-vis an unintended consequence which might flow from an application. I regret that, all too often, commentators unfairly parallel certain atrocities in relation to accounting matters in the United States with Australia. I put it to you that I see that Australian regulators are generally sharper, the profession is more professional and the conduct

of the directors—certainly in the public arena—is of a higher standard. Would you like to comment on that?

Mr Rodgers—It is a dangerous business for a regulator to say, 'Things are better here.' I might remind you that that was the attitude which was, I think, fairly attributed to the Securities and Exchange Commission in the US for a very long time. They maintained that their system of accounting and audit processes were to be preferred to others. That is on the one hand. On the other hand, we have publicly said that, while we are concerned about public confidence in the Australian processes and see domestic and international events as potential threats to that confidence, at this stage we do not have any reason to believe that the worst excesses we have seen in the United States are present in this marketplace. However, that is not to say that we are completely sanguine about that question, which is why we have recently announced that we will be conducting a concerted piece of surveillance activity directed towards testing compliance in Australia with those matters that seem to have been at the heart of problems in the US.

Senator WATSON—Earlier this year Mr Knott was quite critical of certain practices. But, when questioned recently by a Senate committee at which I was in attendance, he indicated that there had been a sea change since he made those comments. Mr Knott has recognised a sea change; why has it taken so long for some armchair commentators to recognise the sea change that has taken place in Australia? After all, some events are longstanding, and it does take them a while to come through the system.

Mr Rodgers—I was present when Mr Knott made remarks at an earlier Senate committee and then at the one about which you have just spoken. I cannot explain why others have not yet recognised the change, but I reiterate what I think Mr Knott said on the last occasion. He said that while we had expressed problems about the effectiveness of our working relationship with the accounting bodies, we have had subsequent discussions with them and we have clearly detected some changes that have given us confidence that we are moving in the right direction, and that some of the things that we suggested needed some improvement are in fact being improved. In particular, I refer to the self-examination that is being done by the accounting bodies concerning their own disciplinary processes and, generally, about working with ASIC processes and the operations of the CALDB. I cannot quite explain why others have not detected what we have detected, but I reiterate that we have detected very positive changes in that area.

Senator WATSON—Perhaps they have some more work to do themselves, haven't they? I disagree with your question concerning the rotation of auditors. I think this is a classic case of the ultimate theory departing from what is essentially application in the real world. In large scale, highly sophisticated, technological corporations, I put it to you that it takes the auditors within the firm who do the detailed work a long time to become familiar, to work around the systems and to understand it. It is true that the people at the top can get a bird's eye view very quickly if they are good, but in terms of looking at the records, knowing how they stand, how they interact, who is responsible and determining people's individual responsibilities to authorise transactions, you cannot get that familiarity very quickly.

I put it to you that in the first year there is a long learning process. I also put it to you that by the fourth year, knowing that you have lost the contract, obviously there is a little indifference because you lose that hunger to keep the audit, to be on top and to be the very best. I am

concerned that perhaps this may lead to an unintended lowering of the standards. As for bringing other people onto boards to oversight auditing standards within a firm, I put it to you that, again, some firms are very proud of their particular expertise in certain areas and what you are really doing is allowing people from other firms to come in and learn about some of their best practices, which they have acquired—and probably paid for in a sense because of their application and diligence. In this way, you are virtually opening up their practices and their working papers to show other firms how it can be done—other firms who are not as good and have not put the resources into that area. You are giving them a free kick. I am a little worried about whether we might be in the process of lowering the standards rather than raising the standards.

Mr Rodgers—I understand those arguments and I have read Professor Houghton's material on this. You are correct to say that we are starting from a point of principle. We are saying that as a matter of logic and principle there should be rotation of auditors. We do say, though, that that may be very difficult to translate into a universal mandate. What we do not want forgotten in the process is why we say this: as well as familiarity with a firm over time, long-term commercial relationships that become dependent relationships should be seen as a potential threat to the integrity of the process.

Senator WATSON—Even with partner rotation?

Mr Rodgers—Even with partner rotation because, after all, it is the firm as a whole that has the commercial relationship with the auditee company. A change of engagement partner does not necessarily change the overall economic relationship between auditor and auditee company. But, again, I stress that we are saying that as a matter of principle those arguments need to be—

Senator WATSON—You might want to rethink that one, because some people are so good by the virtue of their specialities that clients are attracted. I think it even applies in law firms that clients will follow a practitioner. So I put it to you that you might like to rethink that.

Mr KING—How many references has ASIC made to the CALDB in the last 10 years as auditors?

Mr Rodgers—I think it has been a little over 250.

Mr KING—How many of those have led to disciplinary procedures?

Mr Rodgers—Of those—I think it is 251 in total—our records show that 105 registrations were cancelled, 41 registrations were suspended and 11 reprimands were issued. So on my count, 157 of those 250 referrals resulted in some form of disciplinary response by the board.

Mr KING—What is the department of ASIC that deals with the supervision and disciplining of auditors in relation to the conduct of their work as mandated by the Corporations Law?

Mr Rodgers—There are three parts of ASIC that have responsibility in this area. We have an Office of the Chief Accountant which supplies high-level policy and technical advice to the rest of ASIC. I have staff within my area of responsibility who work within the corporate finance area of ASIC and are specialists in financial reporting. But disciplinary matters, when they

move from the inquiry stage into formal investigations that may result in a referral to the board, become the responsibility of the enforcement division of ASIC. So there are really three areas. Regarding the staff levels in my area and in enforcement, I cannot remember the exact numbers but there are as many trained accountants I think working in the enforcement directorate as there are in the corporate finance area.

Mr KING—I assume you are responsible to the minister for finance, are you?

Mr Rodgers—We are immediately responsible to the Parliamentary Secretary and to the Treasurer.

Mr KING—Have you ever advised them that the CALDB is under resourced and not performing an adequate role for the supervision of the conduct of accounting standards and the profession in this country?

Mr Rodgers—Certainly not recently. Mr Niven might remember. I think we had some dialogue a couple of years ago.

Mr Niven—Yes, we made a submission which said that it would be useful for the CALDB to have staff able to sit in more than one division at a time, I do recall that.

Mr KING—The whole area of the monitoring and/or supervision—or whatever you want to call it—of the role of auditors appears to have been, shall we say, lax to say the least. I am wondering why ASIC has not drawn attention to that in the past.

Mr Rodgers—I am a little concerned that this is proceeding on a misapprehension. The board is not an investigative board; it is a disciplinary board.

Mr KING—That is right; it investigates matters that you refer to them. I am asking about your position.

Mr Rodgers—About our position, which is to say, have we put sufficient resources into this?

Mr KING—No, I am asking you whether you have drawn attention to the fact that, in one view, the CALDB has been under resourced and has not been performing a sufficient role in disciplining and drawing the attention of the commercial community to the sorts of problems that we are dealing with now.

Mr Niven—I think it is true to say that CALDB works on referrals from ASIC and that the statistics that Mr Rodgers quoted give you an idea of the extent to which they have dealt with matters that have been referred to them by ASIC.

CHAIRMAN—That does not answer his question.

Mr Rodgers—We would not want to be taken as saying—and I do not understand us to have the view—that the CALDB does not have sufficient resources to do its job properly. What Mr Niven referred to was a proposition that it ought to be able to sit in more than one division at

one time so that it could run, as it were, parallel disciplinary proceedings. I am not sure that we stand for the view that there is some real defect in the resources available to the CALDB that means that they are not performing the function which the parliament gave them. Indeed, I understood them to be on record to this committee that they made no such complaint about themselves.

Mr KING—That is probably right, but that is not relevant. The other question I wanted to raise with you was about putting value back into our audits. I think it has been said that the Australian experience of the eighties—the excesses of the eighties—have led to world best standards of accounting and auditing procedures, if you look at those procedures on the written page. The real problems we have faced have been with the watchdogs. What do you say about that?

Mr Rodgers—There are a large number of complex issues here. It is very difficult to talk about one in isolation from the others. We have drawn attention to a number of things. For example, we have said that, going forward, more attention should be paid to that balance between detailed rules in accounting standards and the need for the result to be reliable in all respects. We have said that not quite enough is available under the current law to ensure the integrity of the audit profession; for example, we have argued, including in our submission to this committee, that audit standards ought to be mandatory for auditors in the same way that compliance with accounting standards is mandatory. That would remedy what is otherwise a gap—because there is no effective enforcement remedy, on a direct basis, for a defect by an auditor to comply with its obligations at the time that it signs off. It is not subject to the same contraventions that a director involved in the same transaction is. I have pointed already to the difficulties or at least the complexity of establishing that directors had not done everything that they might reasonably be expected to do, but there is no contravention in that process for an auditor. So we are arguing that on the audit side there should be a bringing together of the way that the law deals with both accounting standards and the enforcement of accounting standards and audit standards and the enforcement of audit standards. While I understand the point being made is that the problem is not the system but the way the system is being administered, there are some changes that are needed to make that an effective overall system that can be relied on as a whole.

Mr KING—Finally, one of the criticisms that business has of the audit process is that it is seen as an unnecessary financial burden on companies. Is it not possible that if the audit process was seen as really reflecting a true and fair view of the company's position—a spotlight, as it were, on any particular occasion, a bit like a survey of political views of the country or on any issue—it might in fact throw up a valuable business resource for the directors and managers of the business?

Mr Rodgers—I think it would be very desirable for companies to see that there is value for them commercially in having reliable audits that people can rely on. I think the climate that we are now in is more amenable to that view than might have been the case 12 months ago. In the end, that value can be created and maintained only if the system as a whole works well. I agree; we would certainly encourage any entity that is subject to mandatory accounting and audit rules to see these as a source of value as well as a source of burden.

Mr GRIFFIN—I take you back to an earlier question by Mr King regarding the question of the CALDB and the question of what submissions have been made about what it does. Mr Niven mentioned that submissions had been made on the question of allowing them to be able to investigate in a parallel fashion. Can you walk me through that? Who did you make the submission to? Was it a public document?

Mr Niven—It was not a public document. It was a submission made to the parliamentary secretary to the Treasurer and it focused on that one question of sitting in different divisions. At the moment, the CALDB has three members with alternates. It requires, I believe, two members to be able to sit. Of course, if you have got three and you need two members to sit, then you cannot have two divisions sitting at the same time because you would not have the requisite two members to do that.

Mr GRIFFIN—Do you think that was interfering in the actual operation of it?

Mr Niven—We were saying it would be useful.

Mr GRIFFIN—You say it would be useful; was there a need for it in terms of workload and was it the case that that need could not be met under the current situation?

Mr Niven—We do not see a large backlog of work before the CALDB. Matters are addressed. There is some delay. If you look at the CALDB annual report—unfortunately, I cannot recall the statistics—they have been reporting the number of matters that are pending before them. It is not an enormous number. You do not see the same sorts of delays that you may see through some of the court processes. Nevertheless, we thought it would be useful to have that capacity to be able to sit in the multiple divisions.

Mr GRIFFIN—I do not want to put words in your mouth but I do want to try and get this really clear. Are you saying that ASIC identified the fact that there was a problem with the operation of the CALDB with respect to being able to deal with the workload before it? You raised that with the parliamentary secretary; is that correct?

Mr Niven—I guess I am not necessarily characterising it as a problem in terms of the workload. I am just saying that it would be advantageous to have that capacity going forward.

Mr GRIFFIN—Are you saying that that is the only time that you know of when ASIC has raised the question of the operation of that board with the parliamentary secretary?

Mr Niven—That is the only one I am aware of. I could not say definitively that it has not been—

Mr GRIFFIN—How long ago did that happen?

Mr Niven—That was earlier in this calendar year. I cannot recall the exact date. I think it was in February.

Mr GRIFFIN—So it was identified prior to about February this year that there was an issue around the question of the operation of the board?

Mr Niven—It was a specific response to a recommendation in the Ramsay report, so it was not something that we raised as a separate concern that had driven us to say, 'There's a real problem here that needs to be addressed.' It was really a response saying, 'We support the idea of being able to operate in multiple divisions.'

Mr GRIFFIN—Did you get a response?

Mr Niven—I am not aware of a response. I could not say, on that matter.

Mr Rodgers—Nor am I.

Mr GRIFFIN—You are not aware of whether you have received a response about it?

Mr Niven—No.

Mr GRIFFIN—Could you get back to the committee about that?

Mr Niven—We could.

Senator WATSON—But that is only on the basis of it operating on a wider basis than previously, having a multiple response type application, which it has not had in the past.

Mr Niven—That is right.

Mr GRIFFIN—I thought it was more about the fact that cases were not being got to as expeditiously as would be hoped, which is why they wanted them to operate, if you like, in two sections at once.

Senator WATSON—This is where I think there is the ambiguity.

Mr GRIFFIN—I know, and that is why I want to get it clear.

Mr Niven—As I identified before, we have not identified a significant backlog—

Mr GRIFFIN—Just so we are really clear about this—potentially it is quite important—you are saying there was not a large backlog but a backlog of cases, because you identified the fact that, rather than operating on a single case at a time, if you like, it would be better if it was able to operate on more than one case at a time. Is that right?

Mr Niven—I think we were saying it was useful to have that facility so that when matters arose at a single time it would be capable of actually dealing with those. But I want to emphasise that the annual report of the CALDB makes it clear that they do not have a large number of matters pending at any time, and obviously there will be matters pending in any case because they are in the process of hearing them.

Mr GRIFFIN—To be really clear, you have said there is not a large backlog but you used the word 'backlog'. Either there is a backlog or there is not a backlog. Either there is a situation where there is a delay or there is not a delay. We can say it is not a bad delay, but either there is or there is not. You cannot have it both ways.

Mr Niven—That was an unfortunate word to use. I should perhaps have said a large number of matters pending; that is perhaps a better way to describe that.

Mr GRIFFIN—A large number of matters pending. We have gone from backlog to pending in a large number of matters. So what you are saying is that it was identified by ASIC and communicated to the parliamentary secretary in February that there was a large number of cases pending. I want to be clear about this.

Mr Rodgers—If I can intervene here, there will always be things that are before the board which are not resolved, and that is really what we are talking about. They will have matters referred to them which have not got all the material or they have not gone through the processes. I do not understand us to have said that there is a worrying amount of those. What we have said is that it is a matter of efficiency, and in some senses it is proper to think of it as a sort of technical fix. If that ever does become a problem, it is important that the board has the ability to hear a number of matters simultaneously whereas at the moment they must hear them serially, one after the other. Just as a bit of inbuilt efficiency it would be useful for them to have the power to do that, not that there was such a pressing problem that this was an urgent matter.

Mr GRIFFIN—So you are saying this was about giving them an increased capacity in a situation where in fact there is not a need at the time.

Mr Rodgers—To deal with a number of matters at the same time; that is correct.

Mr GRIFFIN—Right. If it is possible, I would be interested in having a look at any correspondence that relates to that. Obviously there is stuff you cannot provide to us, but I would be interested in what is brought forward. It is central to the issue.

Mr Rodgers—We are happy to get back to you on that.

CHAIRMAN—I can assure you we would like some more definitive information.

Mr GRIFFIN—It is central to the issue of how we see the role of the CALDB.

CHAIRMAN—In plain English.

Mr Rodgers—Yes.

Mr GRIFFIN—On the overall issue of corporate governance, my understanding, although I have not seen it, is that in a lecture in July, very recently, Mr Knott put forward the question of whether the regulator should have powers to prescribe and enforce governance standards. Would you care to comment on that in terms of what sort of minimum requirements should be laid down?

Mr Rodgers—I think Mr Knott's speech at the opening of the Monash government research centre has not been read by some commentators as carefully as it should have been. He should not be taken as calling for powers for ASIC to mandate corporate governance results. He raised the question as to whether there might be some case for stock exchanges in Australia, the ASX in particular, to look at what it might contribute on the corporate governance side. I think it was an open question. I think what Mr Knott did was to point out that in some other jurisdictions, most notably recently in the US, both the New York Stock Exchange and the Nasdaq market have promulgated very detailed corporate governance rules. I think what Mr Knott said was that that debate probably ought to be live in Australia.

There was a slightly separate remark about the potential conflict between the ASX's commercial operations and its supervisory role, but I think that was really just pointing out matters that had been on the public record for some time. Mr Knott was not advocating a particular result, and perhaps some of the reporting of that would have benefited from a close reading of what I think were very careful words in this regard.

Mr GRIFFIN—So it was about flagging the need for a debate rather than the question of a solution?

Mr Rodgers—And I think some of that debate was intended to go to the very issue we are talking about—that is, the reliability of, for example, financial reports that are lodged with the ASX as well as with us.

Mr GRIFFIN—So are you saying basically that Mr Knott does not have a firm view on this issue—

Mr Rodgers—That he would not want to be seen, as I understand it, to be saying that we ought to have more powers in this area because of some present defect.

CHAIRMAN—Mr Rodgers, in your point No. 10 you support continuous disclosure versus quarterly reporting. Do you support continuous audit of continuous disclosure where appropriate?

Mr Rodgers—Under the Australian system, the obligation for listed companies to disclose continuously is actually embedded in the ASX listing rules.

CHAIRMAN—I understand that; that is not what I am asking. Would you support a requirement for continuous audit of continuous reporting where it is appropriate?

Mr Rodgers—Not necessarily audit, I do not think. I must say that I have not put my mind to that, because I think that is subject to a continuous monitoring regime already, with a frontline role being played by the Stock Exchange, which regularly queries. It issues many thousands of queries a year, inviting companies to explain whether they have fully disclosed what the market needs to know, and we play a supervisory role in that area as well. I am not sure that I understand what value continuous audit other than by the existing supervisory arrangements would add.

Senator WATSON—It would delay the important announcement, wouldn't it, Mr Chairman?

CHAIRMAN—I would have thought so. But if that is your view, that is your view and it is on the record. Thank you very much for coming. We are going to try to report in late September or early October, and we will certainly send you a copy of our report. If we have further questions, you do not mind if we put them in writing, do you?

Mr Rodgers—We will follow up the matter on which the committee has asked for further details.

CHAIRMAN—Yes, but we may have further questions. Thank you very much.

[12.02 p.m.]

ALFREDSON, Mr Francis Keith, Chairman, Australian Accounting Standards Board

CHAIRMAN—I now welcome Mr Alfredson, representing the Australian Accounting Standards Board.

Mr Alfredson—I wish I was appearing to give comments about auditing, having spent 34½ years being an auditor, but I will keep to accounting matters today.

CHAIRMAN—Thank you, Mr Alfredson. We have not received a submission from you. Do you have a brief opening statement?

Mr Alfredson—I do, but in the interests of time perhaps I will forgo it, except to make a couple of comments.

CHAIRMAN—We do seem to ask a lot of questions, don't we?

Mr Alfredson—Yes. The Accounting Standards Board did not make a submission to your committee. That was a deliberate decision of the board, because we thought you were talking about the independence of auditors. I noticed you moved on to true and fair view and other topics, and I guess that is why I am here.

The functions of the Accounting Standards Board are the setting of accounting standards. I absolutely emphasise that one of our important roles these days is to work to a single set of global accounting standards. The Seekers used to sing we cannot live in a world of our own and my board does not live in a world of its own. Business is globalised, accounting standard is globalised and my board is aggressively following its function of participating in and contributing to the development of a single set of accounting standards.

We are a privileged board. We are one of eight liaison standard setters with the new International Accounting Standards Board. We take that role very seriously. We are aggressively pursuing it. I do not speak for the Financial Reporting Council but, as you are know doubt aware, the Financial Reporting Council has given the board a strategy that by 1 January 2005 Australia should have international accounting standards. I have skipped over some of the other detail I was going to mention, but I will table it.

I would like to emphasise that accounting standards relate largely to the recognition and measurement of assets, liabilities, equity, revenue and expenses. They also relate to the form and content of financial statements, including certain required disclosures. They do this within a conceptual framework that is by no means perfect. The application of these standards requires considerable judgment by preparers, including management, audit committees and boards of directors. These judgments sometimes relate to the interpretation and application of the standards in particular situations. They also relate to the measurements required in the accounting process. Further, I believe they provide an essential underpinning to the Corporations Act requirement that accounts are required to give a true and fair view. Without

this underpinning, there would be no hope that accounts of different entities, even in the same industry, would be comparable. I will be pleased to answer any questions.

CHAIRMAN—Thank you, Mr Alfredson. You were here this morning for the earlier debate, with Professor Ramsay in particular, regarding Mr Liebler's views that both the accounting standard and true and fair are legal requirements on companies. You heard me read the Corporations Act, with which I am sure you are intimately familiar. Could you advise this committee on what we might do to enhance the wording of those sections of the Corporations Act that deal with this issue? How could we go about it so that we do not relieve the company of adhering to your accounting standards, but at the same time do not let them get away with using the black letter law of the accounting standards in some oblique manner to hide or obscure the real value of the company?

Mr Alfredson—Frankly, I have no suggestion. I think the law is abundantly clear: accounts are meant to give a true and fair view, whatever that will mean. The problem is that it is ill-defined and always will always be ill-defined. When it comes to accounts, we always keep talking about corporate collapses. What is wrong with those accounts? Nothing very fancy. Assets are overstated, liabilities are understated and revenue recognition is front-ended. You do not need anything but the truth and you need a set of accounts drawn up in accordance with substance. The accounting standard sets a framework; it sets a measurement, a whole lot of rules, standards and principles—whatever you like to call them—but, in the end, accounts should be prepared in accordance with substance.

I heard the debate about share options, and I can give you my views on that, but accounting standard setting is not perfect by any means. It runs behind the game. I think true and fair view is important in terms of an overall catch-all requirement, but no company has gone broke because of some highly technical accounting standard. Companies go broke because they do not have the assets they say they have; they do not have the revenue, they overspend and all those things, and business is risky. Never forget that business is risky and so sometimes the best boards in the world make wrong decisions. But the accounts ought to be transparent.

CHAIRMAN—We understand the fact that companies are going to go broke. This is inevitable in our system. The strong survive and those that are best win and those that are not so good lose. That is the best we have come up with so far and I do not think anybody sitting here would want to change that.

Mr Alfredson—If you go to the UK, where they do have true and fair override, I do not think their system is any better than ours. I do not think it works any better. If you go to the US, they accord with generally accepted accounting principles. These are just words, but I do think a true and fair view makes that extra comment that directors can prepare a set of accounts in accordance with accounting standards and anything they like to, but they then have to sit back and say, 'Is there anything so wrong with these accounts that a reasonable reader would believe they do not give a true and fair view?'

CHAIRMAN—You heard me say that, in my view, no company goes broke or bankrupt or is liquidated without people involved with the company—as purchasers or suppliers—and without the company's own accounting staff, and auditors, if they have been working continuously in the company, knowing what is happening. Do you think that is a reasonable statement? If so,

then what do we do to achieve a situation where we somehow, through a regulatory regime or an oversight regime, encourage the auditors to put their integrity on the line when they sign the books?

Mr Alfredson—You know, I have signed many audit reports, including the largest in this country. I believe I have signed them with integrity. I have to tell you, on some occasions a year later we found out some of the decisions we made were not as good as what we thought we made. I worked on companies in real estate in the booms of the eighties and the nineties, and I came in on a job that was very tough, I can tell you. A new board of directors, new accountants, assessed all those carrying values and made huge write-offs. The next year they made more write-offs, because you just cannot foresee the future all of the time. Even the most honest board, and all the rest of it, cannot make the best judgments. Frankly, if you have got a management who is lousy, they want to conceal, the auditors have got bugger all chance of getting it right, and I am afraid that is a fact of life.

But I have to tell you the major weakness of an auditor is personality problems. I sit here and hear all these talks about independence. Do you know what you have to do? You have got to get auditors and individuals who have got backbone, and that is tough. ASIC, who I just heard, investigated—I should not say it—Yannon, for eighteen months or two years, whatever it was. As an auditor, and I had nothing to do with that job, I will bet they probably saw Yannon—I do not know whether they did or did not—no more than a couple of days to make some technical decisions. Auditing is tough and it takes a tough character.

I have said to some people—and I can say this because I retired from the auditing game five years ago and my beloved firm has gone—that when someone recruited me at the university they did not say, 'Do you want to be a regulator Keith? Do you want to check compliance?' They said, 'Go and have a great experience in business.' I had a fantastic experience in business, but my tough job was to be a regulator and make tough decisions. I made some tough decisions, and I probably made some weak decisions too. You go against tough characters.

If firms want to do the best things, they have to line up partners and give them personality tests and say, 'Are you going to be tough when it counts?' That is the world these auditors live in. Do not underestimate that. Get all the independent boards you like, but in the end it is individuals putting character on the line. It is tough and sometimes they will make the wrong decision. If you want to be Mr Nice Guy with your client, if you want to take him to the football and have football boxes—go to Colonial or the MCG and see how many of the big four have got boxes there—it has got nothing to do with auditing. That is to do with client relationships, being nice guys. Auditing is about regulation—tough decisions.

CHAIRMAN—We heard this morning that, and I had not heard this, it is becoming difficult to get young people to sign up for courses at university for accounting degrees. I was quite surprised at that since my understanding, particularly when we were going through the GST implementation period, was that we did not have enough qualified accountants in Australia and there was a real push on to train more. If that is true, that we are having difficulty filling the places and encouraging the young people that we need into the profession, is there something that we can do about it? Are there suggestions we can make in this inquiry that can help to enhance the role of the profession and the status of the profession versus what is going on in the daily press in the United States?

Mr Alfredson—I have a son who did commerce/arts at university and he always said he did not want to be an accountant. So what is the silly guy doing? I should not call him silly. He is at PWC as an auditor. I do not know how long he is going to do that but when his father had a billion dollar law suit swinging around his head it was not great fun at home. You have to do something about it when it is a liability. One of the issues you have to face is about delegation—and I am getting on my hobbyhorse here, and none of this has anything to do with why I am here. But, if you look at this rationally, why would you delegate regulation, being an audit—because that is what it is—to the most non-transparent organisation in the world: a partnership? How can you expect young people to go into businesses these days and accept unlimited liability? Arthur Andersen is a typical example.

When I became a partner we had only so many hundred partners or fewer in Australia—probably more worldwide—but these days it is 2,000. If I was going to do a reasonable due diligence on a purchase acquisition, I would say that I wanted to understand the risks. How can a new partner in a firm say, 'How can I be sure that none of the other 2,000, 3,000 partners won't make a decision that will materially affect my financial wealth?' That is bizarre—and let me go on. What does it do? It causes strange behaviour. You give all your assets to your wife. You have trusts and all of that. You have just heard about the distortions share options cause. Talk about the distortions unlimited liabilities have caused. Auditors are the poorest people in the world. They have no assets. Be serious about unlimited liability; it is a serious issue. There will be no auditors in 2010.

CHAIRMAN—If you have read any of our transcripts you know that it is an issue that we have addressed continually throughout this inquiry.

Mr Alfredson—I would like to make one other comment; Keith Houghton is a friend of mine and I think he has got it right and I think some of the questions you guys asked got it wrong. He wants an independent board in a firm. To me, that is no different from an audit committee in a company. It is a risk management device for that company. An audit committee in a company does not mean that it should not have external auditors. An independence board within a firm does not mean there should not be an external oversight. I have told him he has got it wrong, though—that board not only ought to be independence; it should be competence. Some auditors do not believe every firm can audit every company in Australia. Some industries are very specialised. You have got to have specialist auditors. There are not many insurance companies in Australia; there are even fewer banks. How many specialist auditors are there in Australia? If firm 1 is tendering for audit they need to seriously ask, 'In some industries, do we have the technical competence?' I say to Keith: make that an independence and competence board.

CHAIRMAN—I want to go back to what we were discussing before, and that is unlimited liability. It is clear—I am sure you are as aware of it as I am—that the Corporations Act requires an auditor to be a natural person. Have you thought about the consequences of requiring audit firms to be public companies with a limited liability?

Mr Alfredson—They do not have to be public companies. It could be a limited partnership.

CHAIRMAN—But you just knocked partnerships?

Mr Alfredson—That is unlimited partnerships. I do not care what sort of vehicle it is. They could be companies. They can have audits. I do not care. Make them transparent but do not give the guy an unlimited liability; do not make him responsible for every guy in that firm that he just cannot possibly control. It is bizarre.

CHAIRMAN—We have heard the unlimited liability argument substantially throughout this inquiry, but there are mixed views about whether the partnership arrangements and the current professional standards of accountants should remain or whether, in fact—

Mr Alfredson—I do not think they should remain at all. They should be a company with a board of directors. Now, exactly what sort of company—heaven help us if they have stock exchange listings but they ought to have the benefit of limited liability.

CHAIRMAN—Should we regulate that?

Mr Alfredson—We should at least allow it.

CHAIRMAN—Should we regulate it?

Mr Alfredson—Regulate what?

CHAIRMAN—That, in order to be a public company auditor, one must be a company and not a natural person. Should we reverse the Corporations Act in it?

Mr Alfredson—I think that would be helpful. I hope someone will ask me about share options.

CHAIRMAN—Senator Murray will be happy to ask you about share options.

Senator MURRAY—I will not even give you one of my notorious lead-ins. Go for it, Mr Alfredson; what do you want to tell us?

Mr Alfredson—Two years ago, some of the best technical people in Melbourne did not believe that share options gave costs in profit and loss accounts, do not believe that this is all just gung-ho director stuff. Some of the best technical people did not believe that a share option should give a cost in the profit and loss account. One of the best of those people I have now converted to: yes, there should be an expense. But some people legitimately held a view that the issuing of a share option was a dilution of capital; that each shareholder in the company, for their own benefit, gave away some of the company to particular individuals or employees, and that was a legitimate way of funding them. In other words, one shareholder owned, say, one per cent of the company; after giving some options away, he owned something less than one per cent. Some thought that was a legitimate way of attracting good people into the company and be the kings and heroes for the company. Fortunately, that view has gone away. But I raised that view because one of the best technical people I know held that view.

But the world has changed and, unfortunately, the worst culprit in all of this was the Financial Accounting Standards Board in the US. Many years ago that organisation had the right answer,

and the politicians killed it. They ended up with either disclose or charge in the profit and loss account. Of course, no-one charged it in the profit and loss account. But Coca-Cola, God help them, are now going to put it in the profit and loss and a few others. In Australia, there is nothing in the accounting standards to stop people from doing that. In fact, any company could do it. I was speaking to CEDA the other day and someone asked me about it and I said, 'Can I give you a bit of advice? Before you do it, go and get some good tax advice.'

In Australia, there is a serious impediment to charging share options in the profit and loss account. You debit profit and loss and you credit capital. Some rules I know of I do not understand at all, but any tax adviser will talk about tainting of capital. When par values of shares were abolished, one of the antiavoidance measures put into the Tax Act was a strange rule that said, 'If you increase capital by charges to the profit and loss account, you taint your capital, and there are some heavy penalties for it.' I am no expert, but I understand that it affects franking credits. Directors will not rush out and put charges in the profit and loss account this year if they are going to lose tax wise, and only you guys in the parliament can fix that by changing the legislation.

About a month ago I wrote to Senator Coonan about this. I said that the International Accounting Standards Board will have an exposure draft out by the end of this year or early next year—and I hope they will—and that we are going to simultaneously issue that exposure draft. I also said, 'I want you, Senator Coonan, or Treasury, to start looking at the tax act because we have to get this barrier removed.' I am determined we are going to have an accounting standard in Australia on a legitimate way of accounting for share options.

CHAIRMAN—Is that a confidential letter, or can you release a copy of it to us?

Mr Alfredson—As far as I am concerned, it is not confidential. It was written confidentially.

CHAIRMAN—Then I ask you on behalf of the committee: can you please forward a copy to us?

Mr Alfredson—I would be delighted to issue it to you.

CHAIRMAN—Thank you.

Mr Alfredson—It was written to Senator Coonan, but I am sure it can become a public document. It could be obtained under freedom of information.

CHAIRMAN—We do not want to go through that.

Mr Alfredson—I will just give it to you.

CHAIRMAN—Thank you very much.

Mr Alfredson—But that is one of the reasons why I want people in Australia to participate in international standard setting. It is all right for the Financial Reporting Council to tell me 'adopt international accounting standards by 2005'—and that is something I agree with—but we do not

want to cause havoc either; we do not want financial havoc in this country. We want good sound financial reporting, and we need everyone's help to understand the implications of that. We have already issued an exposure draft of an invitation to comment on financial instruments. That will cause reclassification of resettable preference shares in this country. That will cause the banks to jump up and down, and it will cause bank regulation to have a problem. These things all have to be taken into account, and it has to be done in a structured good way. Standard setting is tough, but it is even tougher to properly understand the implications.

Senator MURRAY—I am glad I asked you such a good and clever question. Cause and effect: you rightly and very succinctly summarise the age old—it is much older than you or me—situation where people, for self-interest, will overstate assets, understate liabilities and, as you put it, front-end revenue. It seems that one issue we are grappling with—as a fairly eclectic committee but with much experience, I think, in this kind of discourse—is short-termism. That is, boards and management—some of them are corporate bureaucrats and not, by any means or definition, entrepreneurs—find themselves faced with a real temptation to ratchet up their share price, bring forward the revenue and create an accounting situation that delivers them a very good outcome. That is contributed to, I think, also by a mentality that such people are only in that window of opportunity for a short term; there is much writing about chief executives and even CFOs and so on having a relatively short life span. To summarise my understanding of your earlier remarks, that is an issue of ethics, independence and so on rather than accounting standards. But to what extent can accounting standards contribute to not promoting a cause-and-effect result, not promoting short-termism and limiting, to some extent, those age old practices?

Mr Alfredson—It is very difficult. I think the problem with share options has been that the standard set has really failed. They should have really seriously attacked this thing. One of our great hopes is that some problems are worldwide. The Australian Accounting Standards Board never dealt with share options because the US could not deal with them satisfactorily. There are plenty of people in this country who say, 'Don't be a loner on anything; don't get ahead of the pack' et cetera. The big hope of the International Accounting Standards Board is that when things really count, and tough decisions have to be made, the European Union, Australia, New Zealand, Canada and Japan can all go together with one answer. That will help a bit.

I think accounting standards boards have a great responsibility to try and fill these gaps, and share options is an obvious gap. But, as a matter of urgency, I want to seriously fill the gap in Australia on financial instruments, on recognition and measurement and with derivatives, and all of that. That is why we have issued the IASB exposure draft in Australia. That is another area where accounting in Australia is not too good. We have all these options, et cetera, where I guess the accounting is not as tight as it should be, and the transparency of it is in the notes to the accounts and not in the balance sheet. Accounting standards have to try and keep up with the business, but we will never stop financial engineering and structuring. Gosh, merchant banks parade all these things up Collins Street in Melbourne or Pitt Street in Sydney, or wherever—and what are they to do? Get debt off the balance sheet, get assets off the balance sheet and show a higher rate of return. It is all lacking in substance; it is all causing accounts not to be transparent.

Senator MURRAY—Which is why you put the emphasis on character, ethics, corporate governance and independence rather than accounting standards.

Mr Alfredson—Accounting standards are not perfect by any means. But, when Australia has financial instruments on the table, we will issue a significant package on business combinations and intangibles within the next few months, and I think we will fill that gap. We will follow that, I hope early next year or mid-next year, with an accounting standard on how to account for defined benefit funds, and the public sector in Australia will love that. They are the big gaps in the Australian accounting standards. We are going to fix them; I am absolutely determined that we are going to fix them.

Senator WATSON—I will not ask any questions. But I refer the audience and those reading the *Hansard* to Mr Alfredson's comments made before the Senate earlier this year. I think those comments perhaps pull in some issues that may not necessarily be covered today. Mr Alfredson, I commend you on your forthrightness and I agree with the majority of your comments.

Mr KING—Who are the members of the Australian Accounting Standards Board?

Mr Alfredson—You are testing my memory now, but I will tell you. I am the full-time chairman; I am the only full-time member. There is Ruth Picker, whom I know you have seen here. There is Bridget Curran, an ex-partner from PWC but now on her own as a consultant. There is Greg Ward from the Macquarie Bank. There is Susan Lloyd; she was with Deutsche Bank but has now left because her husband was transferred overseas, but she is still on the board. There is George Carter from DOFA. There is Neil Conn, who was the Administrator of the Northern Territory. There is Wayne Cameron, who is the Auditor-General in Victoria. There is Judith Downes from the ANZ Bank. There is one other, Professor Ken Leo, from one of the universities of Western Australia.

CHAIRMAN—And then he has a huge advisory group as well.

Mr KING—What is the formal relationship between the board and the Financial Reporting Council?

Mr Alfredson—The functions of the FRC are very clearly spelled out in the ASIC Act. Perhaps I could just repeat them here.

Mr KING—No, not the FRC. What is your relationship to the FRC?

Mr Alfredson—The FRC is my oversight body. That is my board of directors. The Financial Reporting Council is an oversight body of the Australian Accounting Standards Board. You have to understand the important roles of the FRC. The FRC appoints the members of the AASB other than the chair. It approves and monitors the AASB's priorities, business plans, budgets and staffing arrangements, just like a board of directors. It determines the AASB's broad strategic direction, such as the decision it has just made.

Mr KING—Is your body, the AASB, publicly funded?

Mr Alfredson—It is largely publicly funded. At this stage most of the money is coming from the federal government and some from the states. The Stock Exchange gives us free offices. The FRC is out raising some extra money for us from corporates.

CHAIRMAN—Thank you, Mr Alfredson. We appreciate your coming. We would like a copy of that letter. We had not heard about that issue and the difficulty there might be in that respect. There have been some calls to this committee—and there have been some calls in the public space, I note—for Australia to adopt a standard that requires directors' share options to be expensed.

Mr Alfredson—We will adopt it, Mr Chairman.

CHAIRMAN—I do not know that that is a critical part of any kind of report that we need to make, because I think we are looking more at structure than at detail. But we appreciate your advice and your frankness, openness and honesty. We thank you, and we will send you a copy of our report.

Mr Alfredson—Thank you.

Proceedings suspended from 12.35 p.m. to 1.31 p.m.

[1.31 p.m.]

MACMILLAN, Mr Graeme Gayer, Managing Director, Ciptanet International

CHAIRMAN—I welcome Mr Graeme Macmillan. Do you have a brief opening statement?

Mr Macmillan—The reason I made a submission to this committee after reading the terms of reference was that I felt that the terms of the reference in the press releases made some direct parallel between corporate collapse and auditor independence. As the previous witnesses have offered, there is a lot of complexity around corporate collapse—which I call 'financial failure'—in that the emphasis on auditors appeared to me to be auditor bashing. My background is as an auditor. I have been the technical director of an international accounting firm, the founding director of a publicly listed company, an academic and, most recently, I have consulted to governments of developing countries who are developing their public sector accounting frameworks. I was the original contractor to the Australian Accounting Research Foundation, developing lease accounting. So I am familiar with some of the pressures that are applied to people developing accounting standards.

Having seen the *Hansard* reports of previous hearings, I believe that much of the discussion has centred on institutional roles in the accountability framework, rather than core issues. Several changes suggested to your committee involved new or different external oversight committees or increased regulatory measures. The most recent use of this approach was the financial system inquiry—the Wallace report. The structural changes that that committee achieved certainly did not prevent the current insurance industry collapses. As a small diversion, as a student of financial failure I researched the demise of the Premier Permanent Building Society in Melbourne in the 1880s. It was the cause of the collapse of the finance industry in that century. It was liquidated in November 1890 after speculating in property, issuing shares in itself and offering higher than necessary interest rates. In December 1990, the Farrow Group failed for exactly the same reasons. The message there is that there is not much that is new or different in financial failure. My questions are really these: who is responsible for financial failure? Is the current financial regulatory framework in Australia deficient in any material respect?

CHAIRMAN—Mr Macmillan, if I can interrupt you: we do not take questions; we ask them. Just make sure you understand that.

Mr Macmillan—Okay. The major issue is that, as accountants, we have to follow the International Federation of Accountants and the Australian accounting bodies standards. They require that every reporting entity should prepare general purpose financial reports in accordance with the accounting concepts and standards and be audited, where required, by a competent auditor applying auditing standards. These include ethical guidance, and where the standards are not complied with there are remedies at law and by the professional bodies. These standards apply to all reporting entities whether in the public, private or social sectors.

Accounting, auditing and ethical standards are now being issued internationally and are not subject to any vested interest or government. As qualified accountants, we need to apply these

standards rigorously while continuing to improve them through research. We have an obligation to assist professional accountants in developing countries improve their frameworks. I think the areas of significance in the current climate are the negative image of the auditing specialisation, as Mr Alfredson referred to, the failure to attract the best to the accounting profession in universities and the paucity of research funding in auditing and standard setting. I think the auditing and assurance board received a grant of something like $800,000 in total.

In response to your question as to what your committee can recommend, I have what I think are four key issues. There is currently confusion between the law and the accounting and auditing standards. You could recommend that the provisions relating to audit independence and operation in Corporations Law could be repealed and replaced by a general statement that the auditing standards be applied; that the Australian accounting bodies introduce an audit practising certificate as a specialist requirement in addition to the general practising certificate they already issue, and thereby have a greater role in the regulation of auditors; that the Australian governments contribute to the international accounting auditing standards; and that research on the causes if financial failure in the private, public and social sectors be continued and published.

CHAIRMAN—Thank you, Mr Macmillan. Your submission to this committee was, if I remember right, 3½ pages and you spent 2½ pages attacking the committee. Why did you bother to appear before the inquiry?

Mr Macmillan—I was invited.

CHAIRMAN—But why bother if we have no idea what is going on and we are inquiring into the wrong things? Why would you bother coming to talk to us?

Senator WATSON—To put the committee right.

CHAIRMAN—I am asking him the question.

Mr Macmillan—So I can contribute some suggestions, Mr Chairman.

Senator WATSON—That is fair enough.

CHAIRMAN—One major point of your submission was that we should review the ASX listing rules and make them more rigorous. How?

Mr Macmillan—In some respects the entry to public listing in Australia is through the ASX listing requirements. I think there should be some value judgment on the quality of the boards and on the management of the companies coming to a board.

CHAIRMAN—I see. Who would do that?

Mr Macmillan—It is a difficult question.

CHAIRMAN— Should there be an examination?

Mr Macmillan—No, I think it is a value judgment. Whether the regulators would do it or whether the—

CHAIRMAN—Do we ask Dick Humphry to examine the directors of every company that goes before the ASX for listing?

Mr Macmillan—Not necessarily, no.

CHAIRMAN—Who would do it then?

Mr Macmillan—As I say, it could be a combination of ASIC and ASX.

CHAIRMAN—You also stated that greater emphasis needs to be given to audit competence and that this could be achieved by:

requiring the professional accounting bodies to actively police the auditing sector of the profession on an individual basis.

What exactly do you mean?

Mr Macmillan—One of the difficulties that we have at the moment is that the regulation of auditors is split between various bodies—ASIC and their boards and the profession. The effect of that is that there is not any real regulation. The only group or body that can effectively police auditors is the accounting profession itself. This could be done through the use of an audit practising certificate—in the same way as the medical boards have surgeon certificates or specialist qualifications—and this could be regularly assessed by examination or by peer review.

CHAIRMAN—You also say that it is wrong to say that public expectations are not being satisfied. How do you mean? Have you judged the public? Do you think the public is happy with the current regulatory regime that we have with respect to accounting, auditing and corporate governance?

Mr Macmillan—The only way I could judge that is by press reports which indicate that people are not satisfied. A lot of press reports—and your own comments this morning, Mr Chairman, about it obviously being the fault of the accounting reports and auditors that is behind the corporate collapse—indicate that there is a general pervasive blame being allocated to accountants and auditors, none of which, to my knowledge, has been tested in the courts as yet, by the way.

CHAIRMAN—I do not think I have heard anybody blame an auditor for a corporate collapse. When an auditor signs off on corporate accounts and they are subsequently proved, in a very short period of time, to have been wrong, it seems to me it is our responsibility, as a Public Accounts and Audit Committee, to examine the rules, parameters and regulations surrounding the profession and the operation of auditors. Is that unrealistic?

Mr Macmillan—As I said at the beginning, from the terms of reference in your press releases, there is a direct line from corporate collapse to independence of auditors. My point in

my submission and in my notes is that corporate collapse is almost entirely the responsibility of management. Dr Alan Greenspan concurred with that by pointing out that the CEOs were responsible. That is my concern.

Senator WATSON—Thank you. Mr Macmillan. I think you have a public responsibility to point these things out. At the end of the day, the committee will ask questions and people will question the committee. That is all part of the democratic process which we, as senators, have to acknowledge. Could you speak about the expectations gap as you see it?

Mr Macmillan—Certainly. It can be explained in that professional accountants and auditors, as Mr Alfredson explained, know what an audit is about. An audit is providing an independent accountant's opinion on a set of general purpose financial reports. Those general purpose financial reports should be prepared in accordance with accounting standards. The belief in the media, as they are reporting, is that somehow auditors should be responsible for corporate clients or for preventing financial failure. Certainly in our standards we say right up front that signing off on a set of financial statements does not ensure there will be no financial failure. We are quite clear about that. We are judged by our professional standards, and if that is not satisfactory then the professional standard should be changed. I would say that the role of this committee would be to recommend where they think the professional auditing or the accounting standards fail.

Senator WATSON—Do you believe the auditing profession to be able to self-regulate, or should it be imposed by an outside jurisdiction?

Mr Macmillan—The accounting professional worldwide is now self-regulating. We are now following accounting standards, auditing standards and ethical guidance set internationally. We are doing that now. We have a professional obligation to apply those standards. I believe that we have a professional responsibility not only in this country but also in other countries to achieve those standards.

Senator WATSON—Do you think, though, that global standards have to be brought down to a local application to give them a little more meat because, with general principles, it is very difficult to discipline and to enforce general philosophical outlines?

Mr Macmillan—This question has come up in a number of countries I have worked in. The first question that I am asked is, 'Can you simplify the international public sector accounting standards so that we can understand them or because we are different or because we need to apply them?' My answer is, 'I would love to but, unfortunately, I cannot because they are our standards. They are the accounting standards. They are the auditing standards.' I can certainly assist in interpretation and helping them understand it, but I really cannot simplify standards. So the answer to the question is: they are the professional standards being set by the international accounting and auditing bodies.

Senator WATSON—If you changed the introduction so that they had to comply with the intent of the standards, surely that would get around the opportunity of some creative accounting within those standards. This is one of the problems which the Accounting Standards Board recognise. That is why they frequently change their standards.

Mr Macmillan—Of course. We are constantly changing and improving them—or hope we are improving them—as Mr Alfredson said. But the basic standards—the format of the presentation, the type of presentation and more particularly the items that are included in it and the statement of financial performance or the profit or loss or surplus—have to be measured in accordance with those standards.

Senator WATSON—Finally, do you think that, at the end of the day, there should be some simplified statement that gives greater emphasis or focus on cash and cash movements and the importance of cash in terms of what has happened? You can create all sorts of valuations and dress-up your balance sheet and improve your profit and loss but, at the end of the day, if you are paying dividends out of some of those decisions you may not necessarily have the cash to be able to support those decisions. Is there enough? Are we losing sight of the importance of cash in our attempt to get so-called sophistication into our accounts?

Mr Macmillan—The accounting standards require that the production of a statement of cash flows is one of the four parts of the financial statements. So the answer to that is that it is already included.

Senator WATSON—But the way it is presented does not necessarily stand out as a premier type document or a focus that people should be looking at. Can we improve the manner of its presentation or require directors to report on these particular issues?

Mr Macmillan—I do not know what other answer I can give. In the accounting standards we are required to produce a statement of cash flows in a particular format, and this is now an international accounting standard. So I would have to say, as a member of the profession, that that is the—

Senator WATSON—You think it is quite adequate at the moment?

Mr Macmillan—As a purely personal aside, I think that the emphasis on cash is somewhat inconsistent with the conceptual framework and we should revert to the funds statement. But that is only a personal view. I would support the accounting standard on presentation at the present stage.

CHAIRMAN—Thank you very much, Mr Macmillan, We appreciate your coming and talking to us today. If we have further questions, I am sure you will not mind if we put them to you in writing.

[1.51 p.m.]

HOUGHTON, Professor Keith Allen (Private capacity)

CHAIRMAN—I now welcome Professor Keith Houghton. Professor Houghton, you were with us for the entirety of the first day of hearings and you have been here all day and I understand that you have read the transcripts of our hearings to date.

Prof. Houghton—No, I have not read all the transcripts.

CHAIRMAN—Considering what you have heard thus far, have any of the views in your submission to us or any of the views that you have put to the committee—as you were our first witness—changed?

Prof. Houghton—By and large, many of the observations I made in my submission and in my evidence to the committee on the first day hold. I think there are some opportunities for enhancing some of the suggestions I have made. There are some enhancements, for example, that Mr Alfredson has suggested to me that I warmly agree with and I think there are some suggestions that would be very useful in terms of the role that the regulator would have in the model I have suggested.

CHAIRMAN—Would you like to tell us about those?

Prof. Houghton—I have proposed what has been called a model of auditor independence boards. Since the original concept, there have been a number of developments in terms of this being operationalised and developed into something that can be used practically. Those developments and enhancements have made me, and some of my colleagues, think about how the various parties in the process of auditing could interact and communicate with each other. In terms of how I see the model of auditor independence boards develop, I would see a clear module in respect of the independence board, a module in respect of the audit firm, a module in respect of the audit committee and board of directors of the auditee and a module in respect of the regulator.

I understand the secretary has handed out some papers. If you turn to the last page you will see the sorts of modules I see in respect of an auditor independence board and how it might be put in place. Each of those modules would have various component parts to them. For example, the independence board would have a set of objectives and it would have a set of risks that would need to be considered. For example, one major risk of an independence board would be that it might be captured by the audit firm. So there would be risks identified and means of protecting the independence board from risks like capture. Would you like me to give an illustration?

CHAIRMAN—Could I ask a question first? Are we talking about an external oversight board?

Prof. Houghton—No. Perhaps, given Mr King's observations earlier today, I might try to explain the difference. An oversight board that is a general across-the-community type board, has an important role in terms of protecting the public's interests. But those sorts of boards tend to only operate after the fact—after there has been some economic damage done. They tend to deal with only extreme or fairly gross occurrences. They tend to deal with only things that are easily measured. Auditor independence involves lots of subtle things—lots of things that are hard to measure, that are not necessarily obvious, that might not be evident unless you breach client confidentiality.

CHAIRMAN—So you are talking about your model of a group of individuals within the audit firm more or less like the audit committee of a listed corporation?

Prof. Houghton—I would parallel it more with the external directors on a board of directors of a listed company.

CHAIRMAN—Are you familiar with the way that Ernst and Young operates?

Prof. Houghton—That is the one firm I have least knowledge of.

CHAIRMAN—Please continue.

Prof. Houghton—I would see that there would be a group of individuals who would be appointed who would not have any direct association, affiliation or obligation to the audit firm. These people would have distinguished reputations. They may have expertise in auditing but they might also have expertise in ethics, the law or some other aspect that would be useful in terms of making judgments about ethical or independence dilemmas. The process I would see is the independence board would have rights of access to information within the audit process of the audit firm that they relate to. For example, if the audit firm has electronic working papers, they would have the opportunity of extracting information from that electronic working paper and returning it to a server of the independence board so it could not be shredded or deleted. They would make judgments and decisions in respect of key potential independence dilemmas and then they would report in respect of that on each individual audit. The sorts of illustrations are the first three pages of that material that I have given to you.

CHAIRMAN—At the public hearing on 21 June, you agreed with the following remark from Senator Watson:

You have to equip audit committees with some mechanism to get the real information.

What sorts of mechanisms do you see as being appropriate?

Prof. Houghton—What I think we were discussing at the time was where there were potential conflicts or issues that would be relevant to the auditee and, in particular, the audit committee and external directors of an auditee. This would be one mechanism where they could access information in respect of potential threats to independence, potential conflicts and difficulties that have arisen, and these would then be reported via these sorts of mechanisms to not only the audit committee but also all stakeholders, including, most particularly, shareholders.

CHAIRMAN—You were here this morning when we started debating the paper by Mark Liebler, who will follow you today. You have heard his contention that 'true and fair' is a legal requirement as is complying with the accounting standards. Can you tell us your view of that issue?

Prof. Houghton—There are two general issues that I would raise. I personally believe that 'true and fair', if the culture around which the set of words is upheld, is a very powerful tool because it goes beyond a checklist, which in a simplistic way accounting standards are—that is, you can check off all the accounting standards and you have a bunch of numbers. 'True and fair' means something much bigger—a more wholesome, more complete type of assessment of the company. My view of 'true and fair' is that you stand back and you decide whether the financial statements in terms of the position and performance of the company are reflected in the quantum of all of those statements that are produced for them. So it is something rather bigger than just a checklist of accounting standards.

CHAIRMAN—Having said that, and having an appreciation of the words in the Corporations Act, do you agree with Mr Liebler that both are legal requirements; that is, adherence to accounting standards and adherence to true and fair?

Prof. Houghton—I am not a lawyer; I introduced myself as an accountant. I think that was something of a legal question, Mr Chairman.

CHAIRMAN—All right.

Prof. Houghton—If you would like an inexpert view—

CHAIRMAN—I would indeed.

Prof. Houghton—then I would think that they both apply.

CHAIRMAN—We have had many witnesses who do not agree with that view—or some, anyhow. I am informed that 'some' is more accurate. If that is the case, and because some do not read it that way, it would seem to me that it might be appropriate that we examine how those words in the Corporations Act might be modified to make sure that nobody misunderstands.

Prof. Houghton—I think that would be useful, but I also think there needs to be a culture in which those words are interpreted. From my understanding, there are essentially two alternative ways in which 'true and fair' can be interpreted. It can be interpreted that 'true and fair' needs to be used to protect against the situation where the financial statements, if presented as they are, do not truly represent the underlying economic substance of the firm; to overcome shortcomings in accounting standards. I understand many UK practising accountants interpret it in that way, whereas some in Australia take the view that 'true and fair' is not used in that way but to overcome accounting standards that are not as 'helpful' as they would wish.

CHAIRMAN—You will recall that I suggested to you during the first hearing that the Corporations Act requirement that an auditor be a natural person might be something that we would look at. I suggested that you think about what your view would be of a change to the Corporations Act that required the audit group to be a company rather than a natural person.

Have you thought about that issue? If so, would you like to share your thoughts with this committee?

Prof. Houghton—I think the idea of having an incorporated entity poses no significant risks or difficulties. It does introduce the issue of limited liability, which I am sure every auditor in the country would applaud. It would provide the opportunity for more interrogation in terms of the substance; by virtue of being a company, there would be further obligations in terms of disclosure of the underlying substance of the organisation that do not exist with respect to a partnership. I think that, in terms of dealing with scale, there are some advantages to being a company.

The one difficulty that occurs to me is that, by and large, my understanding of the operation of large and small audit firms in particular is that the income stream is relatively volatile. So, if it were a listed company, it would probably be seen to be a fairly high risk organisation because of its volatility. In addition, there is always the difficulty faced if the audit clients are the owners or part-owners of the audit firm. We might start further narrowing the number of companies that an auditor could make, because they could not audit their own shareholders. The market is already very limited, and I think that is a potential difficulty.

CHAIRMAN—Some auditors have suggested to us that unlimited liability makes it more difficult for them to threaten a company determined to apply accounting principles in a manner such that the auditor questions whether that is what the accounting standard means. It also makes it more difficult for them to put pressure on the director to conform with the auditor's view. Does that ring any bells?

Prof. Houghton—I do not really understand the logic of that argument, frankly, because if an auditor genuinely believes that there is a problem in respect of that particular disclosure, surely he or she would be decreasing the potential liability by insisting that that did not proceed or, if it did proceed, that there would be a qualification. That would be limiting their liability rather than exposing themselves to an increased liability.

CHAIRMAN—Fair enough.

Senator MURRAY—Professor Houghton, you have achieved somewhat iconic status with your various submissions and evidence to the committee. I am still dissatisfied by the whole process. I rather enjoyed the interchange with Mr Alfredson earlier today because he brought it back, for me, to the reality that in the end human behaviour is best affected by good culture, good ethics and good conduct and by mechanisms which enable—to use his terminology—backbone to be put into people who might already have character but need the independence to show that character. Right at the heart of my query is still the threshold issue which I have been on about in various forums for well over five years, and that is independence: how you actually arrive at independence. As I have said to some people, if you use other models which exist elsewhere, you know it is the process of appointment and the security of tenure, within which is the level of remuneration and of risk and the method of termination, which apply. To me, the three key players in this particular issue we are discussing have to be management, directors and auditors.

Prof. Houghton—And shareholders, too. They are the ultimate stakeholders.

Mr KING—Not in the context that it is being raised by the senator.

Senator MURRAY—I almost feel that in most cases shareholders en masse—I am not talking about that shareholder or those shareholders with controlling interests—are acted upon, and really the concern of parliaments and governments is the mass. They think those who have the controlling interest are big enough and ugly enough to look after themselves, in most cases. Do you feel that, as you have felt your way through the processes of submissions, hearings and re-reading the interaction here, you have got closer to an environment which will contribute to a recovery of an ethical culture where independence is practically achievable, as opposed to just a tag put on bodies and organisations?

Prof. Houghton—Yes, I do. While it is true that there is a notion of a culture of ethical behaviour and what have you, you do need to give people the right structure within which to operate.

Senator MURRAY—That is right.

Prof. Houghton—At the heart of independence, for me, is transparency and objectivity. A part of objectivity would be, for example, where a decision is made independent of the commercial interests. The illustration I have given elsewhere is that there are circumstances where a decision has to be made—an independence decision, a threat to the independence of the audit—and if that decision is exclusively left to someone who would commercially benefit from the outcome of the decision, then I think there is a real threat to the independence of the process. Therein lies my idea of establishing a group of high integrity, high reputation people that can operate in real time within a firm, protecting client confidentiality, and that have no commercial interests in the outcomes of their decision. In addition, if the existence of such a board or committee means that an audit partner faced with an intimidatory client can say, 'I cannot make that decision; that has to be referred to the independence board,' it gives the partner some backbone. It gives them the opportunity to return fire to an intimidatory client by saying, 'It is not my call. It is an independence board matter.' And that independence board should have very limited, if any, contact with the client in respect of those sorts of decisions. It puts a structure in place within the firms, in real time, with detail that is not presently available.

Senator MURRAY—I hate to get to the circumstance of saying what is or is not the most important, but it seems to me, in my own judgment, that the failure has been in boards—

Prof. Houghton—Boards of companies?

Senator MURRAY—In boards of publicly listed companies, in terms of their management and their directors. It has not been in audit so much, yet people are trying to address the problem with boards by making auditors more capable of doing the regulatory job. So, I keep coming back to the issue of how do you make board decisions objective and separate from those controlling interests—either management or financial, whose interest is in corrupting the system—as opposed to the rest of the shareholders' needs. And how do you get that distance between the board and the auditor to ensure that there is genuine independence? I do not feel that, in all the submissions we have received, that issue has been addressed. There has been terrific attention on the audit side but I am concerned that the attention has not been applied where the real problem is.

Prof. Houghton—The number of submissions and the quantity that you have talked about is probably related to the title of your committee. I accept that there are really three alternative solutions, and I think Ian Ramsay said it correctly. You can have a solution based at the audit firm, you can have a solution based at the company level and you can have a solution based at the regulator—or some interchange between all three. I think a more comprehensive solution that deals with at least some aspects of all three of those is probably a superior solution that will be more sustaining and more long lived. I confess that the solution that I have been talking about really attaches to the audit firms with some interactions with the other stakeholders, but I am sure there are people much more expert than me who could assist you in respect of the boards of directors.

Senator MURRAY—I have come to the conclusion that, regardless of the terms of reference of the committee and our particular focus, we are going to be obliged by the nature of the problem to at least try and deal adequately with the three areas you outline. I will end with a request that if you have any blinding—or as you describe them 'inexpert'—insights into areas which I think have been insufficiently addressed so far, it would be useful if you could drop us a further note.

Prof. Houghton—Agreed.

Mr KING—Professor, looking at your model of an audit independence board, it seems to me to involve two processes. One is the management of the audit firm asserting that the checks and balances are in place and working, but wouldn't it be better to come from them in a public statement?

Prof. Houghton—Better to come from the audit firm?

Mr KING—No, from the managers of the firm.

Prof. Houghton—I think they do frequently say that their systems are excellent and working fine—

Mr KING—But they do not explain how.

Prof. Houghton—But they do not explain how, and I am not sure the market would be entirely satisfied by the management of an audit firm explaining that their processes are good. I think they might be much more satisfied with people that do not have commercial interests in that audit firm making that assessment, independently on each audit.

Mr KING—I have some doubts as to whether or not outsiders can say terribly much about the internal management of an organisation such as that.

Prof. Houghton—I think it does depend on how much detail they are given access to.

Mr KING—Yes. The second issue you raise in your model concerns not the audit firm itself but the firm which is the subject of the audit by the audit firm. It seemed a little bit cumbersome that your board should be examining both issues at once. In relation to the second issue, if this board idea of yours gets up, it is going to be a very busy outfit, isn't it?

Prof. Houghton—Yes. And if it is busy and it does work it will help restore market confidence in the output of the audit process.

Mr KING—And who pays for it?

Prof. Houghton—It would be paid for from within the audit firm. I have explained that there are mechanisms to put in place a trust to try and distance it. I would suggest that there are mechanisms for causing separation between the audit firm and the independence board, and that is one of the key risks, that the independence board be captured by the audit firm. But there are processes and policies that can be put in place. There is also the question of people of considerable integrity being called on to serve on these boards. Yes, they would be busy, and the busier the better, because I think the market wants some system to feel more confident about the output of an audit process.

Senator WATSON—There has been a lot of emphasis on audit independence and auditors' roles and auditors' failures, but there are other people involved. For example, in 1999 the Australian Stock Exchange admitted something like 120 new companies. In your view, are their listing rules sufficiently rigorous? Had they been more rigorous, they may have prevented some companies getting aboard that perhaps should not have been there, thereby saving a lot of people, including auditors, some loss of reputation. How much blame do you think has to be attributed to bodies other than auditors? It seems to me that there is an unhealthy focus at the present time on the auditors alone rather than all the other players within the system. I said this morning that I thought the focus on auditors was because they had deep pockets and they were the ones at the end of the line.

Prof. Houghton—I think that is true. There has been a lot of focus on auditors as having deep pockets, and there is actually part of the research literature that talks about the deep pockets hypothesis as being explanatory of some of the behaviour we have observed. It is true to say that there are some interesting results in respect of initial public offerings. Interestingly, there seems to be a disproportionate number of IPOs that have high-profile, well-known audit firms as those that investigate the process, disproportionate relative to the market as a whole. Yes, there are checks and balances, so it is not just the auditors that have a role in respect of IPOs. However, IPOs are systematically high risk and you would expect a fair number of them to be problematic. But I agree that auditors are not the only ones when it comes to IPOs. There are other stakeholders and other processes that are less than perfect.

CHAIRMAN—I go back to your model. Would your model necessarily be less effective if the audit firm had, instead of calling it a board, an independence committee which looked at risk assessment and looked at the operation of every audit group and what it did with the client independently of the audit partner? If as a failsafe mechanism it reported to the chairman of the board and/or the chairman of the international company or partnership, whichever it was, of one of the big four, would that fulfil the same objective?

Prof. Houghton—Less so that having something that is entirely distant from the firm itself. I think the biggest single risk to the independence board is that the market believes that the audit firm has undue influence on the deliberations in respect of independence. My view is that the market has lost a lot of confidence in auditing. As I have characterised in my submission, to have any value auditing must be competent and it must be independent. It must be competent,

otherwise why bother. It must be independent because the financial reports are the representation of management, and if the audit is not independent of management you may as well have the original representations anyway; it does not bring any value. So it needs to be competent and independent, and the market needs to be satisfied that that audit is both competent and independent. An internal committee might be useful in quality control processes within the firm, but in terms of restoring market confidence we need something distinct and separate and not captured or even thought to be captured by the audit firm.

The next extension is that if we have just a public oversight process, that tends to be after the crisis has happened, in extreme cases and without the fine detail. That is why a real-time system will actually enhance the audit process and, hopefully, bring value back to an audit so that it is priced as a premium product and not as a compliance good.

CHAIRMAN—If I remember right from our first discussions, you are not a regulator; you believe in encouragement rather than regulation. Yet here you are supporting a three-stage regulation which does not exist today, as I see it. Firstly, you are proposing that we require an audit firm to have an independence board. Then you are also agreeing with the suggestion of Professor Ramsay and others that the public companies have an independent audit committee of the board made up of independent directors, and that that be mandated. And then you are going along with Ian Ramsay's suggestion that we have an audit oversight independence board. Good grief! What happened to the non-regulator Professor Houghton?

Prof. Houghton—Obviously, my primary submission is in respect of the audit firm, because at the moment audit firms can compete on competence and on price, but there is no mechanism for them to compete on the quality of their independence. It is non-transparent. The quality of their independence decision making is completely unavailable to the market. And that is what the independence board does. I do not see that as a regulatory function. I see it as a window for the market to look at the quality control procedures within an audit firm of the independence decision making. It is not a regulator; it is a window for the market to look through.

CHAIRMAN—The first time around, did we discuss—I will ask you to remind me, because I do not have the transcripts here—the independent auditor doing other work to enhance the quality of their work with respect to reporting to the shareholders?

Prof. Houghton—I am not sure whether you discussed that with me, but I am familiar with the general issues.

CHAIRMAN—The general question, then, regarding the general issue is: would you support a performance audit? That is the term we use. Others, particularly the accounting profession and the auditing profession, do not seem to like that. If the independent auditor, in addition to reporting on the state of the books, reported on the state of risk analysis within the company, reported on the state of internal corporate governance in an open and transparent way to the market—what views do you have on that sort of regulation?

Prof. Houghton—I suspect, if the market really wanted that, we would see it evolving. We do see it evolving in the public sector, because the market for information in the public sector wants that material. I have not seen evidence of that in the private sector other than in a few rare instances, so I am reverting to my market stance.

CHAIRMAN—Thank you, Professor Houghton. We do appreciate your attending this committee once again.

Prof. Houghton—Thank you for the opportunity and for your time.

[2.25 p.m.]

LEIBLER, Mr Mark Matthew (Private capacity)

CHAIRMAN—Welcome to today's hearing. We have received your submission and have authorised it for publication. I am aware that you would like to make a brief opening statement, but my colleague Mr King must leave us very shortly and he would like to ask you a question, so if you do not mind we are going to reverse procedure and let him go first.

Mr Leibler—Okay.

Mr KING—Thank you, Mr Chairman. I hope this does not inconvenience you at all, Mr Leibler.

Mr Leibler—Not at all.

Mr KING—I have had the opportunity of reading your submission, which we recently received, and I found it to be of great assistance. My question concerns the true and fair view about which you have made some points. Are you of the view that a correct approach—and I am using the words 'true and fair' in the ordinary meaning—to the true and fair view, which should be something that ASIC amongst others ought to be examining and administering, would allow investors, shareholders, creditors, administrators and others interested in the books of a company to obtain more than a black-letter view of the state affairs of the company? That is, would it give a true view of the affairs of the company so far as the financial statements would enable that to occur?

Mr Leibler—My view is that the law today requires that that be so. I was appalled by what ASIC had to say this morning and I will have something to say about that.

Mr KING—That is all I wanted to know, Chairman.

CHAIRMAN—You have asked for leave to make a longer than normal opening statement, but could you please make it as quickly as possible.

Mr Leibler—I will make it very quickly, Chairman. The submission speaks for itself, especially the conclusions, and the bottom line is that the law requires that financial reports comply with both accounting standards and present the true and fair view—not subject to debate. If there is a conflict between the two then a reconciliation is to be provided in the notes to the accounts—not a subject matter for debate. The suggestion that compliance with accounting standards, ipso facto, amounts to giving a true and fair view is unsustainable as a matter of law—I did not regard it as a matter subject for debate. The law has two separate requirements and expressly provides for how a potential conflict is to be resolved.

As a matter of law, accounts cannot be said to give a true and fair view if they provide a misleading picture of the financial position and performance of the company. Those words—they are not my words—are taken out of the Corporations Act. By the way, the words 'financial

y are not my words—are taken out of the Corporations Act. By the way, the words 'financial position and performance of the company' were first introduced into the Corporations Act in 1998. If you look at the explanatory memorandum which accompanied the introduction of that, it stated that this approach of linking true and fair view with the financial position and performance of the company was viewed as being consistent with information that is relevant to the assessment of the performance, financial position, financing and investing. It was taken straight out of the statement of accounting concepts. I repeat: information that is relevant to the assessment of performance, financial position, financing and investing.

I argue and I passionately believe that a move to mark to market accounting—setting out everything at market value—is necessary in order to give a true and fair view. But I recognise the suggestion—if you take it all away as controversial—mark to market does raise some difficult issues particularly in relation to treatment of wasting assets and special purpose buildings and plant. What I do say, however, is that if you are going to give meaning to the expression 'true and fair view' at the very minimum you look at mark to market and you work backwards from there. It is important, however, that this committee understand, because I do not want to create confusion here, that the basic thrust of my thesis is not dependent on adopting a purist approach to mark to market accounting. Whether or not mark to market accounting is adopted it is demonstrable, and in my view beyond argument, that in many cases compliance with accounting standards can and does produce grotesque, misleading accounts which cannot be viewed as complying with the true and fair view requirement.

Take for example, the case of a building acquired for $20 million that is now worth $10 million. It is included in the accounts at $20 million simply on the basis that the undiscounted—and I repeat undiscounted—cash flows resulting from the sale of the building and net leasing cash flows produces in 10 years time—I repeat in 10 years time—that figure of $20 million. Let me give you another example: concerns of treatment of goodwill. A company buys a milk bar for $500,000 of which $400,000 represents intangibles—goodwill. Accounting standards require that the goodwill be amortised over a period of not more than 20 years and that it be taken into account at cost less amortisation. If the readily realisable goodwill value of the milk bar increased by another $1 million over two years that key fact could never be gleaned from looking at the accounts. However, by giving effect to the true and fair view requirement, the notes ought to bring that additional value of $1 million into account and in practice this does not happen. Just to make your day and by the way in case you wondered, the goodwill, which is represented by a brand name, can be brought into account at fair market value and there is no requirement for amortisation.

The standards, which mandate these different treatments, are referred to by my accountant colleagues as accounting standards. I say they are more accurately described as legally mandated accounting distortions. My submission, I believe, demonstrates that accountants do not understand their legal obligations. By the way, and in there now, aided and abetted by ASIC which I will come to in a minute. Take Michael Coleman, National Managing Partner, Risk and Regulation, KPMG who stated in evidence to the committee—and this is important:

I believe that if true and fair view was returned to the primacy position that it was previously in, an auditor has another very strong tool, because the 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 the accounting standards, are still not right. I do not believe that they are right. I would really like to see the true and fair override reintroduced.'

Mr Chairman, I put it to you, and to this committee, that under the law as it stands today—without any amendment—the auditor would be obligated in the circumstances outlined by Mr Coleman to say to the board of directors, 'I'm sorry, but the actual accounts, even though they may comply with accounting standards are still not right. This has to be rectified by way of a reconciliation note to the accounts.' Mr Coleman's misunderstanding of the auditor's legal obligation is clearly reflected in the general practice of the auditing profession today. Alarmingly, he is not alone—far from it. I regret to say that ASIC bears a significant part of the responsibility for the failure on the part of the auditors to carry out their legal responsibilities.

ASIC is the enforcement agency. ASIC has an obligation to provide the audit profession with its view of what a true and fair view means. It is an independent requirement and cannot as a matter of law simply be equated to compliance with the accounting standards. I have with me a copy of the latest amended legislation that has been introduced into the United States Congress. Indeed I believe it has just been passed by their House of Representatives. That legislation will require each set of accounts to be accompanied by a statement signed by the CEO and CFO attesting to the appropriateness of the accounts and that they:

... fairly present, in all material respects, the operations and financial condition of the company.

Is it not ironic that, just when the United States is introducing a true and fair view override, ASIC is writing to the chairmen of all public companies to inform them that they must be scrupulous in abiding by the accounting standards. Moreover, and I do not say this lightly—I have had a couple of hours to think about it—today when giving evidence before this committee ASIC issued an open invitation to directors and auditors to flout the law.

Mr Rodgers said that the law should not be read as a general invitation to rewrite accounts, prepared in accordance with accounting standards, in order to give a true and fair view. But that is exactly what the law requires. What ASIC should have been telling public company chairmen is that, whilst it is important to comply with accounting standards, this is not enough. And it is not enough as a matter of law. ASIC should have been emphasising that corporate financial reports must, independently of compliance with accounting standards, give a true and fair view and that compliance with accounting standards will not necessarily achieve this legal objective. ASIC has a duty to insist that an appropriately highlighted reconciliation statement should be incorporated into the notes to the accounts when this is necessary to ensure that they give a true and fair view. The media release that this committee issued earlier this week made two significant observations. Firstly, it said:

We now have a golden opportunity to get things right.

Secondly, it said:

The regulatory bodies need to be firm in enforcing the law.

In my view, the committee got it right on both counts. Right now, the law, as it stands, is not being enforced. Right now, the critical need is to ensure that the law, as it stands, is enforced. Finally, for the sake of completeness, I just want to point out that the committee's inquiry deals with auditing and therefore my focus has been on the role of auditors. However, everything I have said applies, and with even more force, in relation to the legal obligations of public company directors. Thank you for your indulgence, Mr Chairman.

CHAIRMAN—Thank you, Mr Leibler. You have heard my questions throughout the day regarding your view and regarding the Corporations Act. You know what it says as well I do, except that I am looking at it. Notwithstanding your view that it is now the law that the true and fair view of the accounts is equal in value, having complied with the accounting standards, because it is clear that that is not clear throughout the profession, how do we revise these words to make it clear and succinct? Have you thought about that?

Mr Leibler—Yes.

CHAIRMAN—You are the lawyer.

Mr Leibler—First of all, if ASIC decides that it is going to enforce the law then we do not have to change the words. If ASIC continues with its present attitude then I think the law can be revised quite easily by adding an additional paragraph that says that the obligation to give effect to the true and fair view et cetera has equal primacy and must be applied equally with the accounting standards but that this ought to be included by way of a reconciliation note. It can spell that out in more detail.

I am not of the view—I was originally, when I started looking at this area—that we should have a true and fair view accounting override, because there is very considerable force in the contention that it is important to have accounts which are comparable. You cannot have everyone preparing accounts in a different way. The beauty of our current system, if the law were only applied, is that we have our cake and we can eat it at the same time, in the sense that we have comparability of accounts. When you have the new international standards coming in, all companies all over the world can and should comply with them. When you lodge your corporate accounts with an income tax return with the Commissioner for Income Tax, you include a reconciliation statement and show the difference between accounting income and taxable income. In this particular case, you can put in a reconciliation statement that shows income, profit or a balance sheet according to accounting standards that, as modified, will reflect what is necessary to give a true and fair view.

CHAIRMAN—Let us take Mr and Mrs Joe Public, who have some shares in two or three companies: they read the annual reports and they depend on the annual reports to give them some idea of whether they will continue to invest in that company and do not just listen to their broker. Report A gives the accounts. The auditor signs off at the bottom and says, 'I agree that the accounts represent the financial state of the company,' but 20 lines down there is this wee bit of type that one needs a magnifying glass to see that says, 'There is an emphasis of matter here regarding the treatment of leases.' What about that situation?

Mr Leibler—First of all, 'emphasis of matter' is misleading. Second of all, there is no reason why the statute cannot say that this particular note must be highlighted above other notes and must be placed in a prominent position in prominent type and must be headed 'reconciliation to true and fair view' so that everyone will know this is the first place to look if you really want to find out what is going on. If you really want to find out that your milk bar, although it is in the accounts at $500,000, is really worth $1½ million, this is where you will look and this is where you will see it.

CHAIRMAN—Mr Leibler, could I ask you to do the committee a favour and write us a set of words that we might—

Senator MURRAY—At no cost!

CHAIRMAN—At no cost—absolutely. Could you prepare a set of words to change sections 295(3)(c) and 297 of the Corporations Act so that we can get this balance in plain English?

Mr Leibler—Chairman, I would be happy to do that, in the expectation that I would find this as part of your final recommendation.

CHAIRMAN—I have been accused in this morning's press of being plain speaking. We like plain English, because it does not hide things and people understand what is going on. Thank you for your confidence in the committee's inquiry into auditing, because that is what we started out to look at: this is a committee of audit.

Mr Leibler—Mr Chairman, ASIC can and will probably ignore me. I do not think they are in a position to ignore this committee, so this committee has got a golden opportunity to get things right. The reason ASIC have adopted the attitude they have is that, were they to adopt a correct and unarguable view of the law, as I have outlined it today, they would have to explain why they have done nothing about it over the last few years. So I do not think you will get them to back off, but maybe we can at least come up with a solution that spells out beyond any possible doubt what is now the law. I am very happy to cooperate by assisting in that.

CHAIRMAN—We would appreciate that.

Mr Leibler—Without any pay, Mr Chairman.

CHAIRMAN—Thank you very much. Could you also deal with the issue that we just discussed about where to put a non-qualification as a qualification on the accounts so that my Mr and Mrs Joe Public can expect to see it there with the signature of the person who signs off the accounts, where it is not hidden, where it is not buried? It is a nonsense, in my view, to skirt around the issue by calling something an 'emphasis of matter'. It would be helpful to get rid of that. I do not think I will have any trouble convincing fellow members on the committee that we deal with this issue. It has been highlighted throughout the inquiry. You said in your submission that the act does not define the expression 'a true and fair view'.

Mr Leibler—That is correct.

CHAIRMAN—And you said that there is no clear judicial determination of its meaning. Would you also give us a definition?

Mr Leibler—For my part, I would be very happy to adopt the one that was given by Professor Bob Walker. I think it is in my submission.

CHAIRMAN—Yes, at page 14.

Mr Leibler—That definition virtually applies in any case, because his definition is very similar to the definition in the 'Statement of accounting concepts 2'—I think it is. It was said in 1998, when this legislation was changed, that this was intended to be consistent with that particular requirement.

CHAIRMAN—Whose definition was it?

Mr Leibler—Professor Bob Walker. It is in my submission and it is also in his submission. He says, 'Without affecting the generality—

CHAIRMAN—Could you tell me what page?

Mr Leibler—In Walker's submission on page 4.

CHAIRMAN—We do not have that submission.

Mr Leibler—Do you want me to read it to you?

CHAIRMAN—Yes, please.

Mr Leibler—He says, 'Without affecting the generality of the meaning of the term 'true and fair view' a 'true and fair view, in relation to accounts—

CHAIRMAN—We do have that. He goes on, ' ... or group accounts means a representation which affords those who might reasonably be expected', et cetera.

Mr Leibler—Chairman, let's start off with something fairly fundamental: let's have accounts which are not misleading. I am serious here. These accounting standards in some cases produce misleading accounts.

CHAIRMAN—I think you and Keith Alfredson would agree absolutely.

Mr Leibler—I thought his testimony was very good this morning.

CHAIRMAN—So did I. You say on page 14 that Alan Kohler recently highlighted the difference between the applicable law in Australia and in the United States and you quote him as saying:

One thing that has been highlighted by WorldCom and Enron is that the quantity of disclosure does not equal transparency.

Can you comment on that?

Mr Leibler—In America until now, depending on whether this legislation goes through parliament, they have had what we call process driven, black-letter law. By the way, it has been much worse than our Australian accounting standards. If you have a look at the annexure to my submission—

CHAIRMAN—I did.

Mr Leibler—and what Walter Schuetze has to say. He makes the point, for example, that with a basic thing like a definition of an asset you have to be a genius to begin to understand it and to come to grips with it. Forgetting about people generally, very few accountants in the United States are able to understand what the definition of an asset is. WorldCom may have just been blatant fraud but, I think, Enron was another story altogether—it was a matter of black-letter accounting standards. The beauty is that in Australia we still have the requirement that accounts overall have to give a true and fair view; at least, I thought that was the case until I listened to ASIC this morning—maybe more on that later.

CHAIRMAN—Mr Schuetze said and I quote:

... under the FASB's—

The Financial Accounting Standards Board in the United States.

definition of an asset, corporations report as assets things which have no market price whatsoever; examples are goodwill, direct response advertising costs, deferred income taxes, future tax benefits of operating loss carry forwards, costs of raising debt capital, and interest costs for debt said to relate to acquisition of fixed assets. I call these non-real assets. Today's corporate balance sheets are laden with these non-real assets; this is the kind of stuff that allows stock prices to soar when in fact the corporate balance sheet is bloated with hot air. Of course, when it comes time to pay the bills or make contributions to employee's pension plans, this stuff is worthless.

He goes on further too.

Mr Leibler—According to ASIC, we have to push to comply with this stuff as it applies in Australia. One thing you should appreciate about ASIC's comments this morning is that what they put to you in terms of interpreting what is in their submission is inconsistent with their submission. They say quite explicitly in their submission, and I am reading from it, 'International standards should reintroduce to the law an overriding qualitative accounting consideration and audit opinion that accounts truly and fairly report the financial condition of the corporation.' Mr Rodgers then comes along and says that we really did not mean that; we are not talking about a general override; we are saying that we believe our standards themselves should be more principle driven. With respect, if ASIC change their minds over something they ought to say so instead of trying to interpret what they say in a way that bears no possible relationship to what they said in their original submission.

CHAIRMAN—We have dealt with true and fair view. Can we move on to seek your view on some other issues? Mr Leibler, you are a company director. You heard my last questions to Professor Houghton. It seems to me that he is proposing, in conjunction with Professor Ramsay and others, a three-pronged regulatory approach to this issue of quality of audit and assurance to the public of good, clean, independent auditing: each of the companies themselves have an auditing committee made up of independent members of the board of directors and mandated not even by ASX listing rules but by the Corporations Act, they must be independent and they must act as a functional audit committee and will have certain responsibilities. In addition to that, the company that audits the audit company must have an internal independent audit review group, and it must be made up of members who are independent of the audit firm itself. On top of that, we have an audit independence oversight board that looks over the whole industry. That

is in addition to ASIC and to the accounting and auditing disciplinary board. How do you come down on all that?

Mr Leibler—It is a ridiculous case of overkill; it really is. Once accountants and auditors understand what their responsibilities are in relation to true and fair view and that those responsibilities are going to be enforced, I think that is what is going to make the big difference. Professor Houghton quite correctly said, 'It's a question of fostering the right sort of culture.' I must say, the thing that really upsets me about what ASIC had to say this morning is that they appear to be deliberately fostering a culture of noncompliance with the law. I think that is a very serious matter. What we ought to be doing now, particularly in light of what has happened in the United States, is saying to accountants and company directors, 'Hey, you guys, sit back there and listen. You should understand that these accounting standards in many cases have produced bad and misleading results. You've got to sit there'—as Professor Houghton said—'and look at everything overall. Take an overall view of it, and decide whether or not it gives a true and fair view.'

Those words might not be capable of precise definition, but there are many other standards in our law that are incapable of precise definition. It does not mean that you cannot clearly say in a particular case that it falls squarely on one side, on the other or somewhere in the middle where you have got alternative views. That is the approach that I believe will lead to correct practices. We are human beings; if there's something funny going on between management and an auditor, do you really think that one of these independent bodies up here is going to find out about it and do something about it? I think we should all grow up and live in the real world.

Do you know what will have an impact? The one thing that will have an impact is if the auditor thinks that ASIC and others are going to be looking at these accounts afterwards and that, if they do not present a true and fair view, he is going to be in real trouble. That will get him thinking. I tell you what, it is going to be a different ball game. In all public company boardrooms this year, it is going to be an entirely different boardroom. The auditors are going to be questioned as never before. The auditors are going to be questioning management as never before. There are treatments that have been accepted in the past because of blind adherence to accounting standards, which I do not think are necessarily going to be accepted now. The real problem is that, in terms of enforcement and in terms of promoting the rights of culture, ASIC today in this room has put things back considerably by what it has said, and the committee needs to do something to set this right.

CHAIRMAN—I agree with you that there will be much more intensive oversight of companies and auditors today. That is inevitable when you consider the meltdown in the United States. We had three pretty bad cases, but they had a meltdown. But the fact that that is going to happen does not really fix any structural problem, does it? We visited this issue in the late eighties and early nineties, did we not? We are now revisiting this issue in 2002; that is little more than a 10-year cycle. As chairman of this committee, I do not want to be back here again in 2005.

Mr Liebler—Let us be clear about this. Some recommendations were made by Professor Ramsay which, I think, make a great deal of sense. I am not in favour of compulsory rotation of auditors every seven years, but I am in favour of compulsory rotation of the audit partner. I do believe that having independent directors sitting on audit committees is important. There are

two issues in relation to the integrity of the audit. First of all, audits cannot be seen to be tendered for in loss-leading situations. Second, auditors cannot be placed in the position of having to audit work that they have done in some other capacity. Subject to those sorts of restrictions, I think that nowadays you are going to find audit committees and boards right across the spectrum looking very carefully at this and being very conscious of what auditors ought and ought not to do outside their audit activities. But I do not think we ought to be totally inflexible in all this; I think that can be counterproductive.

Senator MURRAY—As you know, Mr Liebler, I have had the pleasant experience of interacting with you in a number of committees over the years. Every time I am reminded that not only do you have a fine mind but also a very clear method of putting your arguments, which is always helpful for a committee like us. If I contrast you with the responses that the committee got from ASIC, I think it is a reminder that regulators need to be very clear about what they mean. It is like having policemen who confuse you; you want to know what the word 'no' means. I thought there was a bit of a lesson there for us. Thank you for your input which, as we know, is based on considerable experience. There is another thing I want to say, which you passed over but which I am sure was meant to be there. That is that 'a true and fair view of the accounts has not been expressed' does not necessarily relate to a negative situation; it can relate to a positive situation, which is exactly your milk bar example.

Mr Liebler—Exactly. It is equally misleading.

Senator MURRAY—That is right. For various reasons there are deliberate understatements of asset values, overstatements of liabilities and retarding—as opposed to front-ending—of revenue circumstances, which I am sure you have come across in your professional life. I am a bit wary after some experience of legislation. Is it your view that, rather than too much prescription from us, we should just get people like ASIC or whoever is the appropriate body—and I would think that they are the people—to give guidelines on this? If you are saying 'true and fair view' you must cover the following things; you mean it positively or negatively; it is significant or material; and those sorts of qualifications. How would we address that in our report?

Mr Liebler—I am not so sure about giving guidelines. Section 180 of the Corporations Act says:

A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

(a) were a director or officer of a corporation in the corporation's circumstances …

There is no other guidance; apart from something about business judgment, that is fundamentally it. It is 'a true and fair view', not 'the true and fair view'. That envisages that there will be a band of cases somewhere in the centre where you can have alternative treatments which are quite genuine and justified. If the accounting standards mandate one of them and not another, you will take the accounting standard. There is no issue with that at all.

But there are many cases—for instance my milk bar example and others—where we will be able to say, 'Look, even though we cannot define "true and fair view" any more than we can define "degree of care and diligence" we can see straight away if you take a reasonable man test

that this falls on the wrong side or this falls on the right side'. We have got to be very careful because to trust ASIC with giving guidelines on something like that is to trust ASIC on giving guidelines on due diligence when it comes to directors. I really think that that is a matter for the parliament and not a matter for ASIC. That gives ASIC quasi-legislative sort of powers and it would give me a greater feeling of confidence to know that they are being exercised by the parliament and not by some regulatory authority.

Senator MURRAY—The issue of independence of auditors to me means we have got to address those things I have outlined earlier, such as security of tenure, proper remuneration, depth and scope and nature of audit, method of appointment and method of dismissal. If, from whatever our recommendations are and whatever the government comes up with, we end up with a more independent profession, I would hope to see something which does not rely as much on law and relies more on standard setting, if I may put it that way.

Let me give you an analogy: in motor car magazines, manufacturers—who have got their hands somewhere in the back like a hand in a puppet—will rate cars. All motor cars fulfil the requirements of the law: safety standards, emissions et cetera. They will rate them and they will say, 'This car is the best'. I would hope to see a situation arise—and again to return to something you said which I thought was insightful—where they would say, 'The company has drawn up its accounts in accordance with accounting standards. Those accounting standards do represent a true and fair view of the accounts. However, we as an audit firm believe, in this particular instance, this company would be far better served by doing an accounting to market valuation circumstance or suggesting that their hedging routine was inadequate. I think the signals we rely on from broker companies or from financial journalists and the ASX would be greatly assisted if audit companies were more precise about improving the statement of their view.

Mr Leibler—I agree with that, but let me take it one step further. What about a change which requires the auditors to identify the five most significant accounting issues which were the subject of some discussion or some concern in terms of drawing up the accounts—to identify them and to set out what the concerns were and how they arrived at their decisions. What would be wrong with that? I think that would make the accounts much more revealing. It would straightaway give anyone who had a look at the accounts some idea of some of the difficult, sensitive issues that led the board and the auditors to come down one way or the other. But at least you would get a better view of why those issues were there in the first place and have an opportunity to think about them.

Senator MURRAY—I like that. I say through the Chairman, if you felt so inclined and were to drop us a few words which could express that desire in law, that would be useful. I think, ultimately, the people on both sides of these tables have goodwill. They essentially want a market and a corporate environment which operates far more effectively and creates far more wealth and jobs with minimum risk. These mechanisms exist to advance it, I think. That is useful.

Mr Leibler—I am happy to do that but, at the end of the day, investors and the public require protection of the true and fair requirement which, unlike now, is in fact actively enforced. If I could go back to my tax analogy, when I started practising the Income Tax Assessment Act was 150 pages and it is now about 5,000 pages and nobody understands it.

CHAIRMAN—Do we need to know that?

Mr Leibler—We do need to know it and no-one really understands what it means. People have woken up recently to the fact that instead of plugging more and more loopholes in more detail, you achieve your objectives more through general antiavoidance provisions. You know what: true and fair view is like the equivalent in accounting terms of the general antiavoidance provisions; it prevents people from manipulating accounting standards using them in a way that was never intended in order to afford protection to the investor. ASIC today effectively appear to be dispensing with that protection and I find that a matter of great regret.

Senator MURRAY—Are you saying that those words should mean what they say?

Mr Leibler—Correct. By the way, their meaning is clear. In my submission I have quoted various eminent jurists who point out that the words say what they say and they mean what they say. It does not mean that you can clearly define everything, but you can clearly say that 'a' does or does not fall within it.

Senator MURRAY—I do not know if you have been following some of the things the committee has been saying, but one of the areas we have discussed and examined is whether we should be encouraging a situation whereby financial audits, or insurance audits as we might call them, are supplemented by performance audits in the public sector and government business enterprises. Have you thought about that and do you have anything to say about that?

Mr Leibler—Not in any great detail other than to say it is a great idea.

Senator MURRAY—Thank you, I do not think we need any more.

CHAIRMAN—In your conclusion 3 you said:

Although, occasionally, auditors pay lipservice to the 'true and fair view' requirement, in practice that requirement is not treated as having any independent significance over and above compliance with accounting.

Have you any proof of that or is that just a view?

Mr Leibler—No. It is not something that I can prove; all I can say is that I have read the evidence that has been given before this committee so one can see for oneself what the auditors say about how they regard their role. I have spoken to many accountants about this. I was invited by someone very senior to a well-attended luncheon hosted by the Institute of Chartered Accountants where a very senior auditor said that, in his view, it was the role of the auditor to form the true and fair view in accordance with accounting standards. This is reflected in some of the testimony before this committee, so it is not really a question of me telling you what the auditors do; it is simply me pointing out that one would think that the auditors would do things in accordance with the way they perceive and publicly articulate their obligations.

CHAIRMAN—Thank you for your submission, Mr Leibler. It has been enlightening and informative. As you are well aware, having spent the day with us, we have pursued your issue comprehensively throughout this hearing. You owe us some words on paper, which we would appreciate, and if we have further questions will you mind if we put them in writing to you?

Mr Leibler—Not at all.

CHAIRMAN—We have run out of time for public hearings if we intend to report on time, and we do, otherwise we will not make the difference we would very much like to make.

Mr Leibler—By when do you need something?

CHAIRMAN—The answer is the age-old cliché—as soon as possible—which is about as useful as nothing. How long is a piece of string?

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

That an additional submission by Graeme Macmillan, submission No. 52, dated 26 July 2002 be accepted as evidence and authorised for publication.

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

That a document entitled EX15—Exhibit 15: 'Presentation on Internal Risk Management' presented by Ernst and Young be taken as evidence in the committee records as exhibit 15.

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

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

Committee adjourned at 3.10 p.m.