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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: CLERP (Audit Reform and Corporate Disclosure) Bill

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MELBOURNE

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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Thursday, 18 March 2004

Members: Senator Chapman *(Chair)*, Senator Wong *(Deputy Chair)*, Senators Brandis, Conroy and Murray and Mr Byrne, Mr Ciobo, Mr Griffin, Mr Hunt and Mr McArthur

Senators and members in attendance: Senators Chapman, Conroy, Murray and Wong

Terms of reference for the inquiry:

To inquire into and report on:

The exposure draft bill, CLERP (Audit Reform and Corporate Disclosure) Bill, and relevant matters.

WITNESSES

Committee met at 9.41 a.m.

ACTING CHAIR (Senator Wong)—Today the committee resumes its public hearings regarding its inquiry into the exposure draft of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, and relevant related matters. The committee expresses its gratitude to the contributors to this inquiry, including those who will be appearing as witnesses before us today. To date, we have received almost 60 submissions, but we would welcome, and are still accepting, additional submissions.

Before we commence taking evidence, I wish to reinforce for the record that all witnesses appearing before the committee are protected by parliamentary privilege with respect to the evidence provided. Parliamentary privilege refers to special rights and immunities attached to the parliament or its members and others necessary for the discharge of parliamentary functions without obstruction and fear of prosecution. Any act by any person which operates to the disadvantage of a witness on account of evidence given by him or her before the Senate or any of its committees is treated as a breach of privilege. I also wish to state that, unless the committee should decide otherwise, this is a public hearing and, as such, all members of the public are welcome to attend. This is the committee's fourth public hearing for this inquiry. Additional hearings will be held in April on dates still to be determined.

RAMSAY, Professor Ian Malcolm, Director, Centre for Corporate Law and Securities Regulation, University of Melbourne

ACTING CHAIR—Welcome. The committee prefers all evidence to be given in public, but should you at any stage wish to give any part of your evidence in private you may ask to do so and the committee will consider your request. I now invite you to make a brief opening statement and then we will proceed to questions.

Prof. Ramsay—I welcome the opportunity to appear before the committee. Underpinning the recommendations in my 2001 *Report on the Independence of Australian Company Auditors* is the key principle that ensuring the independence of company auditors involves a multipronged approach. Firstly, there must be a focus upon audit firms, ensuring that 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. 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 desirable that the Auditing and Assurance Standards Board, following the recommendations in my report, has announced guidance on enhanced disclosure of non-audit services. I also regard as highly desirable the increased and important focus on the role of audit committees. Thirdly, there must be a focus on 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 indeed done so. Finally, there needs to be a focus on disciplinary bodies, and I made recommendations in my report for the improved operation of the Company Auditors and Liquidators Disciplinary Board.

I welcome the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003. Many of the recommendations in my 2001 report to the government are contained in the bill. The bill introduces a number of important reforms that are very welcome and desirable.

A number of the recommendations in my report are now contained in the bill and include the following: for the first time there is a general requirement in the Corporations Act for auditor independence; a requirement that auditors make an annual declaration that the auditor has complied with the auditor independence requirements contained in the act and applicable codes of professional conduct; the introduction of specific restrictions on certain employment and financial relationships between auditors and their clients; the imposition of mandatory waiting periods before partners of audit firms may join an audit client; a requirement for the compulsory rotation of auditors after a fixed number of years—I recommended seven years; I note that the bill contains a period of five years but with a power granted to ASIC to waive that period in certain circumstances; a requirement for the auditor to attend the AGM of a listed company at which the audit report is tabled and to answer reasonable questions about the audit—I did regard it as an anomaly that the Corporations Act had not hitherto contained such a requirement; strengthened oversight arrangements, in particular new powers vested in the Financial Reporting Council, which I will comment upon separately; and a requirement for listed companies to disclose in their annual directors' report fees paid to the auditor for each non-audit service, as well as a description of those fees.

In my report I focused also upon disciplinary arrangements, and it is therefore pleasing that the bill contains a number of improvements in relation to the Companies Auditors and Liquidators Disciplinary Board, including the capacity for that board to sit in more than one division simultaneously and to provide for the appointment of a deputy chairperson and for the board to provide information in the course of its proceedings to investigation and disciplinary committees of relevant professional bodies. Again I regard that as an important initiative contained in the bill, and it was one that I recommended.

The bill also contains provisions based on my recommendations relating to qualifications and practical experience of auditors, and I welcome those. Finally, registration of auditors: the bill contains a proposal to lodge an annual statement with ASIC on the part of registered auditors rather than the current triennial statement with ASIC. I regard that as an improvement over the current situation, where information can quickly date. I am pleased that that is incorporated into the bill. Also, very importantly, ASIC may impose conditions under the bill on an auditor's registration. I did regard it as an anomaly that auditors may not necessarily choose to belong to professional associations. Given the current environment, which I support—a co-regulatory environment in which we delegate significant responsibility to the professional bodies; we entrust them with this important role—then of course there is quite a gap if auditors, perhaps for very good reason, are not members of those associations. So with this new provision in the bill ASIC can impose conditions upon registration. As I stated in my report, one very important condition would be that they comply with those ethical rules in a sense as if they were members of the relevant association.

There are other parts of the bill that I welcome even though they were not in my report: for example, the introduction of the operating and performance review has the potential to significantly assist shareholders by providing them with meaningful information about the challenges facing the company.

I do, however, see some scope for improvement in the bill. I recommended the introduction of a new body to supervise the new auditor independence requirements. The bill gives this task to the Financial Reporting Council. This could work, but there are two key issues: will the FRC have sufficient resources, and does it have the right membership? I am not yet sure that the FRC has sufficient resources to undertake these new and important tasks. In relation to membership, I recommended that there be representation of the public interest on any body charged with the important task of monitoring the independence of Australian company auditors. It is unclear to me who represents the public interest on the FRC.

Another matter is what is termed critical accounting policies. On 26 July 2002 I gave evidence before the Joint Committee of Public Accounts and Audit in relation to its inquiry on the independence of auditors. I said:

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 … As noted by the … 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—

as I said before the committee in July 2002—

… there is a need to improve accounting disclosure.

I suggest that a focus upon critical accounting policies—where good faith differences of opinion may have a significant impact, if you like, on the financial results of the company and how they are reported—should be considered.

Let me also make two other brief comments. There is a new provision in the bill that was not in my report: clause 324CK, which relates to multiple former audit partners. This is a recommendation that is based upon the report of Justice Owen, resulting from the HIH royal commission. In brief, it limits the number of partners or former partners of an audit firm that can join a client. I have some concerns about that particular provision. It appears to have no time limits, so that a person who retired from an audit firm many years previously, and may in fact have expertise and skills that would be of significant benefit to the client, would be prohibited from offering those skills and expertise to the client if indeed there is one other former partner from the audit firm already on that company.

In an age when we only have four large audit firms and they have a lock on the largest listed companies in this country, and we have large companies that are transnational in operation, there are some important issues to do with whether this particular clause, which I think is clearly well intentioned and arises out of an appalling situation involving our second biggest general insurer, may be overinclusive and have an undue impact upon the market—if you like, the financial expertise—at a time when, for very good reason, companies need financial expertise on their audit committees and in critical accounting positions. In sum, then, might this catch—and I suggest it would—situations where there would in fact be no conflict; where the independence of the auditor would not be jeopardised by someone who might have stepped down from the audit firm 20 years previously? I suggest, with respect, that this might be a provision worth reconsidering.

My final comment takes me outside audit. The bill extends the existing clear, concise and effective presentation of product disclosure statements to prospectuses. I recently completed a research report on prospectuses that was published at the end of 2003. It demonstrated that investors or consumers really struggle with what is contained in prospectuses. It was a survey of members of the Shareholders' Association—the ASA—which of course by definition is a sample that does not reflect the broader population. In other words, these are people who, by definition, have an interest in their investment possibly beyond that of some others.

My survey showed that only 36 per cent of respondents said that prospectuses gave them sufficient information to make an investment decision. Fifty-six per cent of these respondents thought that, as a general rule, prospectuses were not easy to understand and they had particular difficulty with legal and technical jargon. So, in sum, I think that this particular provision—as I say, it takes me outside the audit provisions—focused upon the clear, concise disclosure that we have with PDSs at the moment, but moving generally into prospectuses, is something that I welcome, given my research, which shows that investors currently struggle with much of the content of prospectuses. Thank you. I welcome questions.

CHAIRMAN—Thank you, Professor Ramsay.

Senator CONROY—One of Justice Owen's recommendations relates to alternative accounting treatments. I think you mentioned this briefly. He said:

> … where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material … the impact of the position taken by the reporting entity—

should be explained in the audit report. Do you agree with Justice Owen's recommendation?

Prof. Ramsay—I do agree with that recommendation of Justice Owen. Indeed, as I indicated in my opening remarks, before Justice Owen published his report, in mid-2002 I gave evidence to another joint committee, where I indicated that such a provision would in my view provide meaningful information to shareholders of a company. There can be good faith different interpretations of accounting standards. It seems to me that we see a focus on this issue in other countries—and I draw particularly on the United States in this respect—where I think there are some things that we should give further consideration to, and this is one of them. I also think that some of our companies have moved down this path. As I recall it—I may need to be corrected—ANZ has announced that this is something they will do. Sometimes we see some companies doing these things voluntarily, and others may need a little bit of a prod.

Senator CONROY—Should auditors be specifically required to report on alternative treatments of financial information that have been discussed with management, the ramifications of such alternative treatments and the treatment preferred by the auditor?

Prof. Ramsay—In my view, yes.

Senator CONROY—Should that discussion of the alternative treatments form part of the audit report?

Prof. Ramsay—I think that where that would be located is an open question. I would be happy to give that further thought. It is a question of where that information would be most meaningful for shareholders. That may well be the audit report, but I would want to give further consideration as to whether that is the best location.

Senator CONROY—In addition, should auditors be specifically required to report to shareholders and the audit committee on such alternative treatments?

Prof. Ramsay—In my view, yes.

Senator CONROY—The CLERP 9 bill requires auditors to attend the AGM and to answer questions on the audit. The Australian Council of Superannuation Investors, ACSI, have advised the committee that they are concerned about situations where the chairman of a public committee has refused to allow questions to be put to an auditor about the appropriateness of the accounting policies adopted by that company. They say that the chairman's standard response is that the choice of accounting policies is the responsibility of directors and management. In your view, will company chairmen use this same excuse in spite of the new provisions in the CLERP 9 bill?

Prof. Ramsay—In my view, they should not. It seems to me that this is an area where shareholders are entitled to ask questions and indeed are entitled to receive meaningful answers in relation to them. So I would hope that, if there is an issue concerning a particular critical accounting policy and, if you like, good faith different interpretations, that is something that shareholders can quite legitimately ask a question in relation to and expect a meaningful answer.

Senator CONROY—ACSI's concern was that, not withstanding the good intent of the bill, this would still be a practice that management and the CEO or chair could use. They suggested that, to overcome that problem, the bill should be amended to require the auditor to answer questions about the basis on which the financial statements have been prepared. Do you have a view on that proposal?

Prof. Ramsay—It may in a sense be a different way of approaching the first question. Concerning the basis on which reports are prepared, again, without necessarily wanting to have AGMs bogged down in minute detail, if there is something that is significant in terms of its outcome for the report, then I think it is appropriate for shareholders to receive an answer to that question. We must acknowledge that discretion is vested in the chair of the meeting, but we would hope that the chair would be across these sorts of issues. And, of course, we would hope that a number of these questions would come in advance. If this system is to work properly, AGMs will not be hijacked by long statements, although one cannot totally prevent that, and perhaps one should not. But if the system works properly, we will have a good dialogue between shareholders and the board—and, in particular, the auditor—and information can be obtained prior to the AGM.

Senator CONROY—Have you been to many AGMs, Professor Ramsay?

Prof. Ramsay—I have been to a few; I am a shareholder in several companies. I have been to a few AGMs so I appreciate some of the dynamics of them, but there are others who are more expert on the running of AGMs.

Senator CONROY—The CLERP 9 bill introduces a general statement of principle requiring an auditor to be independent. This was also recommended in your 2001 report. Are you satisfied with the test of independence that is required under CLERP 9?

Prof. Ramsay—Yes, essentially I am. I appreciate there has been some change along the way, and I think the change that has unfolded in the most recent version of the bill is one that more closely sits with my original recommendations.

Senator CONROY—The general standard of independence is not met where a conflict of interest situation exists as defined by section 324CD (1). Are you satisfied with the definition of 'conflict of interest situation', or are there any modifications you would suggest?

Prof. Ramsay—I am essentially satisfied with what is in the bill on these particular issues.

Senator CONROY—Your 2001 report recommended restrictions on the employment of immediate family members. Are you satisfied with CLERP 9's proposals with regard to this?

Prof. Ramsay—Yes, I am essentially satisfied with the CLERP 9 proposals.

Senator CONROY—Subsection 307C applies to an individual auditor and requires the auditor to give to the directors of a company either an unqualified declaration or a qualified declaration that there have been no contraventions of the auditor independence requirements or the corporations legislation or any applicable code of professional conduct. Do you support this requirement for the auditor to give this type of declaration?

Prof. Ramsay—That was one of my recommendations and, therefore, I support it.

Senator CONROY—In a practical sense, how will it impact on the independence of auditors in your view?

Prof. Ramsay—My report was largely focused upon processes and essentially endeavouring to have the key participants involved with the company, both internally and externally, to ensure the independence of the auditor. One would hope that this sort of statement by the external auditor will not be a mere ticking of the box. If it works properly it will require the auditor to ensure that proper processes have been conducted within the audit firm and in the relationship between the audit firm and the client in order to make that statement. Of course there is a sting: for the first time it will be in the Corporations Act. If there are no proper compliance procedures in place, no proper monitoring and no proper reflection upon what is an appropriate relationship, there is quite a sting.

Senator CONROY—So where a qualified declaration is given to the directors, the individual auditor is required to set out the details of the contravention of the declaration. I appreciate the point you just made that you are looking at process, but would you have any idea about what types of contraventions you expect to be disclosed arising from this clause?

Prof. Ramsay—We see around the world instances of contraventions of auditor independence requirements. Some of these would be very clear threats to independence. It may be possible to have an inadvertent breach of a requirement and, indeed, in my recommendations and what is contained in the bill are certain defences in certain circumstances. One possible scenario might be where, for example, a relative has some very modest, minor investments that breach the requirements. The point I am making is that one needs to test these. Any breach is a breach and must be reported promptly and dealt with appropriately, but there are degrees of significance in terms of what relationships—employment or financial—impair the external auditor's independence.

Senator CONROY—The CLERP 9 bill asserts cooling-off periods before a member of an audit firm can join a former client. The final version of the CLERP bill states this cooling-off period only applies where the member or director was a professional member of the audit team for the audit. Are you satisfied with the scope of the cooling-off provision insofar as who the provisions actually apply to?

Prof. Ramsay—Yes, I am satisfied with those provisions. I realise that in terms of cooling-off periods there has been some variation in different versions of the bill. The time period in the one that is currently before this committee more closely sits with the recommendations in my original report.

Senator CONROY—Page 111 of the explanatory memorandum to the CLERP 9 bill says:

Division 3 implements recommendations of the Ramsay report—

and welcome to an explanatory memorandum!—

as refined in CLERP 9.

Are you satisfied that the CLERP 9 bill does in fact implement your recommendations? Are any key recommendations missing?

Prof. Ramsay—The CLERP 9 bill largely implements my recommendations and therefore I strongly welcome the bill, subject to what I said in my opening comments. As I say, those go to issues such as the role of the Financial Reporting Council—to take one matter.

Senator CONROY—I am going to move to the FRC in particular now, and you did talk about it a little bit and make some very valid points. I want to go over them a little bit now. Do you support the proposal for the FRC? You talked about a body. You are comfortable with that body being the FRC if there is not going to be another body?

Prof. Ramsay—I have given this considerable thought because what is in the bill does not sit with my original recommendation, which was for a separate and new body. However, I have said on prior occasions that I do think the FRC can fulfil this role if: one, it has sufficient resources; and, two, it has the appropriate membership. As of today I am not sure that those two criteria are satisfied.

Senator CONROY—Should the secretary of the FRC be provided by Treasury?

Prof. Ramsay—In my report I suggested that there be a separate secretariat. I would still prefer that, but in a sense I think that if the first two issues were satisfied—namely, membership and resources—a secretariat from Treasury could be appropriate. But I do have some reservations, and let me express them because I am not sure that I have articulated them publicly before. In my report, I said that if you have a separate secretariat where this is their mission, their objective, their priority, and how well they fulfil their job is judged according to the tasks given to that body, the question I would have—and it is not a question I have an answer to—is whether, if it is resourced out of Treasury, it will get the priority that it deserves. It may well get that, but, as I say, that is one of the reasons why I thought a small, separate secretariat would be appropriate. I raise that as a question but I do not have an answer to it. I am cognisant that Treasury has many important demands on its time.

Senator CONROY—The FRC currently meets behind closed doors. Do you think it should be more transparent and meet in public? Are there any other changes you think it should make to the way it currently operates?

Prof. Ramsay—In my view, as a general rule there are certain things the FRC currently does where I would see merit in more openness in their proceedings. At the same time, I think one must acknowledge that on certain matters of auditor independence, for example, while there would be a general principle of openness there may be some matters of such sensitivity that it would be appropriate to have closed proceedings.

Senator CONROY—I know you have mentioned that public interest representatives should be on the FRC. Are there any others you think should be? More importantly, are there any groups who should not be on the FRC, given its vital role?

Prof. Ramsay—The FRC as currently constituted largely has nominees from bodies. When I considered this issue of what independent body should best take carriage of auditor independence, I thought it quite appropriate that key stakeholders have representation. That would include the professional associations, ASIC and end users of financial statements.

To a certain extent, the FRC currently has those nominees but, as I said, I do see an important role for the public interest and I am not quite sure where that is when I see the current FRC membership. In my report I also made an observation that, in terms of representatives of the public interest, one should give thought even to public advertisement. The relevant minister might want to think about advertising, and choose the best qualified people on the basis of public advertising. I know that is not the current process but, again, I think these sorts of initiatives may be worth thinking about to ensure that you do have the best possible pool of people to choose from.

Senator CONROY—Do you support the proposal for the FRC to oversee audit standard setting arrangements?

Prof. Ramsay—Senator, I am not in a position to comment upon auditing standards.

Senator CONROY—Should the FRC also have oversight of the financial reporting panel?

Prof. Ramsay—Senator, I would say two things—one of which might be helpful, and the other might be less helpful. I generally support the concept of the financial reporting panel. I do not have a view as to whether that panel should be overseen by the FRC.

Senator CONROY—Keith Alfredson, who I am sure is known to you, has suggested in a submission to the committee that, before the FRC is given additional responsibilities, the ANAO should perform an audit of its activities with a particular emphasis on the FRC's governance arrangements. Would you agree?

Prof. Ramsay—I am not in a position to either agree or disagree, Senator, because I do not put myself forward as an expert—and this is an important point—on the FRC or indeed its membership, in the sense that I am not a member of the FRC. I do see their minutes when they come out, but I am not close enough to the issue to advise on that particular question.

Senator CONROY—Mr Alfredson was a member of the FRC. He has had the experience on the committee. It is an interesting observation from a former member. Could you advise the committee of your preferred model for funding the FRC in light of the failure to obtain corporate donations?

Prof. Ramsay—I think there is a number of alternatives. In my report I considered whether indeed the profession itself might want to provide money to largely support the body, provided, of course, there were no links that went with that funding model. One of the reasons I thought that was worthy of consideration is that it is the profession that has the greatest interest in

ensuring that the integrity of auditors is untarnished, because clearly they fulfil such a vital role in corporate governance in this country and in others. Having said that, I do think that it may be appropriate to have government funding. I am open to suggestions as to avenues for funding, but it is important that we get a clear message as to whether there is sufficient funding. Again, we have a body now that has a multitude of tasks. It might have responsibility for the new financial reporting panel, so how the FRC prioritise these issues seems to me to be quite important. How do they select from amongst their scarce resources where they put each dollar?

Senator CONROY—I would like to discuss the proposal in the CLERP 9 bill for the CEO and CFO to sign off to the board on the financial accounts. The ASX corporate governance guidelines and the Sarbanes-Oxley Act go much further than the CLERP 9 bill. The ASX guidelines require that the sign-off by the CEO and CFO should say that the statement is founded on a sound system of risk management and internal compliance and that it implements the policies adopted by the board. In your view, should the CEO and CFO sign-off under CLERP 9 extend to a sign-off on a company's risk management procedures?

Prof. Ramsay—I will say two things. Firstly, I do welcome what is currently in the bill in relation to CEO/CFO sign-off. Again, I think that if this system works properly it will improve what we might loosely call a culture of compliance within quite often complex organisations. A CEO/CFO sign-off should not be a mere tick of the box; in order to ensure that the system works properly, the CEO/CFO will have to make sure that appropriate, high-quality procedures exist throughout the organisation leading to a final sign-off. Secondly, I would prefer to just wait and see what happens with the current arrangements in the CLERP 9 bill and to wait for a little big longer to see what happens with the ASX corporate governance principles.

Senator CONROY—Do you think they might be nobbled along the way?

Prof. Ramsay—On the risk management in internal controls issue? I think it is a bit early to see what will happen in relation to the ASX guidelines on this. I have heard some preliminary evidence—it might have been a survey from one of the audit firms—that this sign-off on the internal controls, not just the main sign-off, was viewed by companies as presenting particular challenges.

Senator CONROY—We have had a presentation on that very issue.

Prof. Ramsay—I do not think the *Hansard* has been available, so I have not had the opportunity to look at prior evidence. Without the benefit of hearing that presentation, my view would be that we should see what occurs with what is currently in CLERP 9.

Senator CONROY—As you are aware, the CLERP 9 bill will require disclosure of executive and director remuneration, in accordance with the regulations which have not been drafted yet. Page 168 of the EM says that the information to be disclosed under the regulations 'will be the same as that proposed to be disclosed under the accounting standards'. In addition, there will be disclosures required in relation to performance hurdles et cetera. So in addition to disclosure under the regs, disclosure is required under the accounting standard. However, disclosures made under the accounting standard are not subject to the non-binding vote. In your view, should disclosure be required under the Corporations Act as well as under the accounting standard? Will this create inconsistency and confusion?

Prof. Ramsay—It should not. I would say, as someone who has done some research on remuneration issues—indeed, one of the early studies in this country on pay for performance—that we have had some challenges in this area. We have had inconsistencies between Corporations Act requirements, ASIC policy and accounting standards. It is regrettable that those inconsistencies in this very important area, where there is such interest from consumers and others, have continued for so long. I think it has taken too long for the standards board to come up with its recent standard. The fact that there were such inconsistencies and that they existed for so long does not reflect well on some of our processes. Having said all of that, it is a little difficult for me to assess what is going to come out of this. I welcome what is in the CLERP 9 bill on a number of remuneration issues. There is considerable sensitivity about this and I think that there is much that is positive in it. I appreciate, though, that we will have to wait, because we delegate through the regs as to what is contained in the act. I feel as though I am not yet in a position to answer that particular question.

Senator CONROY—The Australian Council of Super Investors, ACSI, have suggested that disclosure of executive remuneration should be made in accordance with a mandated table similar to that required by the SEC. I think they say that there is no need to reinvent the wheel. The new accounting standard AASB 1046 also suggests that disclosure is made in a table format, although it is not compulsory. Do you support the table format in the AASB 1046 for disclosure of executive remuneration, and should such a table be compulsory rather than voluntary?

Prof Ramsay—I wrote an article in, I think, the early nineties that drew attention to some international developments and the value of some of these tables on remuneration. I think it does focus the minds both of those within the companies and those externally on endeavouring to get clarity on key issues of remuneration. We have seen in the marketplace some tardy behaviour, I must confess, on this. I think that we have tried to improve transparency and yet we still see evidence that some companies struggle to appropriately disclose their remuneration arrangements. So, in sum, I go back a number of years to where I said that I had looked at what the SEC requirements were—I am sure my article was in the early nineties—and I thought that that sort of transparency was something that could well be in the interests of shareholders.

Senator MURRAY—I would just like to make the remark for the record that the BCA made it quite clear in their evidence the other day that they absolutely oppose transparency in this area. That was my reading.

Senator CONROY—In fact they called for a winding back.

Senator MURRAY—And they represent 100 top CEOs of this country, so it is no wonder that we have got a tardiness and a difficulty. You can have a look at the *Hansard* record for your own illumination, but there is the motive and the reason for a lack of transparency and proper disclosure.

Prof. Ramsay—I would only note that I detect a global trend to increase transparency. It would seem anomalous to me that some of our largest companies, many if not most of which have international operations, would be complying with increased transparency in other jurisdictions and perhaps feel as though they should not need to comply with that sort of transparency in Australia.

Senator CONROY—It is remarkable what the wannabe of globalisation, the BCA, do not embrace! I want to talk about termination payments. Are you aware of the existing sections 200B and 200G in the Corporations Act and related provisions which state that shareholder approval for retirement benefits is required only where the payment exceeds the amount prescribed by the formula? That is a little-known part.

Prof Ramsay—I have read them but it was some time ago. I do not believe that I am qualified to answer technical questions on those provisions, I am sorry.

Senator CONROY—There is a formula. If you go through it, you will see that it says that payments can still be made without shareholder approval which amount to up to 3.5 times their average annual income if they have been with the company for 3.5 years; five times their average annual income if they have been with the company for five years and seven times their average annual income if they have been with the company for up to seven years. When you look at the size of some of the salaries nowadays those are quite astronomical amounts: they can go well past $10 million and up to $20 million for relatively short periods of time. The Corporations Law says that they do not have to be approved by shareholders. In your view, should those types of payments be approved by shareholders—payments that would currently fall within the exemption that is in the act right now?

Prof Ramsay—As I said a moment ago, I do not feel as though I am necessarily qualified to comment on those particular provisions of the Corporations Act, although I think it is true to say that there is significant shareholder concern about what we have seen in inappropriate termination payments by some very notable companies—a payment of many millions of dollars for seven months work et cetera.

One of the challenges we have in this area—as I said, it is something that I have done research in—is that we endeavour to ensure that companies provide appropriate financial incentives for their executives. That means that there must be appropriate transparent hurdles. I am convinced that many companies are getting better at this, but getting companies to set the right hurdles on things like options has been a slow process. At the tail end, if someone needs to have their employment terminated because of poor performance, then shareholders are genuinely concerned if they see payments of many millions of dollars for poor performance and sometimes employment contracts that appear to go for under a year. In some instances we see companies getting it wrong at both ends, yet both ends are important in providing the right environment for senior executives.

Senator CONROY—The Australian Shareholders Association advised this committee that they are concerned with a resolution passed by Boral in October 2003 which nullifies the 100-shareholder test in relation to the proposal of certain types of resolutions for debate—not the EGM issue. The ASA said an amendment should be made to ensure that the Corporations Act takes precedence over provisions in a company's constitution. Do you have a view on the resolution passed by Boral? I am not sure whether you are totally familiar with it.

Prof. Ramsay—I am a little bit familiar with it. I have actually read the Boral statement. I believe that Boral obtained at least one QC's opinion on this particular matter, so I have no doubt that they believe they have a credible argument. I think it is an issue that needs close attention. because there appears to be an inconsistency in our Corporations Act between provisions that allow companies to do things in their constitutions and the existing provisions on shareholder

entitlement to call a meeting. That is the first point: I do think the Boral instance has shown us that there is an important issue here, an apparent inconsistency. The second thing is I have long maintained that the 100-member rule does need some changing.

Senator CONROY—The calling of an EGM?

Prof. Ramsay—That is right, the calling of an EGM.

Senator CONROY—This was related specifically to—

Prof. Ramsay—I understand that. Perhaps some senators may have a different view on that—the fact that a mere 100 shareholders in Telstra, for example, can call an EGM. As we have seen with the NRMA instances, there were a number of judgments from the New South Wales Supreme Court, including one in which a judge indicated that this was an inappropriate provision. I think we need to ensure that shareholders with an appropriate entitlement have the right to call an EGM; I am just not convinced about the figure of 100 members.

Senator CONROY—I think that is probably a unanimous view around the table. I do not think you will find there is any argument. Finding what the appropriate level is has been a matter of some debate over a lengthy period of time.

CHAIRMAN—I have a question in relation to the rotation of auditors. The University of Technology Sydney's Centre for Corporate Governance said:

The minimal research available—

on audit partner rotation—

suggests that the pursuit of independence benefits via mandatory rotation may come at the expense of audit competence.

The particular issue they raise is that expertise in certain industries might be limited to a handful of auditors, so auditor rotation will operate to deprive companies in those industry sectors of the highest level of competence available. Given the concentration of expertise in the big four, do you think this could be a problem?

Prof. Ramsay—I would just like to clarify whether, in relation to their submission, we are talking about the rotation of audit partners or the rotation of audit firms.

CHAIRMAN—Partners.

Prof. Ramsay—When I did my research and met with many auditors, I found that it was very common—indeed, it was regarded as best practice—for audit firms around the world to rotate their partners. So I am not sure what this research tells us. Any decent sized audit firms around the globe have for many years regarded it as best practice to rotate their partners. So are we saying that the research tells us that this global practice by audit firms is somehow not in the interests of their clients?

As part of my research, the 2001 report has a detailed chapter surveying all the empirical studies at the time on auditor independence issues. That must be 50 or 60 pages of the report. Of course, that was 2001, and more research has been done since then. But, if I recall correctly, there was some evidence from one study that the longer an audit partner stayed with the client the more there was a tailing off of a propensity to qualify the audit opinion. In other words, there was some evidence from one study that familiarity might make the individual audit partner less sceptical than she or he should be.

CHAIRMAN—The other issue I want to raise is the comment from the ASX that proposed requirements for the operating and financial review need to be more specific, and they point to current requirements in section 299(1) regarding operations and activities, which they say have:

... produced ... generic disclosure which is ... significantly less helpful than that required in equivalent jurisdictions.

To avoid this, the ASX has suggested that the legislation should specify a list of required minimum disclosure topics, possibly drawn from the proposed international financial reporting standard on management discussion and analysis. Do you have views in relation to the requirements of the IFRS? Can you indicate whether you agree with the ASX?

Prof. Ramsay—It seems to me that this has the potential to be one of the really important developments in the CLERP 9 bill. It has been less than fortunate that for so many years we have not had management discussion and review or this sort of disclosure in annual reports. Some of the corporations I have spoken to have said, 'We do this, Ian.' But when you grill them it turns out that they are doing it to analysts. They are doing it selectively. But there are bigger issues here. I do have a strong interest in ensuring that this works effectively—that we do get good quality, reflective disclosure and not boiler plate. Regrettably, we do see too many instances of boiler plate. I did a study—it is a little dated now—of the first couple of years or so of the new disclosure of corporate governance practices under the ASX listing rule. I think that showed that there was too much boiler plate. Again, given the heightened interest in governance, we are getting better.

I have an open mind as to how one should tackle this; in other words, whether you should leave it open ended at the moment—to use the jargon, 'principles based'—and allow companies full capacity to reflect and come up with good quality disclosure, or whether you give them some hints and guidance as to the sorts of things we might typically expect. There may be merit in giving companies a bit more guidance, but at the same time we would not want people to think that if they have done the five things, that is it, because a good quality MD&A must be different for every company, because each company faces different challenges and must be different each year as the challenges unfold. I feel that this is an opportunity to really progress quality disclosure, and there must be a bit of concern that there might be some boiler plate hawked around by some of the accounting firms to satisfy this—although I think the tenor of things has changed significantly in recent years. Some additional guidance might be appropriate, but you must fully understand that this additional guidance does not cover all the bases and could not ever be expected to.

Senator MURRAY—Returning to the 100-member rule issue, I was surprised and you were surprised. Three political parties determine corporate law, regulations and policy—the coalition, the Labor Party and the Democrats. We have said on the record, as had Labor, that the day the

government wants to sit down with those three parties and work out improvements to that law, we will, because we recognise it needs reform. The quarrel is over the nature of reform. But there is no disagreement that it needs improvement. I want you to be clear on that.

I turn to the FRC. Its enhanced role makes it a very important body with, I think, a huge impact on Australia's corporate nature, if you like. There are no established criteria which the government issues as to the basis on which it makes appointments to this body or similar bodies. Do you think that the law should require the government to publish the criteria by which it makes these appointments?

Prof. Ramsay—I think that, particularly if the FRC does obtain all these additional powers, there will understandably be increased interest in its membership and their qualifications, and I think it is appropriate for us to think about what criteria are appropriate in terms of appointment to the FRC.

Senator MURRAY—Let me be clear. I do not have in mind that the law should determine the criteria.

Prof. Ramsay—No, I understand that. If all of these powers are given to Financial Reporting Council, its mandate will be significant. I include in that audit independence issues, accounting standards and the new financial reporting panel. Some of those different tasks will require different skills. That has to be the case. So I am not sure—and I have said this already today—that we have the membership right. I guess part of determining whether you have your membership right is ensuring that you know what criteria should be imposed.

Senator MURRAY—People are very fond of talking about principles based legislation, but they kind of skip over the principles, and behind the principles should be philosophy. One of the principles that I think should be in the act is that appointments should be made on merit. You will not find that anywhere in the act—or in any other act, I might tell you. Do you think that the law should require as a principle that appointments be made on merit?

Prof. Ramsay—Are we thinking here of—

Senator MURRAY—The FRC or any other body that has appointments made to it through the Corporations Law.

Prof. Ramsay—In my 2001 report I always assumed that all appointments to the body that I recommended would be made on merit, including positions that are appropriate in terms of being nominated by organisations such as ASIC. I always assumed that, in a sense, appointments to those positions would be made on the basis of a person's qualifications and experience. I do not know whether that needs to be in the act, but I guess in principle you are right: the appointments must be on merit and they should be on merit.

Senator MURRAY—I ask you the question deliberately because in the partial democracy—and I use the word 'partial' deliberately—of the United Kingdom, where the executive dominates, the Lord Nolan commission of 1995 recommended that appointments to all boards and statutory authorities should be on merit and put out a list of requirements that should accompany that. That is now standard practice in the United Kingdom. I would have thought that

that was a good example to follow. It is a principle based example. I am happy to send you some material if you want to join me in the advocacy of this issue.

Prof. Ramsay—I would be very happy to receive that material and review it.

Senator MURRAY—I move to a fundamental issue which you know I have been concerned with: the motives which might lead to preferring a lack of independence in certain areas. As you know, in criminal matters—and I do not imply that we are talking about criminal matters—motives are a huge issue. It seems to me that much of the emphasis has been on auditors, when more emphasis should have been on boards, and that those with motives to pervert the spirit of corporate governance are the dominant management and financial interests. If those dominant management and financial interests control the members of the board, through patronage, you lack independence. My question is: does CLERP 9 address the issue of ensuring that directors who claim to be non-executive and independent are demonstrably independent of the dominant financial and management interests? That particularly matters, given the importance the proposed bill gives to audit committees. If the dominant and financial management interests end up controlling the elections to the board, who in turn appoint the audit committee, I do not think you have the right checks and balances in the system. What is your reaction to that proposition?

Prof. Ramsay—I believe that what is in the bill is a significant improvement on our current system and, it seems to me, will have positive outcomes for improving auditor independence. I specifically address comments on the audit committee. In my October 2001 report, I paid particular attention to the role of the audit committee as an important mechanism for ensuring the independence of the auditor. When I met with auditors, and others, during my consultations it became clear to me that many of our companies—and we are going back to 2001—did not have the right people on their audit committees and were not always giving the right tasks to the audit committees, so a large portion of my report focused upon audit committees. Of course, there has been a revolution since then—and I think a very welcome one—and companies are resourcing their audit committees better. They are focused on getting the right people on the audit committee. We are seeing audit committees meet more frequently and for longer periods of time. The old idea that the audit committee could meet shortly before the main board seems to be rapidly diminishing. I think they are very good responses. I think, though, that companies rely upon your critical point that the audit committee must essentially be independent.

Senator MURRAY—'Demonstrably independent' were the words I used.

Prof. Ramsay—Absolutely. I may not have necessarily used that phrase in my report. Certainly, I said in my report that companies should have audit committees and independence was important. In terms of independence, by and large I drew upon some of the established tests for independence in this country and elsewhere. I acknowledge, though, that the more one endeavours to define 'independence', the more you guarantee that you will not catch everything. For example, take auditor or directors' independence, a threat to being able to exercise independent critical, sceptical judgment might simply be a long friendship; whereas another director might be able to exercise terrific independent judgment, yet be taken out of being independent through one of the tests we have. So there has to be some discretion on some of these matters. You cannot have a situation of false comfort—and this is a very important point that I think is sometimes lost sight of—where, simply because you satisfy the IFSA tests on

independence or other tests that might circulate, that is it. As I say, long friendship might in fact impair independent judgment on a particular transaction.

It is one of the arguments I have made on non-audit services. I do not support the idea of banning a range of services—and I am happy to carry with that—because that might give false comfort. You cannot necessarily think that, because you have banned eight services, that is it in terms of auditor independence. Those sorts of rules have the real risk of being overinclusive and underinclusive—missing important issues that might threaten auditor independence and catching ones that may not be a threat to auditor independence.

Senator MURRAY—I think there is insufficient critical tension in boards. There is an open advocacy of a unified team approach, of an 'us versus them' approach, that board decisions must be unanimous and that, if attitudes are contested, they are not contested publicly, that the board has a unity of expression to ensure market stability. I do not think the extra checks and balances, which should be available through a vision of corporate democracy, are available. I will explain that. Take the example of HIH where the principal cause of the terrible goings on lay with the board and senior management. The ability of the dominant financial and management interests to pervert the future of that company was facilitated by the constitution of the company. It did not oppose the barriers to entry in a way that the board could re-elect directors and determine which directors were there. It did not attend to sufficient protective devices to ensure that there were non-executive, independent directors who would demonstrably express an independent point of view. In my question to you, I suggest that the bill does not devote enough attention to known techniques for ensuring that you get the best spread of talent and the most contestability for directors' positions. I think that is a weakness of it. The bill focuses far too much on auditors and far too little on boards.

Have you given any thought or analysis to examining the constitutions of companies and their methods of suggesting the election of directors—the way in which directors' names come forward, and the sort of patronage that is implicit in the system—to see if there is a best practice way of ensuring that the process of bringing people of talent forward and having them elected to the boards is as open, transparent and contestable as possible to guarantee that there are sufficient people of an independent nature and mind on boards to counterbalance the dominant financial and management interests. That is at the heart of my question.

Prof. Ramsay—It is important—to use your phrase—that board elections in a sense be contestable. I would say that this country and a number of other countries appear to be well in advance of the United States on these particular issues. Their recent debates are debates that we really have not had in this country, because we empower shareholders in a way that clearly does not exist in the United States. So I am rather intrigued as to those sorts of debates that they have and the strong resistance by some interests in the US to what we would regard as basic rights on the part of shareholders.

In terms of improving what we have at the moment, it is the case that many boards are not diverse in terms of a range of skills, experiences and backgrounds. We know that board discussions can be robust and that there can be strong dissenting views and, in some instances, we could perhaps expect some of those issues to resonate outside the company. For example, we can look at what happened with Mayne as an exception and, some years before that, a resignation from AMP.

I am not sure that I have any identifiable solution for ensuring that boards, which have a sense of self-perpetuation, necessarily get the right balance of highly talented individuals, but we are getting more transparent about this process. Indeed, one of the provisions in the bill is information about multiple directorships in terms of other listed companies. We are moving to give shareholders more information about the experiences and skills of those who are their directors or will stand for directorship. That sort of enhanced transparency is a step in the right direction.

We also need meaningful voting on the part of the institutions in this country. It is a major debate now and important because, in an era of shareholder democracy, we need to make sure that those votes are informed. The evidence appears to be that we could expect more from our institutions. After all, they have the economic influence to be a very positive force for ensuring good governance in our companies.

Senator MURRAY—That relates to my final question. For some time I have pressed ASIC—and, to a lesser extent, ASX—to produce best practice guidelines for the election of directors; in other words, a constitutional template and the processes and procedures which would minimise barriers of entry. They have not done that, and I am inclined to use this bill to enforce that process, either by requiring a review by CAMAC or by requiring ASIC to produce guidelines that are not binding but are an examination of the issue to determine whether the process of corporate democracy is maximised, because I think there has been very little attention to the mechanics. As politicians, we are so attuned to making sure that the mechanics of elections work well. We pay a great deal of attention to it in our political democracy. But in corporate democracy there is almost no formal, academic, analytical work being done on what is a fundamental issue about how to maximise contestability, minimise barriers of entry and ensure that you get demonstrably independent and capable people on the board for the maximum effect. That is really the nub of my question. In your generalised answers, I sense that you, as an expert, have never really examined that issue. Would that be fair to say?

Prof. Ramsay—In many respects, I have indirectly examined the issue by studying governance issues, but I have not specifically undertaken a research project that looks at the contestability of board elections.

I might add that the Corporations and Markets Advisory Committee did a report several years ago called *Shareholder participation in the modern company*. We see in the CLERP 9 bill some good provisions on enhancing and facilitating shareholder participation, but there are a number of reports from that committee that have not yet been implemented. It may be that some recommendations in that report would need consideration as part of achieving the objective that you have articulated.

Senator MURRAY—Which you do not object to?

Prof. Ramsay—No, but I think there is a general sense that you want contestable board elections and that you do not want self-perpetuation, if you like, where the board is not subject to proper contestability and proper testing that the right people are directing the company. I would be hard put to think that people—those with a strong, genuine interest in ensuring good governance—would think they are not worthwhile objectives.

Senator MURRAY—Thank you.

Senator WONG—On that last issue, if there is any additional evidence you could provide to us on that point subsequent to this hearing, I am sure we would be grateful for it. I just have a short set of questions about the FRC. I understood from your opening statement and from your answers to Senator Conroy that you have—if I can put it this highly—some serious reservations about the FRC, given its current make-up, performing the role that is contemplated for it under the bill. Is that correct?

Prof. Ramsay—I have reservations, if I can put it like that, about whether it has the resources and the right membership as currently constituted to do this multitude of very important tasks.

Senator WONG—You referred to the fact that there does not appear to be anyone whose focus is the public interest, for want of a better term.

Prof. Ramsay—That is correct. Having examined the membership, it is unclear to me if there is such representation. The bulk of the representation is really nominees. It is important that key stakeholders have their representatives, provided that even those nominees, to take Senator Murray's point, are selected on merit—that those bodies when they select their nominee assure themselves that the best possible person is represented on the FRC. That has to be more important if the FRC gets all these powers.

Senator WONG—But the appointment on merit does not deal with the issue of the representation of different perspectives.

Prof. Ramsay—I agree: it does not.

Senator WONG—So one would have thought it would be better to have a body, whether it is the FRC or not, where you deal with the different categories of perspectives, as I think you did in your report when you set out the membership of your proposal.

Prof. Ramsay—Indeed, that was my original recommendation, and I would still adhere to that.

Senator WONG—On the issue of Treasury providing the secretariat, given the proposed role for the FRC would you not agree that there is a potential conflict between what might be the government's interests, which Treasury obviously has to represent in a variety of areas, and the role of the FRC?

Prof. Ramsay—Perhaps I can answer this more directly. I think that question was asked earlier and I said that I was open to the idea of Treasury providing the secretariat, if there were sufficient resources. To answer more directly, when I do look around the key governance bodies, I look at the Corporations and Markets Advisory Committee. It has its own independent executive. I am a member of that committee, I should disclose. I am also a member of the takeovers panel, which has its own highly focused, highly talented executive—as does the Corporations and Markets Advisory Committee. Perhaps what is contemplated here does cut against established practice in areas where, in my opinion, we have bodies that work well

because of a talented, highly focused executive. The problem is not that you do not have highly talented people in Treasury, but what are their priorities.

Senator WONG—So, in your view, it would be preferable to have a structure similar to what CAMAC operates with?

Prof. Ramsay—Answering it very directly, that was my original recommendation in my report: I do think that would be preferable.

Senator WONG—Thank you.

Senator MURRAY—If I may use a phrase, what you are suggesting is that we need to encourage specialists not generalists. A Treasury person is likely to be a generalist in the sense that that is not their only or specific mission in life, whereas for a specialist it is their specific mission in life.

Prof. Ramsay—I might add that, if in Treasury there is someone highly specialised and skilled, there is no reason why that person, provided one checks the relationship, may not be part of the independent secretariat. One would need to think about how that might operate. But I take your point, Senator: you do want to encourage on the secretariat specialists rather than generalists. I think that has to be right.

Senator WONG—That goes to the issue of the talents of the people employed. As I understood your answer, there is also a broader, principle based issue, which is: to whom do these people report and what is the agency's agenda? I am not critical of Treasury on this, but you made the point that it is important to have some independence. Obviously Treasury has a perspective, which will generally be a perspective associated with the government—which may or may not be a good thing. The role of this body surely would be enhanced by having an independent secretariat.

Prof. Ramsay—I agree with that observation.

CHAIRMAN—There being no further questions, I thank you for your appearance before the committee. It has been most helpful to our deliberations.

[11.01 a.m.]

LARSEN, Mr Gregory James, Chief Executive Officer, Certified Practising Accountants Australia

MULCARE, Mrs Catherine, Policy Adviser, Financial Reporting and Governance, Certified Practising Accountants Australia

CHAIRMAN—Welcome. The committee prefers that all evidence be given in public but, if at any stage of your evidence or response to questions you wish to provide your evidence in private, you may request that of the committee and the committee will consider such a request to move in camera. We have before us your written submission, which we have numbered 31. Are there any alterations or additions you wish to make to the written submission?

Mrs Mulcare—Not at this time.

CHAIRMAN—I invite you to make a brief opening statement, at the conclusion of which I am sure we will have some questions.

Mr Larsen—CPA Australia appreciate the opportunity to appear before this committee. We understand that it is at the final stages of consultation and that, during that consultation, many of the issues have already been addressed. We would like to point out that the amount of work that has already been undertaken should not be discounted. Australia should be quite proud of the achievements over the past two years in addressing the issues of the financial reporting framework in the public interest. CPA Australia have invested significant resources in the development of the financial reporting framework, which has become the cornerstone of our involvement in initiatives such as the corporate governance council and CLERP 9 consultation as well as our involvement in international initiatives such as the IFAC credibility task force paper, which we made a significant financial contribution towards. We are very proud of the recommendations of the CPA Australia April 2002 paper, *Financial reporting framework—the way forward*. Many of the issues and proposals raised there are reflected in the outcomes of the domestic and international initiatives.

The strong leadership position that Australia has demonstrated over the past two years—and I can assure this committee that it has demonstrated such a position—is recognised internationally. We would encourage speed and diligence on the part of the committee to ensure that the bill has clear passage through the Senate to enable an effective application date of 1 July 2004. Not achieving this will seriously undermine not only some of the processes we have put in place but also the credibility of Australia and its leadership role in the international marketplace.

I would point out that CPA Australia provide a unique perspective, as our membership encompass a lot more than auditors and preparers. Our membership represent the majority of stakeholders across the whole financial reporting supply chain. Those members include professional accountants in business and commerce, managers, directors, regulators, analysts and—since we have more than 100,000 members—a few shareholders as well. We do have a very broad responsibility, and we have taken consultation from esteemed members in all of those

areas in coming to our policy positions. The greatest challenge facing the profession is the restoration of confidence in financial reporting, and CPA believe that the challenge for everybody in the supply chain of financial reports is to strengthen that financial reporting.

We have consulted with our broad membership base, but we have also hosted—together with the Institute of Chartered Accountants in Australia—two joint corporate reporting and public accountability fora in Canberra. The last one was only two or three weeks ago. These involved many stakeholders from around Australia in these issues and an in camera discussion on the issues for Australia. We have also been involved in discussion fora domestically and internationally as a member of the Stock Exchange Corporate Governance Council. We support the intent of the HIH royal commission's recommendations and believe that they can be achieved within a principles based regime to achieve CLERP 9 objectives of promoting transparency, accountability and shareholder activism.

We provided a submission to the committee on 17 November 2003, at the exposure draft bill stage, and on 4 December 2003 the government introduced CLERP 9 legislation incorporating quite a significant amount of the technical improvements that we supported at the exposure bill stage. We welcome those changes reflected in the final bill as a result of the consultations, and we look forward to early consultation with all stakeholders on the development of regulations and guidance which will enable the effective implementation of this bill.

We would like to make two or three points about the legislation. The first is regarding auditing standards being given the force of law. Australian standards must be aligned with international standards. If Australia chooses not to align standards with those that are implemented and recognised by other jurisdictions, our standards will be perceived to be lower. The potential impact of that on the capital market should not be underestimated. We support internationally pure standards that are flexible enough to cope with the changing environment. We support the IFAC reforms that have been developed in consultation with international regulatory bodies and all the professional accounting bodies in the world to ensure appropriate oversight of the international audit standard-setting process.

We believe that the Auditing and Assurance Standards Board, the AuASB, has quite frankly done a fantastic job internationally, contributing to the development and acceptance of auditing standards. We believe that committing two years of its valuable time solely to the job of rewriting standards is a real waste of resources, and we cannot see within the bill where the funding for that is reflected in the impact statements. There is no precedent anywhere in the world that we are aware of where the profession is told how to meet its legal obligations. Whilst it is appropriate that laws deal with the obligations of professions in the public interest, they should not be extended to the procedures of how they should be undertaken. If the committee is to support the legal backing of auditing standards we would prefer another mechanism, such as regulation.

Another point we want to raise is that, whilst we support the oversight of the financial reporting framework by the FRC, we do not believe that the model proposed by the bill is necessarily as robust as it could be or that there is as clear a purpose and explanation to the public at large as there could be. We believe that the responsibility of oversight is in the public interest, and we stand by the original oversight model we proposed. The third point is that we do not believe that the funding requirements or the financing of the financial reporting framework

have been sufficiently dealt with in the financial impact statement, and at times the regulatory impact underestimates the true commitment by business, the profession, the investors, the people sitting on these committees and the FRC to ensure the effective implementation of the CLERP 9 bill. Financing is a real issue which is not addressed and which is still a very difficult one. We have a couple of other points. We welcome the CEO-CFO sign-off on the requirements in the bill and we support the principle of continuous disclosure as an essential component of an efficient capital market. Cath and I would welcome any questions you might have.

CHAIRMAN—Thank you very much, Mr Larsen. One of the issues that has already arisen in our hearings and also from the HIH royal commission was a concern about whether accounts really reflect a true and fair view of a company. The HIH royal commission was concerned that preparers of accounts may have forgotten the significance of the true and fair view and endorsed the Joint Committee of Public Accounts and Audit's recommendation that the true and fair view requirement should be clarified. The other day we had evidence from Mr Geoff Dunsford, who believes there is a potential conflict—if not an actual conflict—between international accounting standards and the true and fair view means of accounting. Does CPA Australia consider that the true and fair requirement should be clarified, given the evidence we have had at the inquiry and also the recommendations of the HIH royal commission and of the Joint Committee of Public Accounts and Audit?

Mr Larsen—Over the last 20 years we have put in a lot of work to get accounting standards that we can rely upon, and we are moving towards international accounting standards. The issue with true and fair view is that it can be subjective. We are trying to move the profession to a point where the subjectivity of what is true and fair is less of an issue and the application of the accounting standards is a much more visual representation of conformance with the public interest.

Mrs Mulcare—In relation to some of the evidence that has already been put to the committee, there is some confusion from what I think somebody referred to as the 'fit for purpose' tests of the users. At the forum we have just had in Canberra, the Australian Shareholders Association correctly pointed out that there are a number of different users of the financial reports and, because of that, what is true and fair for one purpose may not be for another. There are many people calling for fair value measurement, for instance, and they believe that would be a better representation of what a true and fair view is; there are others who believe the historic cost and reliability of that information must also take precedence. I think that one of the things the committee probably should be made aware of is that, internationally, significant work is happening, as we speak, to deal with a financial reporting methodology that meets the needs of the various users, which I believe will be the way forward to finding an appropriate balance between accounting standards and a true and fair view.

CHAIRMAN—Do you agree with Mr Dunsford's view that it is important to at least have in the financial statements a note setting out the current fair market value of all assets and liabilities in a form which enables comparison with the values adopted under the accounting standards?

Mrs Mulcare—I think that issue is being explored—for example, by the value measurement reporting collaborative, in which CPA Australia is involved. The question, though, has to come back to the fact that the information presented in financial reports has to be reliable. Those notes also require that assurance be provided through the audit process. It is that reliability of

measurement that is currently being explored. I believe there was some discussion by the committee about what is fair value. Is it a market price? There was one extreme view that if there is no market—if there is no ability to sell it—there is no benefit in that asset; there is a counter view that if there is value in the use of the asset that value should also be reflected. The profession is working very hard to find those solutions as quickly as possible to provide the answers that the users need in financial reporting.

CHAIRMAN—On the same issue, several of our witnesses have indicated that financial reporting does not provide serviceable information about an entity's solvency, which is obviously of great interest to investors. If accounting standards alone do not produce financial reports that provide this information, is there merit in ensuring that the true and fair requirement does do that?

Mrs Mulcare—You would be aware that I also presented, somewhat informally, at a previous hearing in regard to the insolvency inquiry. The purpose of the financial report is very much to reflect the position and performance of the company as a going concern, and it is appropriate for the accounting standards to deal with that very issue. The problem comes in at the point when solvency might be brought into question. Whilst we acknowledge that shocks to the system undermine the confidence that investors have in financial reports, it is vitally important that that underlying premise of being a going concern is withheld in the financial reports. It should also be pointed out that it is absolutely the responsibility of the directors, under the Corporations Act, to consider the solvency of the company and those reports. At any time that the going concern principle is brought into question, that and the reasons for that concern should be disclosed in the financial statements.

CHAIRMAN—You raised the issue of the financing of the new regime. Do you believe that sufficient funding is being provided for the various bodies that are required to have supervisory roles under the act, including the FRC, the AuASB and the AASB?

Mr Larsen—My answer to that is that it is not quite clear. Firstly, it is not clear that we have all the funding. But the issue is who is going to provide the funds for whatever amount is required. I do not think that that has been settled. In the current FRC environment there has been an ongoing debate about the contributions of the profession, the government and business, and the processes around that have been flawed. The reason I raised the point was that I think that there is no clear process under this system for how the funding will proceed, either—where the funds will come from.

CHAIRMAN—Do you have a feeling on that?

Mr Larsen—Yes, our proposal has always been one-third, one-third, and one-third: one-third from professions, one-third from business and one-third from government. I think it gives an indication of the interests of the parties. Certainly, that is where the professions have been. We have made a major contribution. We are prepared to continue to make a major contribution, but we would like to see a better process for business making their financial contribution as well.

CHAIRMAN—So the shortfall is in the business contribution?

Mr Larsen—I would not say where the shortfall is, because the government's money is everybody's money, I suppose. The shortfall has been around the processes for collecting funds so that the businesses have been seen to be contributing their share.

CHAIRMAN—Do you believe that the FRC having control over the funds of the AuASB potentially compromises its independence?

Mr Larsen—Compromises the independence of which body?

CHAIRMAN—The AuASB.

Mr Larsen—I have not really thought about it. I do not really have any comment on that. I would not have thought that it should. The FRC has the oversight of the Accounting Standards Board and it will have the oversight of the Auditing and Assurance Standards Board. I think that funding is an important issue, but I would not have thought that it created a conflict, no.

CHAIRMAN—What about the powers of the FRC in relation to the AuASB? Do you think that that has any potential to compromise its independence?

Mr Larsen—The Accounting Standards Board's? No. I think the Accounting Standards Board needs some direction from a body like the FRC about where it should devote its resources and priorities—effectively, that is what it is about—and take responsibility for the quality of the people who are appointed to the Accounting Standards Board.

CHAIRMAN—What is your view on who should service the technical and administrative needs of both the AASB and the AuASB? Should it be a separate statutory body?

Mr Larsen—There should be a separate secretariat for the working committees, if you like—the Accounting Standards Board and the Auditing and Assurance Standards Board. We have always provided it under our Australian Accounting Research Foundation. We provided a separate secretariat to the standards setting authorities. They are focused on the work of those bodies. They support them, they are technical and they are administrative, but they are totally focused on those outcomes. That has worked for both those accounting and auditing standards setting bodies under the research foundation, and I think that that should be put in place under the FRC.

Senator WONG—Mr Larsen and Mrs Mulcare, I turn back to the FRC. You were here for Professor Ramsay's evidence. Do you share some of the concerns that he raised regarding the proposed role of the FRC, given its current make-up?

Mr Larsen—I do not remember what he said, so I am not quite sure what his concerns were.

Senator WONG—Among other things, he made the point that there is no-one on the FRC whom he would regard as representing the public interest.

Mr Larsen—I presume somebody from the ASA was on it.

Senator WONG—I am not sure that that is the public interest.

Mr Larsen—No, I am sure that he can represent the public interest. Certainly as a professional body we would like to think we take due notice of the public interest, and I am sure that others do as well. But I am not sure who would represent the public interest—if we could find one.

Mrs Mulcare—Interestingly, this is a challenge that is also being faced by IFAC in the establishment of their public interest oversight board. It is a challenge which I think we will probably have the benefit of learning from when we determine the composition. The concerns are definitely there, and it has to be seen to be meeting the needs of the public interest in order to be effective in the restoration of investor confidence. It is a challenge that will be worth facing and resolving.

Senator WONG—Do you have any suggestions for any changes in the make-up of the FRC?

Mrs Mulcare—Our original financial reporting framework paper and the model we originally put forward in response to the original CLERP 9 talked about the composition being a smaller group with the expertise necessary to deal with the issues that the new powers would face. The model put forward was broader than the model that is currently in the bill. It incorporated corporate governance and it took care of the whole range of the financial reporting framework. We do not think that CLERP 9 and the rules contained within the Corporations Act are the only parts of the solution for Australia. We believe that the ASX Corporate Governance Council's guidelines are a very important part of the restoration of confidence and therefore should fit in there as well. We can probably provide that report and the composition that we suggested within it.

Senator WONG—Does it differ greatly from the composition that was originally proposed in the Ramsay report?

Mrs Mulcare—I do not think it differs greatly. I will do the comparison and check—

Senator WONG—It would be useful if you could do that.

Mr Larsen—Picking up on that point, I think that, when we are looking at this in depth, the important thing is that the people appointed to the FRC have public credibility. That is important to the public interest. Whether they are nominees of an organisation or direct appointments of government, they should certainly meet the requirement of being seen as representing the public interest.

Senator WONG—It seems to me that there are two issues: one of them is public credibility, or whatever term one chooses; then there is the issue of stakeholder representation and categories of membership on the committee. We would appreciate it if you could provide us with your suggestions for the various categories of membership. Mr Larsen, I think you have already raised the issue I was going to ask about, regarding how to fund the FRC and its secretariat. Do you agree with some of the issues raised by Professor Ramsay that there is benefit in having an independent executive rather than having Treasury provide secretarial support to the FRC?

Mr Larsen—Absolutely.

Senator WONG—Why do you say that?

Mr Larsen—Basically, I think that it is worth while. Under the previous regime of the Australian Accounting Research Foundation, we had an executive and secretariat that supported the standards boards and were focused on the outcomes of those standards boards. I think that, for all their goodwill and good people, Treasury's first call has to be the political requirements of the Treasurer and the government, and therefore it will always be a part-time job for them to be the secretariat to these people—or so it seems to me.

Senator WONG—Do you support the proposal for the FRC to oversee auditing standard-setting arrangements?

Mr Larsen—Yes.

Senator WONG—And to oversee the financial reporting panel?

Mr Larsen—Yes.

Senator WONG—Do you consider that they ought to be required to consult publicly on issues such as the proposed strategy for the AASB and the AuASB?

Mr Larsen—Yes.

Senator WONG—I think Senator Conroy referred this morning to Keith Alfredson's suggestion that the Audit Office perform an audit of the activities of the FRC, with particular emphasis on its governance arrangements, before it takes up any additional responsibilities. Do you have a view on that?

Mr Larsen—No, I do not really have a view. Is it a usual practice for the Audit Office to do that? I do not know where that idea came from.

Mrs Mulcare—I would suggest that, at this point in time—and to move forward under the new powers of the FRC—a review should be undertaken to ensure what the requirements are of the FRC under CLERP 9 and what is required in order to meet those new duties and fulfil those powers. Looking forward would be far more constructive than looking backwards to determine now whether or not these new powers should be given to them. The important thing is that people agree that these powers should be given to the FRC. Now let us get the constitution and the governance framework right. A past review appears to me to be a waste of time and resources at this point in time. In the future, get the structure right and we have no argument with it.

Senator WONG—I think the issue is: is there a process whereby that can be done? I presume—although I was not there when Mr Alfredson suggested this—that one could give the brief to the Audit Office with a view to what the statutory function of the FRC was going to be and say: 'Given that, look at what they can do now. What can be done in order to achieve that?'

Mrs Mulcare—I think that the ability to look at a whole new organisation, for instance, no matter what that organisation does, and say, 'This is the job that we have to do. Who do we need

to do it and how do we need it to happen?' can be there. Companies, for instance, and other organisations get started all the time, and that is exactly what they need to do. I see the FRC and their needs going forward as being no different to that. I think you will find, Senator Wong, that where that quote from Keith Alfredson comes from is Tuesday's *Financial Review*, and the quote is in the paper. So I do not think it was actually in a forum such as this. I have not read his submission, so I am not sure whether it was in his submission.

Senator WONG—I think it was in the submission that was received on Tuesday. You have expressed again a view that you do not consider it necessary to give auditing standards the force of law through the introduction of disallowable instruments. Can you explain why that is the case?

Mr Larsen—I can try and I am sure that Cath will be able to explain more. Basically, the auditing standards are advice to the profession about how they should carry out their professional role. They have been framed in such a way that they are guidelines and advice, and that is exactly how they have been framed. To make them disallowable instruments would take a significant amount of work by the Auditing and Assurance Standards Board, together with government draftspeople. We do not know anywhere else in the world where that has been done. My biggest concern, as a representative for Australia at international forums, is that if we put them into law we would have more trouble adapting and changing them as the international standards develop. There is going to be quite a lot of development around international auditing standards over the next five years.

Senator WONG—Surely the answer to that is that they could be redrafted. There could be a process of consultation in terms of any changes to international standards that are recommended to be incorporated into the Australian regulations. Why is the fact that there might be changes to these standards in the future such a difficulty? Why does that preclude their inclusion in regulations or other instruments?

Mrs Mulcare—On Tuesday Senator Brandis asked the question: why, when the obligations of directors are included in the Corporations Act, should equal standing not be given to the obligations of auditors? My answer to that question would be that the obligations of auditors are absolutely included in the Corporations Act. The difference in what is being proposed now is that the procedures—the judgments—by auditors be included in law. There is no other profession where the procedures undertaken to meet obligations under the law are included in the law.

Senator WONG—I am not sure that I agree with that.

Mrs Mulcare—There are a number of obligations, and there might be professions where particular procedures get—

Senator WONG—Lawyers are regulated with regard to certain areas of conduct—for example providing mortgage guarantees and so forth. There are very strict regulations around procedures for a variety of legal advice that is provided.

Mrs Mulcare—There are also around auditing in a number of jurisdictions. What I was referring to was the extent to which those procedures are not necessarily obligations, and there is

a danger in that. I think that we may be underestimating the extent of work that is necessary to do that. The danger is, in bringing these auditing standards into law and in changing them so significantly, that we will actually set up a structure that is not in the best interests of Australia being a player in the global economy. That is a danger worth exploring.

Senator WONG—What is that danger? Is it that we would have different standards, in which case the answer is surely that we can change them—surely the system is set up so that it could be altered if there was sufficient weight behind an argument that international auditing standards had moved on? Or is the answer that we would have more stringent auditing requirements, which is a different policy issue? What is your argument?

Mr Larsen—The argument is that a lot of what we are trying to do is to prove to the markets, both national and international—and to the public—that we have rigorous processes in place to protect the public through the financial reports. Auditing standards are one means to an end to that—they are not an end in themselves; they are a means to end—but it is important, as auditing standards and the complexity of business grows, that you are reasonably adaptable to that change. In some ways the profession has not been adaptable enough in the past: in things like financial instruments, we basically have not got the standards that we should have in place because they have been too complex. All we are worried about—and it is not about whether it is in the law or not—is that Australia can keep up with the gang as the complexity of business changes and that our standards will be adaptable to international practices. Being international is an end in itself, because then we do not have to explain the differences. If we have a different set of standards—

Senator WONG—Yes, I understand that argument.

Mr Larsen—It is the major argument. It is not a philosophical argument; it is a practical argument.

Senator WONG—But is your objection that it would be difficult for us to translate subsequent changes to the international auditing standards if we include auditing standards in a disallowable instrument or some other regulatory instrument?

Mr Larsen—It is one of them. The first one is that the work required to do it is going to absorb the energies of the Auditing and Assurance Standards Board over the next two years. It will not be improving standards; it will just be making them legal.

Senator WONG—Do I understand your submission to say that, even if legal backing does occur, you do not wish that to be in the context of disallowable instruments?

Mr Larsen—I think it has got legal backing now, under the Corporations Law, and you are required to meet the auditing standards. That is the sort of framework that we were comfortable with. The second part is that, if the government or the parliament decrees that there should be more rigour around the auditing standards, then there may be regulation which allows for more flexibility to change—some other mechanism than disallowable instruments, which allows more flexibility to adapt.

Senator WONG—I am a bit confused by that answer, Mr Larsen. Are you saying that you do not want parliament to have the ability to disallow the instrument, or are you saying that you want it? I do not understand your answer, I am sorry.

Mr Larsen—The simple answer is that we probably would prefer not to see the changes to auditing standards having be seen through the floor of parliament, yes.

Senator WONG—What is the problem with that, Mr Larsen?

Mr Larsen—The problem is that we think it will take a long time and it will not be as flexible as we would like.

Senator WONG—Essentially your position is that you do not want parliamentary scrutiny of these standards?

Mr Larsen—To the extent of the detail of the standard, that is right.

Senator WONG—And your policy justification for not having parliamentary scrutiny is?

Mrs Mulcare—It is not necessarily solely an argument of parliamentary scrutiny. It is the argument about how to restore confidence in reporting and in the auditing process. This is not necessarily a challenge that is being faced just by Australia. International regulators have been meeting with the International Federation of Accountants, who actually write the standards that we base our standards on, to get the oversight necessary in order to restore that confidence in the audit process internationally. We think Australia can achieve the benefits set out in the proposal which gave rise to this change in the law through oversight by FRC and reporting that back through their reporting mechanisms—

Senator WONG—To the minister; it is not to parliament.

Mrs Mulcare—Yes.

Senator WONG—That is the fundamental difference.

Mr Larsen—That is the difference. I understand that.

Senator WONG—We might have to leave that; we will not agree on it. Can we go to the Financial Reporting Panel. I think it is your suggestion that the FRP's jurisdiction be expanded to enable adjudication of issues prior to the publication of financial statements. Is that right?

Mr Larsen—That was our initial perception of what it would do, yes.

Senator WONG—Would you agree with Mr Alfredson's submission which states that this process would 'undermine the independence and professionalism of auditors and could become a process for allowing auditors not to have to make the "tough" decisions'?

Mr Larsen—There is a risk of that; I think that is true. There is also a risk that, having made an assessment prior to the accounts, the independence of the FRP could be at risk as well. I

understand that. On the other hand, there is the opportunity to clear some of these things before they become seriously contentious issues.

Senator WONG—Isn't there another process? Isn't this really the auditor's job though?

Mr Larsen—It is the auditor's job. Of course it is.

Senator WONG—Perhaps the audit firm should have a review process themselves to deal with this rather than expecting the FRP to sign off on questionable issues.

Mrs Mulcare—It is the auditor's job, but I think the HIH royal commission recommendations included an acknowledgement about doing that job—and Professor Ramsay's comment this morning was 'in good faith interpretations'. The concern is: what happens when it is not necessarily in good faith but in accordance with the accounting standards where there is a disagreement between what the auditor and the management believe? One of the proposals being put forward is to include it in the auditor's report, where in fact one of the proactive solutions to ensuring credibility in financial reporting may be to allow something like this to go to a Financial Reporting Panel. You might find that it is the very ability for the auditor to say, 'This is a crucial issue to the accounts being true and fair and in accordance with the standards and I think it should go to the Financial Reporting Panel.' In making that suggestion, that in itself might be the path to finding a solution between the company and the auditor.

Senator WONG—Essentially, the FRP could become a tool for managing any conflict between the client and the auditor is what you are saying.

Mrs Mulcare—On a particular issue.

Senator WONG—I have one final area to go to: non-audit services. ASIC have a view about this: 'The provision of some non-audit services will almost always threaten the independence or the appearance of independence of auditors regardless of the safeguards adopted.' ASIC concede that, 'The best approach is to prohibit the provision of such non-audit services through the act rather than through the ethical rules of professional bodies.' Obviously, they have a significant concern, shall we say, about the provision of non-audit services. Your association obviously does not agree with that.

Mr Larsen—The F1 document, which included aspects of non-audit services, was produced 18 months ago and I think the world is moving on a little bit. We probably have some more sympathy with the view that some audit services should be excluded, but I am also concerned—and I think Professor Ramsay brought this up—that that does not necessarily say that by excluding or non-excluding you can make the wrong decision. If they are listed in legislation as being excluded, that might mean people interpret that other audit services which should be excluded in particular circumstances are not excluded. So it is important that, if we wanted to actually make some specifically excluded, that is not seen to be the total list and that the principle of independence is always maintained where non-audit services are provided, whether they are listed as excluded or not.

Senator WONG—So provided that was dealt with in how that was drafted, you would agree that there is some benefit in prohibiting certain non-audit services being provided by auditors?

Mr Larsen—I think there might be some benefit.

Senator WONG—Are you able to say what sorts of services you think should fall within that remit?

Mr Larsen—No.

Mrs Mulcare—We have seen the list and there are certainly some instances where that list would be appropriate.

Senator WONG—Which list are we talking about?

Mrs Mulcare—The recommendations for changes to CLERP 9. I cannot remember what the report was called. It was sent to me in something which I believe Senator Conroy shared.

Mr Larsen—Senator Conroy gave it to us at the last set of forums a couple of weeks ago.

Mrs Mulcare—Yes. I think the key, then, is also to make sure that it is not a one-size-fits-all approach such that you find yourself precluding things. Professor Ramsay this morning also highlighted as a risk having certain provisions in the law—you then have to test those against all companies that it would affect to determine whether or not that list is all-encompassing or had other ramifications that you had not originally thought of. I think on the list was accounting and bookkeeping services, as an example. It is really a matter of their being safeguards that you can put in place for the smaller end of listed companies, where those services can be performed without being a risk to independence. That is probably the advantage of F1, which actually goes through those safeguards and what an auditor must consider in achieving independence. I do not think you should underestimate the benefit of the audit committee under the ASX Corporate Governance Council guidelines, which indicate the board is compelled to consider non-audit services and the risk to independence of auditors. That was another point made by Professor Ramsay this morning: he believes there are three parts of auditor independence. A significant part of it is what he termed the audit client taking responsibility for ensuring that they are putting safeguards in place to ensure the independence of auditors. I think that is a mechanism that can work, together with F1.

Senator WONG—From a policy point of view, though, it is not the audit client's responsibility alone. You cannot put too much reliance on the audit client in actually ensuring the auditor's independence, can you?

Mrs Mulcare—Are you saying you cannot put too much reliance on the audit committee in ensuring the integrity of the financial report?

Senator WONG—I thought your evidence was the client.

Mrs Mulcare—I am sorry. The audit committee of the audit client, to use that recognised expression. I do not think you can look at CLERP 9 as being the only initiative happening now. It is CLERP 9 together with the ASX Corporate Governance Council and the revised F1.

Senator WONG—As I understand your evidence, you do contemplate benefit in prohibiting certain non-audit services, provided it does not compromise the broader principle of audit independence.

Mrs Mulcare—Yes.

Senator MURRAY—I want to return to auditing standards. In my professional portfolio and committee work I have had to go through accounting standards—and it is a horrible experience. But I cannot recall ever reading auditing standards. Describe to me what it is. *Hansard* cannot record the fact that you are looking at a book.

Mrs Mulcare—I will give a very quick overview of auditing standards, knowing that certain people are currently in the room who are probably far more qualified than I am to talk to this. There are seven series of auditing standards that deal with financial reports as addressed by the Corporations Act. The place where they predominantly start is the 300 series, which deals with planning. The auditing standards say that in order to undertake a quality audit you need to consider certain things in doing an audit plan, in order to ensure that you look at the right areas—and it is a risk based approach in many instances—such as the areas where material misstatements are likely to occur.

The next series of standards deals with risk standards, which are about how to identify the things that are at risk for the particular entity that you are auditing. You might consider the chances that a material error will occur. You must then consider if a material error might occur, what systems the client may have in place in order to detect or prevent that error occurring and, therefore, determine the overall risk of a material error still being there, in order to focus your audit procedures to ensure that there really is not a material error. That is the idea. It goes on to say, 'These are the procedures that you must undertake in doing the audit,' and then it provides a standard format on how to report. That is the level of detail that it would go into.

Senator MURRAY—I am familiar with the term. My assumption always was that there were three component parts: one, universal principles, which would attach to the way in which auditing was undertaken; two, the mechanics of how that process should occur; and, three, the auditing decisions, which are consequent to the auditing standards, because plainly if you have a standard which deals with a particular issue there are issues of materiality, risk and appraisal which arise from that. Is that a correct set of assumptions?

Mrs Mulcare—I believe so. I have not necessarily heard it described in that way, but yes, you start with the overriding principle that this must be done, and then there is how it might be done and what you must do to consider the findings.

Senator MURRAY—In a general sense, I find your proposition difficult. I was interested in Senator Wong's testing of it. Accounting standards are complex, long, difficult and technical, and yet they are disallowable instruments—and, I think, rightly so. Yet the very objections you have put to making your standards disallowable would apply to accounting standards. By extension, I would expect you then to say, 'Accounting standards should not be disallowable either.' Are you saying that?

Mrs Mulcare—The predominant difference between accounting standards and auditing standards is that accounting standards are about measurement and disclosure, so they are about, 'You must do this and measure it in this way, and you must disclose it and disclose it in this way, in order to achieve comparability from year to year and from company to company and in order to assist the understanding of the users.' I agree that they have to deal with complex technical issues and I agree that they say, 'You must do this.' Auditing standards are somewhat more procedural and somewhat more judgment based, and they need the flexibility to be adapted to the various financial reports of different organisations of different size. They have a wide range.

Senator MURRAY—But listen to the central proposition you put as to why they should not be disallowable. You say:

Auditing standards are in a state of transition due to international harmonisation and clarification of the frameworks within which they are developed.

I could pop 'accounting' in there instead of 'auditing' and it would be exactly the same proposition. My understanding of auditing standards is that their principal interest to the parliament is that they deal with probity and integrity. They are not a mechanical issue; they are an issue which goes right to the heart of ensuring that those who evaluate and assess the pursuance of accounting standards within financial statements do so against a set of standards which guarantees the probity, integrity and quality of what they do. On that hangs the revenue of the Commonwealth, to some extent; on that hangs market confidence and certainty; and on that hangs public assurance that corporations are doing what they should. In that sense it is very much a parliamentary interest. The argument you have given us is: 'By the way, this is mechanical and complex, and we are in a state of transition. Parliament shouldn't be involving itself in that.' My argument is that, on the principles I have outlined to you—with the qualification that I have never read the damned things—it would seem to me that as accounting standards are disallowable so should auditing standards be.

Mrs Mulcare—I guess the point also being made was that in terms of the actual original proposal as to why they become auditing standards—certainly in the regulatory impact statement or any of the proposals put forward previously—the benefits that you are raising here today have not been communicated in terms of the need for parliamentary review. All of the benefits that have been put forward to date about the importance of auditing standards and the law have been about the need for enforcement actions and all the rest rather than what you have presented today. That is not the argument that is put forward here and it is not at risk in terms of international harmonisation. It is certainly a commitment that you would make to ensure that resources are there because currently the financial side of this is not addressed in the financial impact statement. But if what I am hearing is a commitment to almost two layers such that we do not lose the quality in the standards now and we do not lose the international harmonisation and the international convergence, then you are right.

Mr Larsen—Then we do not have the problem.

Mrs Mulcare—In that case we do not have the problem. My concern is that we are talking about major rewrites and draftsmen—

Senator MURRAY—Let me interrupt you. I contest your central proposition. The central proposition I heard from Mr Larsen is that they would have to be reconstituted in a legal form to ensure that they were disallowable. That does not happen with accounting standards.

Mrs Mulcare—It doesn't?

Senator MURRAY—And it would not, in my estimation—and I qualify this by saying that I have not looked deeply at the issue—with respect to auditing standards. If you have a different view to that which you have put, I ask that you reconsider the issue because it is a key issue in this bill. I want to move on to auditors' reporting responsibilities. You refer to the seven-day rule. On page 4 you say:

An appropriate working relationship between the auditor and senior management is vital to an effective audit. Such a relationship needs to ensure management is open and frank with auditors. Laws which unintentionally cast the auditor solely as a 'compliance policeman', such as the draft provision for every breach of law to be reported to ASIC within 7 days (which leaves little or no time for investigation) ...

Do you want to explore that issue with me a bit more?

Mrs Mulcare—For that particular recommendation the necessary changes have been made to the drafting of the final bill that was tabled, in order to address those issues. So I do not think those issues still remain. The time has been extended to 28 days to allow those issues to be explored and possibly resolved with management, which is the place that they should be resolved.

Senator MURRAY—Don't you think that there might have been a grading of reporting? In my view, there are issues which do need to occur within seven days. If the auditor became suddenly apprised of a major issue which would shake the market—either with respect to that particular corporation or more generally—my view is that immediate reporting would be necessary whereas many issues, I agree, would benefit from a longer period.

Mrs Mulcare—The current wording, I believe, leads to that ability. It does not prevent immediate reporting; it just encourages management to do their job in accordance with the law and we would probably remind them of their continuous disclosure requirements.

Senator MURRAY—But the change from the exposure draft to the bill takes away that immediacy concept. I am really asking you whether you feel that a graded timing would be necessary. For instance, one of the thoughts I had—and you would be very explicit in the legislation—is that if in the opinion of the auditor it would cause a major market consequence, either for the corporation or for the market generally, then immediate reporting within seven days would be required, otherwise it would go to 28 days. That is what is in my mind. Do you object to that or do you think the change to the bill is sufficient?

Mrs Mulcare—You would not necessarily need 'seven days' either. It would be 'as soon as'.

Senator MURRAY—Yes, but I deliberately use the expression 'within seven days'.

Mr Larsen—I am trying to envisage what that would be. It is hard, because you are giving an example of—

Senator MURRAY—Let me give you two examples that we know of. The auditor stumbles across the fact that HIH is trading as an insolvent company. A second example would be the NAB hedging losses circumstance, which is going to shake the financial market not just the share market for NAB. Those would be two practical examples for me.

Mrs Mulcare—So you would replace the 'as soon as practicable' wording as it is currently with an additional requirement for immediacy in certain circumstances?

Senator MURRAY—I am not sure. I am yet to form a view, but I am concerned that the change does not deal with a major market consequence and require the auditor to act—

Mr Larsen—Senator, can we take that on notice and come back to you.

Senator MURRAY—Yes.

Mrs Mulcare—I do not think that was our intention in the way in which the submission was made; it was not to undermine that being dealt with.

Senator MURRAY—Let me make it clear: I have no quarrel with the 28 days for normal matters. That seems to me to be perfectly sensible. That is an area I want to explore with you. The other point I picked up when I read that originally was an almost underlying sense of grievance and I want to explore it with you. It concerns the phrasing 'cast the auditor solely as a compliance policeman'. By the way, we are politically correct so it should be 'police officer'. Taking the word 'solely': do you feel put upon as an accounting profession that you are being turned into quasi law enforcement officers for the Commonwealth and that sort of thing?

Mr Larsen—I think the issue for us as an accounting profession is that we are certainly taking the leadership role to accept the public interest and to accept that the accounting profession, whether they are auditors or in other parts of the financial reporting chain, need to take a much more onerous responsibility on themselves. The issue for us around compliance is: does that help or hinder us taking that role? Can we work with the client to get the right answer, rather than using the compliance requirements on us? It can be a hindrance as well as a help. That is just a concern. Certainly, there is no sense of grievance in anything that we have proposed. We know that we have major responsibilities as a profession and they are changing.

Senator MURRAY—I have one last remark and it is to you, Mrs Mulcare. With respect to your acceptance to take on notice Senator Wong's questions on the FRC, could I ask you to please have regard to the *Hansard* record of the interchange between committee members and Professor Ramsay on that topic and make comment where you feel appropriate where you either agree or disagree with some of that discourse.

Mrs Mulcare—Would the committee be happy with a joint submission by us and Professor Ramsay in consultation, or will I just provide you with what we have to date?

Senator MURRAY—I would like your opinion as an organisation, and I think that was Senator Wong's intention—

Mrs Mulcare—That is what I wanted to clarify.

Senator MURRAY—My sense of the interchange with Professor Ramsay was that issues were raised in some detail which had not been explored in a similar forum before. I think you are pretty thoughtful about these matters and I would appreciate your examination of that evidence and whether you agree or disagree with it.

Mr Larsen—We would be happy to do that.

Senator WONG—Is it possible to make any comparison between the quality or stringency of international auditing standards and Australian auditing standards currently?

Mr Larsen—It is, I guess, but I am not quite sure whether anyone has.

Mrs Mulcare—For the most part—and I am sure that the chairman of the board will be able to answer this better—these are harmonised with international auditing standards. In terms of stringency and robustness I would suggest that—

Senator WONG—Equivalent.

Mrs Mulcare—Yes.

CHAIRMAN—If there are no further questions, thank you, Mrs Mulcare and Mr Larsen, for appearing before the committee and for your contribution to our deliberations.

[12.01 p.m.]

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

MIFSUD, Mr Richard, Executive Director, Australian Accounting Research Foundation

CHAIRMAN—Welcome. The committee prefers that all evidence be given in public but if at any stage of your evidence or response to questions you wish to respond in private you may request that of the committee and we would consider such a request to move in camera. We have before us your written submission which we have numbered 53. Are there any alterations or additions you wish to make to the written submission?

Mr Edge—No.

CHAIRMAN—I invite you to make a brief opening statement and then we will proceed to questions.

Mr Edge—Thank you for the opportunity to appear before you today. We have made a submission and I do not intend to make any lengthy statement at all. I will make a couple of short comments and would like to emphasise that the comments we will be making today will be those which we believe are the views of the board. Some of the board's comments in our submission on the ED have already been acknowledged in the bill. As you have discussed this morning, there is the two-year transition for remaking standards as legal instruments, the assurance being clearly added to the agenda in addition to audit, and the section 311 reporting contraventions of the Corporations Act have been revised as well. We hope that no reversal to those decisions will be made.

We support an oversight function being introduced, which really means the key issue remaining in our submission is that of auditing standards having the force of law. Our view has been that auditing standards should not have the force of law—and I am happy to discuss that at length later—because we did not feel that there was a need. No country, other than France, is considering this. We are committed to international harmonisation and convergence and, most importantly, we would not like to see a procedural approach taken to standards rather than a principled approach. We agree that obligations can be in the law but we would rather the details be in standards outside the law.

The similarities which are often expressed between accounting and auditing standards show a lack of understanding of the two standards. I emphasise that one of the main reasons accounting standards were given the force of law several years ago was to enable the enforcement of nonmembers of the accounting profession—that is, directors—whereas auditing standards apply only to auditors and can be enforced appropriately by the accounting bodies.

With that background, the Auditing and Assurance Standards Board is progressing on a business as usual basis. If standards are given the force of law, we will undertake the two-year transition to redraft standards as legal instruments. We are working fully in that direction now. We have a full work agenda with our limited resources. We are continuing to monitor other

activities such as the PCAOB to ensure world's best practice. We will continue to do that. In terms of resources, if we were to redraft auditing standards as legal instruments, we would expect that the increased resources required would be a doubling of our current staffing load. We have drafted a rough budget of $1.7 million a year to reflect that need. With those brief comments, we are now happy to answer any questions you might have.

CHAIRMAN—Do I take it from your written submission and from your comments that the proposal to make audit standards a disallowable instrument is your only concern with the bill?

Mr Edge—Effectively, yes.

Senator MURRAY—I hope you are not going to move for me being thrown off the committee because I have never read the auditing standards! The issues that Senator Wong and I outlined recently are in contradiction to your opinion. Do you want to react to the discourse that we have just had with the previous witnesses and rebut any of the in-principle views that you might have picked up on that side of the table.

Mr Edge—Yes, I would. Thank you for the opportunity. The way it was described was that accounting standards are relevant to measurement and disclosure in financial reports and they are far more easily definable. Auditing standards include what we call basic principles and essential procedures. They can include a lot of guidance or other material that relates to judgment or behaviour. If you understand the difference, you will see the difficulty in enforcing that. As a point of principle no-one could say—and I sit here as the auditing standards board chairman—that we do not want more credibility given to those standards. Putting them in the law would certainly give them a greater force. The issue is that they were never drafted with the intention that they would be interpreted in law. The interpretations to date in law are whether an auditor has been negligent and breached the duty of care which is an overriding obligation.

There is a fear—and I can say that it is only a fear; it is not a categorical answer—that there would be attention to the detail within the standards now if the entire standard were to become a legal instrument. People may concentrate more on, if you like, a checklist mentality of complying with the letter of the law rather than the overarching principles. That is a subtlety which is very difficult to explain. We propose to examine every standard for its appropriateness as a legal instrument. Again, conceptually you could argue not one word would need to change and we could pick them up tomorrow. But the fear is that there are words in there that, had the documents been drafted as a legal instrument, would have been either less stringent or less lengthy. I do not have an answer to that question having not embarked on the process, but that is the fear.

Conceptually, having auditing standards in the law is not so much a problem as a principle. When the original proposals were put out the words used were 'core audit standards'. Reflecting back on that original principle, if you were to think about fewer and more definable principles then that would probably be an acceptable resolution. If you have the entire body, which, as you saw, are some hundreds of pages then you have practitioners and others concerned about whether there would be a concentration either by them or by the enforcement parties on the detail.

Senator MURRAY—I hesitate to apply the same judgment to you, but with a previous witness it seemed to me that I picked up a misconception as to both the way in which such instruments have to be formulated—based on precedent, with which I am very familiar—and the attitudes of senators in addressing these issues. My assumption is that almost certainly those standards will just be picked up as the bill goes through, because the Senate is likely to recognise the integrity and the sense with which they have been constructed. Much more important is the issue of what it means in law. That is a much more important issue. Making it a disallowable instrument gives it a legal status and meaning beyond what it would have as a professional standard or as a set of guidelines.

That is really where I want to test your resistance. It would seem to me that, by upgrading its status in legal terms, in any court action—which would include insolvencies and so on, not just breaches of the Corporations Law—the performance and function of an auditor would perhaps be more precisely determined with respect to those standards than they are at present. I must stress that, until you have jurisprudence, I would not be able to be sure, but that is my instinct. It would seem to me that the intention of government is deliberate in that sense—that auditors and corporations are so important that their liability and responsibility at law does need to be enhanced. That is the basic underpinning of CLERP 9. Therefore, what we are discussing here is a key issue, in my view; it is not a technical matter or a little matter of passing interest. I think you have picked up on that. I do not know if either of you are lawyers apart from being accountants, but perhaps you can give me a better sense of what you think the effect would be at law and what the strengths and weaknesses of that are.

Mr Mifsud—I will answer on behalf of the board. The view that the board expressed in its submission and originally in discussions with representatives of Treasury was very much predicated on the standards as they are currently written—the current body of Australian auditing standards, which are largely compatible with international standards issued by the International Federation of Accountants. The view of the board was motivated by the fact that the way the standards are currently written is that they are really written in two sections. There are what are referred to as mandatory principles and essential procedures, which are bold lettered, and are, if you like, the 'must' the auditors conducting audits who are members of the professional accounting bodies are required to follow. There is a lot of discursive narrative in the standards at present, which effectively constitutes professional guidance. If those standards were to be elevated to the status of legal instruments, the nature of that guidance—which is currently referred to in the profession as grey letter guidance—is also elevated. That prompts the question: are the standards written in such a way that they have been intended as legal instruments? The view of board was originally predicated on that.

Having said that, we are not against standards being in the law per se. We are obviously prepared to work with the government and the parliament to make standards and the law operate as intended by the parliament once CLERP 9 is effected. However, I think it is fair to say that there will be a need to review the wording in the standards—not to water down the standards; that is not the intention, and it would certainly be very much against the public interest and against the professional interest to do that—and to look at those standards as legal instruments, being standards that the profession—auditors who are registered company auditors—would be required to follow not only as a professional requirement but also as a statutory requirement and look at whether some of that guidance is best kept in a statutory document or whether it should be, for example, implementation guidance.

Senator MURRAY—I think there is an inherent contradiction in your position, if I may say so. You accept the idea that the law should say that there should be standards, which therefore immediately gives it a link in terms of legal status, but you then do not want the protection of disallowance. One of the things that disallowance brings to the attention of parliament is whether either the risk to the Commonwealth, in the sense of inadequate standards, or the risk to those to whom the standards apply, in the sense that they might be exposed in ways that they should not be, might be elicited and there is the opportunity, when regulations and legal instruments come through, for people to make submissions to parliament. It seems to me that you have actually been conscious of that contradiction and therefore have recommended in 2.1 that the regulations to the bill include only auditing standards that are pertinent to financial reporting arrangements. In other words, you have tried to narrow the field so that what I think is a contradiction is managed. How do you react to those remarks?

Mr Edge—Let me clarify this. In fact, we agree exactly with what you are saying. The effective principle that auditing standards have the force of law would be a way of elevating their status. We agree with that but the concern, and it may in fact be jumping at shadows as it is not something that we have a legal opinion on, is that the enforcement may be on the detail rather than the principles.

Senator CONROY—Your submission says:

... the AuASB has a long-standing commitment to international harmonisation and convergence, which requires minimal departure from the wording in International Standards on Auditing ...

Your submission also says that, because of your commitment to the international standards that exist, the Australian standards should not receive legal backing—which you did not cover in your discussion with Senator Murray or Senator Chapman. In your view, what is the benefit to Australia in adopting international audit standards?

Mr Edge—When you say 'adopting', do you mean 'converging with'?

Senator CONROY—I was probably going to have a bit of a discussion about that with you, so I am happy for you to address both those points.

Mr Edge—For many years since 1995 we have been harmonised. Everything in Australian standards is equal to or greater than the international standards but the words are different as we have taken the benefit of redrafting some words in Australia. We have now, while wanting to be a little bit more proactive on that, converged. 'Converged' means to adopt them word for word and add material in Australia to make them more stringent if we feel that is appropriate, but you can then hold both standards up and see clearly what is the international wording and what has been the additional requirement added in Australia. We would like to continue that. Again, the issue of the legal backing of standards there is exactly the same as we just said. We may be jumping at shadows but the fear is that we will be precluded from taking word for word from the international jurisdiction because something may be drafted internationally without the thought that this would be a legal instrument. We might find it too onerous or too detailed or too prescriptive so we might want to change it here in Australia but that may cause convergence not to be successful.

Senator CONROY—Given Worldcom, TYCO, Enron and Parmalat—and I could go on for probably hours—and that you are saying to us that we should be adopting world's best practice standards under which all of these disasters have occurred, should we take comfort from that?

Mr Edge—Let me clarify that Worldcom and Enron both happened in the United States, which has a very prescriptive rules based mentality. When you look at the jurisdictions which have had principle based standards, you do not have as many examples—and I recognise Parmalat.

Senator CONROY—Andersen is a worldwide business that seems to have gone out of business with a worldwide problem.

Mr Edge—Triggered very much by the United States circumstances.

Senator CONROY—But they had a string of different jurisdictions from Hong Kong to Australia through Europe and into some notables in the US.

Mr Edge—I would argue strongly that Australian auditing standards—and other jurisdictions—are of a very high quality. What we need to examine is what was the breach of those standards that caused the demise of those entities. Often you will find—

Senator CONROY—And ultimately Andersen.

Mr Edge— And ultimately Andersen. And you may find that there are more elements of incompetence and dishonesty than a failure of a standard to prescribe appropriate behaviour. There may be a failure of enforcement of the standards rather than an issue with the quality of the standards themselves.

Senator CONROY—As you know, Australia is having a debate about adopting international accounting standards. We have been down the path of that once before, back in 1998, when the government tried to legislate that we adopt international accounting standards and it was defeated in the Senate. At the time, one of the main arguments was that the International Accounting Standards Board was a bit of a joke, that it really had very poor quality standards, that it was not properly resourced and that, with the exception of a few individuals, no-one took it very seriously. It would be fair to say that there has been a significant revamp under Sir David Tweedie's leadership—more funding, permanent members, full-time members and worldwide consultations. I put to you that there are similar concerns to those expressed in 1998 about the IASB and its role in recent years—that it is not properly constituted, that it has poor resourcing and so on. I know that there have been some reforms recently, which are welcome, and I hope you will expand on those in a second, but I put to you that the actual body itself has been pretty moribund for a long time, so handing over our auditing standards to a body that has been poorly regarded is a big leap.

Mr Edge—I agree wholeheartedly with the principle you have just outlined. The accounting standard setting regime globally is far stronger than the auditing standard setting regime. But what we are not doing is accepting or letting them take over our standard setting. All we are saying is that we will take the standards they set as a starting point and then we will increase the quality and rigour of them in Australia. Australian standards exceed the international standards.

One would hope that in three to four years time there will have been more resources put into the international standard setting arena so we can be more consistent with the accounting framework. But we would not—and I would argue this quite strongly—take the international auditing standards, for exactly the reasons you have just given.

Senator CONROY—You give us a lot of comfort when you say that. I wish some other jurisdictions would give us similar comfort, but that is not to be at the moment. In terms of your body, what is the representation of, say, shareholders and users of financial accounts?

Mr Edge—We currently have a possible 11 members. On a number of occasions it has been recommended that non-auditing practitioners be involved. The definition of that is a broad one. We have two members from the public sector and two members from academia, both of whom are often deemed non-practitioners. When I became chairman two years ago, we sought other interested parties. We have one member who is a retired company director who gives a different point of view. We were unable to find others who were prepared to put the time and effort in to be a member of the board, because there was a lack of self-interest. We as a board have looked at going forward. As I say, it is business as usual, but we have looked at whether, if CLERP 9 comes in, there should be a reconstitution of the type of membership. The board's view is yes, there should be involvement of users and other interested parties. However, the majority of the board would need to be technically strong in the area of auditing, so there would always be a majority of practitioners.

Senator CONROY—So at this stage there would not be anybody you could roughly point to, like the Shareholders Association or other organisations that might be deemed to be representing investors and users of financial reports.

Mr Edge—We have not come up with a definitive answer, but clearly we have the issue here, and you have already discussed it with the FRC, as to whether you invite people based on merit or whether you invite people as representing a particular constituency. Our preference would be to get people who come with a different point of view but at the board table we will use their merit on a decision. They may be from a shareholder association or representing shareholders; they may represent directors or management. They may even represent regulators, but I think we will find it very difficult to get the regulators to commit to that sort of thing. As to the other users, I think the main two would be management and shareholders, with public interest always being the overriding goal of the board.

Senator CONROY—Keith Alfredson made a submission to the committee. I am sure he is well known to you both. He says:

I believe there is a need to differentiate between the technical Board of the AuASB and the statutory body.

Keith proposes that the AuASB is the employing body but that the staffing to the AuASB—and the AASB, for that matter—is merged into a new entity called the Australian Financial Reporting and Assurance Institute. He says that this body could provide both technical and administrative support to both the AASB and you. He is concerned that your current structure would not attract high quality professionals because, as he says:

... technical experts tend to wish to work in a collegiate style as part of a larger group, so ideas can be shared ...

Do you think Mr Alfredson's proposal has any merit?

Mr Edge—I do not comment on the structural side, but I do comment on the following. At the moment, the auditing standards board secretariat is very small and, I would argue, is working with limited resources. Accordingly, I would argue that it lacks the ability for greater interaction and collegiate behaviour. To combine with the Accounting Standards Board secretariat would have a benefit: I re-emphasise that the technical content and agenda of the audit board is quite different from the technical content of the accounting board. Whilst there may be some potential for interaction and sharing of some resources, it would not be a large advantage. Attracting good people to standard setting bodies is tough, whether it be auditing, accounting or anything else at all. It is a difficult market. It is difficult to get good people there. What is underestimated is the amount of time. We use work of the big four or others as a means of providing a further resource for the board. Structurally there would be advantages in administration, IT and so forth. As to whether we need a statutory corporation or not, I do not have a view on that. Keith has experienced it; I have not.

Mr Mifsud—Could I offer a comment as the senior staff member working for the board and as executive director of AARF.

Senator CONROY—'Help!' would sum it up, would it?

Mr Mifsud—Yes, that would sum it up. Being co-located with the staff of the Australian Accounting Standards Board will be beneficial. We have already had informal discussions—obviously, they have been informal, because the legislation has not been passed yet—with the chairman of the Australian Accounting Standards Board and senior staff of that board about the prospect of co-location and liaison with Treasury, and we are quite confident that the arrangements as currently proposed, albeit informally, will be a positive step.

Senator CONROY—That is great. Your submission also says that you should not have conferred on you a special function to develop a conceptual framework as this function is included implicitly in the standard setting role. Could you just explain why you do not want this special function and what impact that function would have if it was granted to you. I just want to get to the bottom of that.

Mr Edge—The substantial reason there is the difficulty. We want to converge with the international standards board, and there is a framework internationally. They do not have on their work program the intention to develop a conceptual framework. Again, in an ideal world, you could probably say it is appropriate to have that, but the practicality—the difficulty of doing it—is the major thing there. We are happy with a framework that is practicable and usable rather than devoting a lot of resources to determine a conceptual framework that may not replicate itself within the standards.

Senator CONROY—Were any of your recommendations put to Treasury and adopted? If they were rejected, were any reasons given?

Mr Edge—Recommendations for?

Senator MURRAY—In this paper.

Mr Mifsud—The submission is a parallel submission to a submission that we made to the Department of the Treasury. The arguments are exactly the same.

Senator CONROY—Did they adopt most of them?

Mr Edge—The changes were a two-year transition to rewriting standards, adding insurance to the agenda as well as audit, and the section 311 changes.

Senator CONROY—Presumably they rejected some, though. Did they give any reasons why?

Mr Edge—They did not give us a response on the conceptual framework, to my knowledge. I do not think we got a response, to be honest. We did get a letter from Peter Costello asking for some comments on HIH recommendations, but I do not remember receiving a formal response from Treasury.

Senator CONROY—Thank you very much.

CHAIRMAN—Thank you very much for your appearance before the committee today.

Proceedings suspended from 12.32 p.m. to 12.48 p.m.

GRATION, Mr Douglas, Member, National Legislation Review Committee, Chartered Secretaries Australia

JONES, Mr Richard, Chairman, National Legislation Review Committee, Chartered Secretaries Australia

SHEEHY, Mr Timothy Brian, Chief Executive, Chartered Secretaries Australia

CHAIRMAN—I welcome the representatives of Chartered Secretaries Australia. The committee prefers that all evidence be given in public, but if at any stage of your evidence or responses to questions you wish to respond in private, you may request that of the committee and we would consider such a request to move into camera. We have before us your written submission, which we have numbered 8. Are there any alterations or additions you wish to make to the written submission?

Mr Sheehy—No. We have a short statement we would like to read out, but other than that, no.

CHAIRMAN—I invite you to make your opening statement, at the conclusion of which we will move to questions.

Mr Sheehy—Thank you for inviting Chartered Secretaries to appear today. We are pleased to be able to answer further questions on our submission and to contribute to this inquiry, as it is consistent with our organisation's mission: the promotion of effective governance in administration. We are the Australian division of an international organisation. We have 46,000 members worldwide, we have a common entry program and all of us are interested in effective administration and governance.

We would like to say that we are in general support of this proposed legislation. We think that it generally reinforces good existing practice and we urge the committee to recommend passage of the legislation before the end of the year. We would also like to note that many of the provisions outlined in the proposed legislation should apply to all disclosing entities—such as property trusts, not just listed public entities. We have made this clear in our submission to you. We have not provided detailed comment on all aspects of the proposed legislation. Other professionals who have appeared before you have a particular interest in that. We will stick to those things that we think our members have a close interest in. Today, we would like to touch on aspects of continuous disclosure, shareholder participation, whistleblowing and executive remuneration. We would like to take this opportunity to add to our 11 November submission and also to comment on some developments that occurred after that submission was made.

Mr Gration—I will comment on continuous disclosure and Tim might add a few comments at the end of that. Continuous disclosure is one of the core responsibilities of company secretaries. It is something the association has a very strong interest in. We certainly strongly support the principle that good disclosure is essential to fair and efficient capital markets. We think the current continuous disclosure framework has served Australia well and we certainly support reforms that strengthen that framework. There are, however, a couple of issues that we have with the proposals around continuous disclosure in the bill.

Firstly, particularly in relation to the proposed power to issue infringement notices—and I know the explanatory memorandum makes it very clear that it is seen essentially as relating to minor breaches—and company secretaries who are making these day-to-day disclosure decisions, they involve genuinely difficult exercises of judgment. You have to work out what sort of share price impact particular information or proposals might have and what the expectations of investors are in relation to disclosure of that information. You will have things that are reasonably financially trivial that cause quite a significant share price impact and, conversely, quite large transactions that seem to have no share price impact. There is also that ever difficult question in relation to disclosure—when something is sufficiently well developed that you can announce it to the market.

Our view is that these are judgments on which different people acting in good faith may reach different conclusions. They are not a black-and-white speeding offence where you can say, 'Well, you got it wrong. Here's the infringement notice. Pay the fine and get on with your life.' There is a real concern around those infringement notices. Certainly if the regime is introduced we would ask the committee to consider reviewing the regime after, say, 18 months of operation to see just how effectively it had operated.

We also do not support the increased penalties for breaches of the continuous disclosure obligations, mostly because we do not think there is any particular evidence that the penalties at the moment are leading to poor disclosure practices. I do not think there are any company secretaries out there who say, 'The fine's only $200,000 so I'll give it a go, but if it was $1 million I would not.' I do not think inadequacy of penalty is leading to any inadequacy in disclosure.

The final point I will make before handing over to Tim is that we note that the government is proposing to put in some due diligence defences for individuals in relation to contraventions of continuous disclosure requirements. We strongly support those defences. We think—and we certainly encourage all our member companies to do this—that what you really need is a good process and system in place; in determining whether an individual should be penalised for a failure, the courts and ASIC ought to have regard to whether there is a good process and system in place and whether it has been followed. We very much support that amendment. Tim wants to speak briefly about the idea of a corporations panel in this regard.

Mr Sheehy—For some time now, CSA has been advocating an alternative dispute resolution mechanism for a number of aspects of the Corporations Act. We note that many of the principles were picked up in the CLERP proposal for the financial reporting panel, and we have always advocated that a peer review panel, as it was called in the regulatory impact statement, would be appropriate to adjudicate on disputes over whether or not an organisation has followed continuous disclosure obligations. I note that in the regulatory impact statement there were issues raised about cost and continuity of interpretation. The point that we make is that a peer review type panel does not need to involve excessive cost. It can react fairly quickly, but, most important, it would be made up of experts from the industry who would interpret obligations on what a reasonable person would be expected to receive in terms of information. That is one of the underpinnings of the listing rule in determining whether or not disclosure should be made.

We urge this committee to have a second look at the application of a peer review panel, given what my colleague has previously said: that disclosure is not black-and-white and it is not a

matter of applying a fine. We also have concerns about ASIC's ability to handle an increased workload. We underscore our desire to have a peer review panel.

Mr Jones—Would you like to raise some questions on that particular issue before I move on to shareholder participation?

CHAIRMAN—No.

Mr Jones—Thank you, Mr Chairman—I shall move straight on then. Over the years the institute has made a number of submissions on assisting shareholders to participate in the affairs of the companies they invest in, either by attending and voting at meetings or receiving and sending information. The members of the institute have been very active in putting this into place. I think you will find that even in the last couple of days there has been an announcement by eTree, which involved Telstra and some of the major banks. We certainly support the distribution of information by electronic means. What we would suggest, however, is that any legislation be drafted in such a way that it recognises the rapid changes in technology. It is very easy to put something in law now. But of course as the technology moves on it might become out of date.

We are also concerned at the mandating of specific formats—again, because of the rapid changes but also because of the cost for smaller companies. It is all very well saying that companies should put their corporate governance statements or their annual reports on their web site. Some of the smaller listed companies really do not have that capacity to have a web site.

There are two areas of concern with his legislation—in fact, they are more omissions than inclusions. Late last year the institute suggested changes to section 250 regarding the use and abuse of proxies. To remind the committee, that section requires chairmen of meetings to vote proxies as directed. In other words, if they get a proxy for or against, they should vote it for or against. It does not extend to directors and company secretaries. There are significant examples of some directors of quite large companies cherry picking the proxies that have been given to them. An example might be that he has been given proxies for and against and he chooses to only use those that are for because that promotes his particular cause.

Unfortunately, it is clear that that has extended to persons other than chairmen, directors or company secretaries. There are ordinary shareholders who have been given proxies who are cherry picking those proxies. As a matter of good corporate governance we believe that all shareholders, whether they attend meetings or whether they vote through a proxy, are entitled to expect their views to be counted and not cast aside at the whim of a particular proxy holder who chooses to promote his particular cause. The change to section 250 is very minor, and as an institute we are prepared to assist the drafters in making the change.

A second matter is this long-running matter of 100 members calling a meeting. It is a submission that this institute has been behind for some four to five years. What I should say first of all is that the institute has no problem with 100 members putting a resolution on the agenda for an annual general meeting. What we are concerned about is having 100 members calling a meeting. Perhaps I can give you an example. My own company, the National Australia Bank, has 325,000 shareholders. One hundred shareholders is less than one-third of one per cent of the total number of shareholders and they hold an even smaller percentage of the total number of

shares. This matter was included in a bill that has been before parliament for over 12 months. We had hoped that this matter would have been absorbed into this bill. Douglas, I think you wish to talk about whistleblowing.

Mr Gration—I do indeed. Whistleblowing is very important. In a lot of companies company secretaries are finding themselves as the people responsible for implementing whistleblower protection policies. I think Australian and overseas experience—some examples of which Senator Conroy mentioned earlier—show that whistleblowers are often invaluable in identifying wrongdoing within a company. We think it is essential that genuine whistleblowers can air their concerns confident that they will be free from undue discrimination and detriment. So we certainly welcome that part of the bill.

I guess it is a bit like what Richard was saying about shareholder participation. We would really be urging you to consider extending that. At the moment I think the bill only covers breaches to the Corporations Act. This committee or the government generally ought to have a hard look at, for example, the Trade Practices Act. If you listen to someone like Professor Fels, you will hear him say whistleblowers are essential in identifying breaches of that kind of legislation. We would submit that there ought to be some protection similar to what is in this act for those whistleblowers, and likewise for regulations—and I must admit I have not examined in detail the draft of the bill. For example, whistleblowers ought to receive similar protection if they draw to the attention of either ASIC or senior management breaches of accounting standards. We would really urge you to consider extending the whistleblower protection.

One other issue I noticed when I was having another look at the explanatory memorandum last night is the requirement in the bill as drafted that the whistleblower makes their disclosure in good faith. It says that, where the whistleblower has a malicious or secondary purpose, that will indicate a lack of good faith. Again, I think you would find that people like Professor Fels would say whistleblowers have all sorts of motivations. I would have thought the good faith test should be not whether they have a malicious or secondary purpose but whether they genuinely and in good faith believe that there had in fact been a breach of the law. That would be our submission on whistleblowing.

Mr Jones—I will go to executive remuneration. What certainly needs to be recognised is the public and political concern at the excessive executive remuneration—perhaps because company secretaries are not part of that! We fully support the moves to improve disclosure of both the levels of remuneration and policies adopted by the company. In our submission we have expressed concern about the requirement to disclose the amounts paid to the five highest paid in the company. We suggest that that is probably not the right test, because it could include persons who either are not in a position to make decisions affecting the company—that is, it could be a cowboy trader on the foreign currency desk in New York—or have retired from the company with a substantial package for one reason or another. We note that there are some developments in the accounting standards focusing on the five executives with the greatest authority within the economic entity, the key management people with regard to the strategic direction and management. We suggest that that accounting standard be set as the criterion for the report on the five most highly-paid people in the organisation to avoid confusion and to do away with inconsistent reporting.

Our second concern in this area revolves around the non-binding vote at AGMs on remuneration reports, and we have a series of questions. What happens if the report is not accepted? Which bit did the shareholders not really like? Was it the amounts that were paid to the non-executive directors? Was it the amount that was paid to the retired CEO? Was it the hurdles—

Senator CONROY—I am sure you could just have a vote on each bit you would like; it just might be very slow.

Mr Jones—It could be, yes. It could well be the hurdles set out in the options. It is very hard for a board of directors to discern exactly why the shareholders would have rejected a remuneration report.

Senator CONROY—Or they could be asleep at the meeting, I put to you, Mr Jones.

Mr Jones—That also happens! Shareholders already have plenty of opportunity to comment on remuneration disclosed in the annual report, either in the discussion on the accounts or in respect of specific resolutions seeking approval for the grants of options or for the increases in non-executive directors' fees. In those cases they are not non-binding; they are quite binding. The remuneration report is important, and we support clear and transparent reporting. But we would have to ask whether it is more important than the financial statements as a whole, for which there is no obligation to seek a vote—binding or otherwise. Those, members of the committee, are our additional submissions.

CHAIRMAN—Thank you, Mr Jones, Mr Gration and Mr Sheehy.

Senator CONROY—I am glad to see that someone at NAB has maintained their sense of humour, Mr Jones, in these troubled times for you. Your submission supports the increase in the maximum period of disqualification from 10 years to 20 years for those who trade whilst insolvent. However, your submission says there is a question about whether the CLERP 9 bill goes far enough. Would you advise the committee why you think the bill does not go far enough?

Mr Jones—I think we will need to examine that.

Senator CONROY—It is under the heading, 'Disqualification of directors'.

Mr Gration—Having read our submission now, I suspect that what we are getting at is to make sure that you get to the people who are really in control of the company and not those who are nominally the directors or most senior officers. That is to ensure that there is no particular avoidance of the order and not to manage the corporation by putting family members, for example, as directors in place of the individual who has been disqualified.

Senator CONROY—On notification of directorships, your submission says that disclosing past directorships is welcome but that this does not go far enough and:

... consideration should be given to expanding the disclosure to include large unlisted public companies ...

Can you advise the committee of the rationale for expanding the disclosure obligations to the large unlisted companies?

Mr Jones—I think we can suggest that some of the large unlisted public companies are almost larger than some of the listed public companies. There are some quite substantial companies which, if you read the law, would not have to be disclosed. On this point also, there is a vision in the bill that we would have to disclose the directorships in the past three years. We have come to a very strong view that that is unnecessary. The past year is sufficient. If someone wishes to look beyond that, they can get a copy of the earlier annual reports that would be available on the web site.

Mr Gration—To clarify our proposal, it is for directors of listed companies to disclose directorships they might hold on unlisted companies rather than saying that unlisted companies should have similar disclosure obligations to listed companies.

Senator CONROY—Understood. I did not take it that way, but thanks for the clarification. A doozey: how would you define a large unlisted company? I appreciate the points you have made about some of them being bigger, but what sort of threshold would you feel is necessary there?

Mr Gration—I think there are already definitions, as I recall, in the Corporations Act distinguishing between large and small companies.

Senator CONROY—Within the traditional definition.

Mr Gration—For accounting standards and reporting purposes, I would have thought that, rather than introducing a new definition, that would be a good starting point.

Senator CONROY—I am sure you are aware that Labor is supporting your proposal that listed companies are required to list the qualifications of their company secretary. However, CLERP 9 does not include this requirement. Why should the government support Labor's amendment to disclose this information?

Mr Sheehy—It is in the interest of shareholders, we believe, that the individual who is usually charged with the governance of an organisation be properly qualified. That is what we believe, but we believe that shareholders should be informed as to what the qualifications of that person are. It is a pivotal role in an organisation, its importance is increasing and it is as important as the qualifications of a director.

Senator CONROY—Should that information be disclosed in the company's annual report?

Mr Sheehy—Yes. It is a perfectly appropriate place to put it, the same as where the qualifications of a director are disclosed. That is where we believe it ought to be.

Senator CONROY—I hope you have sold that to Senators Chapman and Murray there. That was your big chance.

Mr Sheehy—I believe it is in other proposed legislation, and we had asked that it be picked up in this, as it is consistent with many of the principles of CLERP 9, which are all about increased disclosure. It is not inconsistent, and we thought it was appropriate that it be here.

Senator CONROY—So you believe it is coming in another bill.

Mr Sheehy—I think it was an exposure draft put out in December 2002—the corporations amendments act or something—which had a range of bits and pieces in it. We think it fits very neatly with the intent of CLERP 9.

Mr Jones—The bits and pieces include the 100-member—

Senator CONROY—That bill is destined for defeat, I suspect, so I think it is a wise suggestion to drop it in here. Hopefully the government will accept the amendment.

Mr Sheehy—We would hope so.

Senator CONROY—We will leave that in your hands.

Mr Jones—I should add, I think for US purposes, you certainly have the qualifications of the company secretary included in that 20-F statement.

Senator CONROY—The CLERP 9 bill requires auditors to attend the AGM and to answer questions on the audit. The Australian Council of Super Investors, ACSI, have advised the committee that they are concerned about situations where the chairman of a public company has refused to allow questions to be put to the auditor about the appropriateness of the accounting policies adopted by the company. They say that a chairman's standard response is that the choice of accounting policies is the responsibility of directors and management. In your view, will company chairmen use the same excuse, in spite of the new provisions of the CLERP 9 bill?

Mr Gration—Super investors probably have more exposure to other companies' AGMs than I do, but I have not seen chairmen take that approach. I have certainly seen a notable lack of appetite from shareholders to ask questions of the auditor, as they tend to get the notes to the accounts read back to them which, once you have gone through it once, does not enlighten you again. I do not think there would be any response of that kind by chairmen.

Senator CONROY—We had a professor of accounting appear before us on Tuesday. I do not think he named the company. No, he did. He said Arvi Parbo was in the chair, so it would be Western Mining.

Mr Jones—That was some years ago and it has changed since then.

Senator CONROY—I understand that the world has moved on, but not for everyone: Hugh Morgan has made a comeback—it is 'back to the future'! The professor gave us a concrete example. He stood up and he wanted to ask the auditor a question about an accounting treatment. He was basically ruled out of order and was told that that was a matter to be put to the management and that it was not an issue to be debated on the floor. You would think it was a reasonable question to ask.

Mr Jones—I think it is a perfectly valid question to ask. Certainly my experience of AGMs in the last few years is that the auditor is invited to make a presentation. I would have to say that that they have been somewhat boilerplate presentations.

Senator CONROY—Yours might be more exciting. You never know, Mr Jones.

Mr Jones—I suspect it may well be. As Douglas says, the questions from the shareholders to the auditor are few and far between.

Senator CONROY—Maybe ASCI, as you say, have a broader experience and have dealt with some difficult chairs. I am aware of one very prominent chairman who opened and closed an annual general meeting in 12 minutes. That was a very large public company. Now he has been rewarded with a seat on the Telstra board—that's great! The meritocracy is working in the broader community!

ASCI have advised the committee that to overcome this issue the bill should be amended to require the auditor to answer questions about the basis upon which the financial statements have been prepared. Do you think that would overcome it or do you just believe that they do not really need to?

Mr Jones—I think they should be asked questions relating to the conduct of the audit.

Senator CONROY—The conduct of the audit is different from the accounting policy.

Mr Gration—The auditors can certainly comment on the appropriateness or otherwise of the accounting policies adopted by the company. It is important, I would have thought—and auditors would say this as much as anyone else—that, to maintain the distinction that management and ultimately the directors are the people responsible for the financial statements, the auditors make a general comment that they think that the financial statements have been prepared in a true and fair view et cetera. In fact, they do not say that, but they comment on what the management and the directors have said. But I think it is completely appropriate to ask them to say whether they consider that the accounting policies adopted by management are the appropriate policies.

Senator CONROY—Warren Buffett is famous for saying that the simple way around this is to stand up and say to the auditor, 'Would you have prepared the accounts in this manner yourself?' That ultimately leads onwards. But as you say, we have unfortunately not got that same level of interest traditionally here in Australia. I agree with you: times are changing and it will ultimately be harder and harder to put up a stone wall.

You mentioned the proxy voting issue and I was, to be honest, unaware that this practice went on. Your submission says:

Recent court cases have highlighted the need for clarity in the obligation to vote proxies as directed.

I guess the NRMA case has got everybody wandering around in a fog saying, 'How did anybody get to be the chair?' Osmosis, apparently, according to the judge.

Senator MURRAY—Unanimous osmosis.

Senator CONROY—Unanimous osmosis! He just turned up and said, 'I'm chairing today,' and they said, 'Yes, fine; no other experience or qualifications needed.' Could you advise the committee of a few more of your concerns and of what amendments you think are required to fix this up? This will be a good chance to clarify that issue. I appreciate that the bill has been in train a long time and that this is an issue that came up relatively recently, but this would seem to be the ideal opportunity to put a lot of issues to bed if we can. Do you have any thoughts or amendments?

Mr Gration—I think it is really straightforward. If you are appointed as a proxy and you attend the meeting and vote, you must vote all the proxies that you hold and you must vote them in accordance with the directions given to you where they have given you those directions. If I appoint my aunt as a proxy and she does not show up to the meeting, that is fine and she does not have to vote. But if she shows up to the meeting she must vote and she must vote in accordance with my instructions. If she holds, as Richard was saying, multiple proxies, she needs to vote all of those, not just the ones that she agrees with.

Senator MURRAY—It is not discretionary, in other words.

Senator WONG—It is discretionary to attend but how you vote is not discretionary.

Mr Gration—It is discretionary to attend, but if you are there and you choose to vote you need to vote as instructed and you need to vote all the proxies that you hold.

Senator CONROY—Is there an easy amendment to try and resolve the confusion that has arisen out of the recent judgments regarding the appointment of the chair? Any suggestions at all would be welcome.

Mr Jones—Unfortunately, the law as it stands at the moment talks about the chairman and that is taken to mean the chairman of the meeting, not necessarily the chairman of the directors.

Senator CONROY—It is a hair that has been split; it has been noted.

Mr Jones—Somewhat, yes. Maybe we can suggest an amendment that says 'the chairman of the meeting and the chairman of the directors'. If it were the chairman of the directors, our amendment would also pick up the directors. That is the reason why we initially said 'directors and company secretaries'. We are now suggesting that we go one step further so that all directed proxies, whoever holds them, must be voted. Again, I think that is a very simple amendment to make.

Senator CONROY—Do you think we would need to say that if the chairman were a director—and that would probably be the case in 99.999 per cent of cases—they still had directors' responsibilities in the chair? There appears to be some confusion in the law now.

Mr Jones—No, there is no confusion, because we addressed that issue. I think in the case we were addressing the gentleman concerned was initially charged with breach of directors' duties, but he was able to say, 'No, I wasn't acting as a director at that stage.' We would perhaps have gone even further by saying that it would pick up the responsibilities of the directors and it would be a breach in that circumstance.

Mr Sheehy—That is mixing two issues into one. The principal point we are trying to make is that the voting intentions of shareholders, who generally assume when they fill out a proxy form that their votes will be voted as they had intended—

Senator CONROY—They would probably think there was an obligation rather than just an assumption.

Mr Sheehy—We are just trying to ensure that those voting intentions are carried out, and we think it is a very simple measure to make that change. It is not a leap of faith.

Mr Gration—Most of them think of their proxy form more as a postal vote. I think it is reasonable not to expect the public to understand the nuances of corporate law.

Senator CONROY—I think your position is fair, sensible and reasonable.

Senator MURRAY—And will be supported.

Senator CONROY—I suspect you may have won over certain sections of the committee. Hopefully you have won over all members. You mentioned the 100-member ruling and the calling of an EGM and I note that you have consistently made representations, attempted to resolve this impasse and put forward a range of proposals. Unfortunately, none of them has yet made its way into law but I urge you not to give up. Could you outline where your current thinking is? I appreciate that you made mention of the five per cent in the upcoming bill. That has been rejected by the Senate before. I know you have spent a lot of time trying to work up an alternative. Where are you at at the moment? Are you still behind your previous position?

Mr Sheehy—The principles we espoused a couple of years ago are still the same, and they are that we believe that the number of shareholders required should be on some form of sliding scale relative to the size of the register, that there should be a cap and a floor and that there should be a minimum economic interest. The number should move with the size of the register. Those basic principles need to be enshrined. There was a proposal called the square root proposal. We are prepared to look at other measures if it is a bit too difficult to figure out what the square root is. We are open. We recognise that there needs to be a cap, that in some organisations the register is just so large that it will be seen to be too large.

Likewise, there should also be a floor. We do not think it is appropriate that a shareholder who owns as little as one share can be counted, so there needs to be some minimum economic interest. We had talked a couple of years ago about $500. It is not an insurmountable amount of money, but those principles remain unchanged.

Mr Gration—I guess it is not the CSA's official view, as far as I am aware, but one of the problems with the current process is that there is absolutely no flexibility. If you get 100 members convening a meeting, you have to convene the meeting. Even if there were an ability to go to ASIC or the court and say: 'This is not a matter that we need an EGM for. Can ASIC give us permission to defer that to the AGM—

Senator CONROY—I thought—and I am thinking of the NRMA, which is not a corporation per se—that some judges had given a bit of relief, saying: 'Well, you're only three or four weeks away from your annual general meeting. I give you permission to hold them together.'

Mr Gration—I think you can hold them together, but there are time periods in which you have to hold them. So if you have an AGM in October—as in our case—and you got something like this now, at the moment there is not the flexibility to go to ASIC and say, 'We're happy to debate this issue, but we prefer not to spend $1 million convening an EGM. Can we do it at the AGM?' Even if you gave ASIC some sort of guidelines as to the factors that they might take into account in determining whether to grant that sort of relief, it would give companies the flexibility to address genuine shareholders' concerns and the opportunity for those concerns to be raised. But, where people are really just pushing a particular barrow, companies could say: 'Come to the AGM and push it there.'

Senator CONROY—Again, a fair and reasonable position on that approach.

Mr Sheehy—We are very well aware that the standard around the world is five per cent but, being pragmatic, it is unlikely that that is ever going to go through in this country. The alternative, which is 100 members, is undesirable—it is not practical—and we believe a compromise is in order. We could sit here and wait all day for the five per cent to go through; it is just not going to happen, but the current situation is not appropriate.

CHAIRMAN—Why don't you think it will go through, Mr Sheehy? Is it because of my colleagues here on my right?

Senator CONROY—It has already been rejected.

Mr Sheehy—They have made their points very clear.

Senator MURRAY—Let me give you some relief, or some hope, since it has been raised several times. I think it is appropriate for this matter to be dealt with with this bill, to get it out of the way. The proposition that I would have—and will—put to the committee is that, if the committee can come up with a unanimous view as to an acceptable route and if the government were not prepared to accept that, I would be prepared to co-sponsor that with Senator Conroy and put it through. If the committee cannot come to a unanimous view, I would be happy anyway to consult with Senator Conroy and co-sponsor a change. Everybody accepts that it needs reform; the quarrel is over the extent of reform. That, I would suggest to you in advance, is better than the nirvana of the five per cent, which will effectively make shareholder activism impossible in this country.

Mr Sheehy—The principles I have spoken about have the support of the Australian Shareholders Association and IFSA, so the retail and wholesale investor groups did support that proposal.

CHAIRMAN—Do you mean that the Shareholders Association, which represents essentially small shareholders, supports the five per cent?

Mr Sheehy—No, they supported the compromise principles we spoke about.

Senator MURRAY—And the political point I have just made to you is that the political will exists, so leave it in our hands.

Mr Gration—Would you view it as appropriate for us to make further submissions to you?

Senator MURRAY—Of course.

Senator CONROY—Please feel free to bowl your submission up again, or any variant you want to make on it that might help to break the impasse.

Senator MURRAY—You see, you and other witnesses have raised the issue with the committee, which means that the committee will be obliged to comment. The question is whether the chairman will be willing to broker a unanimous view which is contrary to the government's five per cent view, which is not a unanimous view. That is the issue, and I have clearly put the political dimension to you.

Mr Sheehy—Also, we are not asking for any change to the ability for 100 members to put a resolution to an ordinary meeting—leave that alone; that is dead on the table.

Senator MURRAY—I want to address briefly the question of disclosure of remuneration. As you know, at present the rule is for the five highest paid and the bill proposes to extend it to the 10 highest paid. There have been submissions to the committee which quarrel with that and I have some sympathy with that quarrel, depending on the size and nature of the company. I have thought that the solution is obvious. The public interest is whether the remuneration is properly relative to the size, nature and profitability of the company, and it is performance related. My view is that, pretty well, the public has a commonsense view of this.

I will be asking the committee to think about this. One alternative that I have thought of is an either/or approach—that is, either the five rule, as it is at present, or anybody above an arbitrary figure. Five and 10 are arbitrary figures, but the arbitrary figure would be a monetary figure—say, $1 million for the total package, including options, salary, the whole works—which would mean that in some companies the five rule would stand, but in some very big organisations 14 or 15 people would hit that level. That would allow for disclosure of quantum, in the sense of impacting seriously on the company's wages bill and profitability, but it would also allow for the flexibility which I think is behind some of the resistance to the 10 rule. You can comment now if you wish, but you might want to think about it and come back to us with a view. It is just an alternative view. Do I take it that you accept it on notice?

Mr Jones—We certainly take that on notice. It is an interesting proposition. Obviously it will depend on the size of the organisation. As you said, many large companies have a large number of individuals who receive amounts over the ceiling of $1 million, for the sake of the argument. I assume that a smaller company, with a smaller number of employees, would go back to the top five highest paid rule?

Senator MURRAY—That is right.

Mr Jones—That in itself creates some problems for some companies. I am conscious that there is a—

Senator MURRAY—Which I am alert to.

Mr Jones—There is one listed company where the top five includes the personal assistant to the company secretary.

Senator MURRAY—That is right.

Mr Jones—So it is a matter of trying to get the right balance.

Senator MURRAY—Being from Western Australia, I very much understand that. I know the kinds of companies that are over there. The second issue I want to deal with—I cannot recall if anybody else has—is the issue of corporate political donations. There have been some recent press reports. It is an area of interest of mine, so I am well aware of it. Graeme Orr, who is an expert in this field, has recently issued a report and has indicated that this is one of the most contentious issues worldwide, in terms of political governance and corporate governance.

The proposition I want to test is relatively straightforward. Again, you are welcome to think about this and come back to us on notice. The Corporations Law at present does not deal with this area. My proposition is that shareholders should either approve the actual political donations or approve a policy. The policy might be that the board has discretion over this or the board should be even-handed or the board should direct it all in particular directions, or whatever. It seems to me that, because of the importance of this issue in political consciousness and media consciousness—it is a worldwide issue—it is time we gave shareholders some rights in this area. Do you have an immediate response or would you like to think about it and come back to us?

Mr Jones—I think we would need to take that on notice. An immediate comment would be that, at the very least, companies should be asked to disclose what policies they have—not necessarily seek shareholder approval for them, but at least indicate that they have addressed the issue. I think Telstra may be the same as us. I think we do actually have on our web site the policy regarding political donations.

Mr Gration—We have the very straightforward policy that we do not make them.

Senator MURRAY—Let me make my own views clear. I have absolutely no problem with shareholders delegating the responsibility to the board, but there is no mechanism at present and it seems that some boards are acting without knowledge of what their shareholders want them to do.

Mr Gration—There were some interesting comments, dealing more with philanthropic donations, in the HIH royal commission report. I cannot remember the exact quote, but there was an elegant way of saying that essentially there is no particular virtue in donating other people's money to your favourite causes. I think you could make the same point about political donations. There ought to be visibility to make sure that, if there is perceived to be a corporate interest in making those donations, that ought to be openly and clearly explained. At the opposite end, as I understand it political parties need to disclose the donations they received, so you could reverse engineer that out to find the donations made by the corporates. To have visibility in governance around that is a pretty hard thing to argue against.

Senator MURRAY—Yes. I would appreciate it if you take that on notice and come back to us with a thoughtful appraisal. I assure you that, on the basis of even-handedness, I am pursuing the same avenue on the union side—that members should actually agree the policy of their union with respect to political donations.

You have also raised the issue of voting and of proxies. Followers of the corporate dance would know that this matter was dealt with in 1998 when there were some major changes to Corporations Law—not your particular proposition, but the issue of proxies. At that time the debate was between me, Senator Conroy and Senator Ian Campbell, the parliamentary secretary with responsibility in this area. You move from there to the consideration of voting and whether it should be compulsory, and that is a debate that is very much part of this inquiry. There are a number of views but I will just pick up on a couple in which I have an interest. The first view is that institutions generally—not in every case, but generally in law—either have a fiduciary duty for the shares they hold, because they are on behalf of others, or they hold them in escrow, which has a particular legal meaning in a trust sense, and that part of their fulfilment of those duties or responsibilities should be to exercise the vote, and they do not. So there is a view that you should require them to do so if they are believed to have those duties attached to those shares.

The second area of interest is whether you should mandate voting by institution, trust, fund et cetera or by subject matter. For instance, you might only mandate voting for the election of directors, which is the most important shareholder mechanism because the shareholders effectively delegate their powers to directors, so if there is one issue they should have a say on it is that and perhaps not a myriad other technical things. I would like your reactions to both those ideas.

Mr Gration—I sit on the board of the Telstra superannuation fund, and I think you would find that the challenge would be that any large superannuation fund like that will have investments in a large number of companies on the ASX. There are probably 400 or 500 companies on the ASX. The sheer practicality of turning their minds to how to vote on the AGMs of every one of those companies is a challenge in itself. But I certainly agree with where you are coming from: that if you own the shares you ought to turn your mind to exercising the rights associated with that ownership.

The other issue is the logistical practicalities under the Corporations Act at the moment. I think companies give 28 days notice of a meeting. Most of these shares will be held for super funds—and, I suspect, for other institutions—through custodians. So the custodian gets the notice of the meeting, they send it out to the institution and the institution comes back in. Again, I would have thought it was a logistical challenge to say that every time one of those comes up in that four-week period you will get the voting instructions back.

Senator MURRAY—So you are saying that the period is shortened.

Mr Gration—Yes.

Mr Jones—If you have a range of AGMs at one time, it is extraordinarily difficult to address that issue for each of those companies.

Senator MURRAY—Even for the election of directors?

Mr Jones—I suspect even for the election of directors. They may not even turn their minds to it.

Mr Gration—I think you would find, because the sheer volume would hit them, that they would wind up saying they generally vote in accordance with the board recommendations. I suspect that does not quite address the issue you are putting forward—that there really should be more active participation in ownership rather than going with the flow.

Senator MURRAY—I have explored this matter, separately from the committee, with senior people in the professions and in business. The most common view is that if this were to be carried through they would need to dedicate resource to it, which has a cost attached. My response is very simple: if someone gives you their shares to manage and they have placed an obligation on you, you are entitled to charge something for the exercise of that obligation. It is a basic trustee-client principle. I would have no difficulty whatsoever with the concept that a small fee—and I mean a very small fee—be attached to a relationship. But that has consequences. I stress to you that, as a player in the legislative outcomes, I am very interested in the compulsory route, because I believe that corporate democracy needs to be exercised both for fiduciary reasons and to produce better outcomes. But I am conscious of the points you have made. You have not dealt with it in your submission. Since you are coming back to us on two other issues that I have referred to you, perhaps if you had some further thoughts—if you do not, that is fair enough—you might like to write to us about them as well.

Mr Gration—I am not sure whether you have considered this, but one mechanism that you might use to achieve your objectives and deal with some of the negatives is to specify a particular threshold. You could say that where super funds or whatever hold greater than a particular percentage of the issued capital of a company then they must exercise their voting rights—for example, one per cent or five per cent or whatever. In a sense that would genuinely make a difference. If you have 1,000 shares in a company with, in our case, 12 billion shares issued, you might say, 'We're really not serving any great public purpose getting those 1,000 shares voted.' But where you have sufficient shares to make a difference in the governance of that company, you ought to actually make that difference.

Senator MURRAY—As you know, there is always a difficulty with that route because it is determining a threshold. One of the techniques used in legislation to avoid that problem is to refer to materiality so that the judgment is left in the hands of those who exercise it. In law that can produce some difficulties, but that would be something that we would consider if you were to come back to us.

Mr Jones—A question of materiality on whose part—on the part of the investor or the company they are investing in? I assist the board of a small ethical investment fund and we have gone to exactly this issue. We have a couple of dozen listed companies and we are addressing the issue of whether we should vote at all AGMs. The advice I would give to the board is that we need to look at what the subjects are. You talk about the appointment of directors. In most cases that is fairly noncontroversial, but it may well be that there is an increase in a non-executive directors fees that could be quite controversial and that particular company may have a view on it.

My concern at the moment is that there are a number of investment bodies that are, to use a better word, lazy. Rather than making a decision themselves, they will refer it to a proxy advisory group. That should be looked down upon. Companies really ought to make their own decision about these issues rather than looking to someone else to give them advice on it.

Senator MURRAY—Is that not prudent, though? If you do not have expertise, you go to a lawyer, a valuer, an actuary or something.

Mr Jones—Perhaps the answer to that is to get the expertise. To answer your question, if you are looking after large sums of money for people, perhaps it should not be difficult to find within your organisation someone who can give the advice, someone who understands the culture of the organisation, rather than just someone providing straight across-the-board advice.

Senator MURRAY—Without wishing to burden you, the committee will have to deal with this issue and I would appreciate your further thoughts.

Mr Jones—Certainly.

CHAIRMAN—Thank you.

[1.41 p.m.]

AZOOR HUGHES, Ms Sufiya Dianne, National Technical Director, Pitcher Partners

CHAIRMAN—Welcome. The committee prefers that all evidence be given in public, but if at any stage of your evidence or in answers to questions you wish to respond in private you may request that of the committee and we would consider such a request to move in camera. We have before us the written submission from Pitcher Partners, which we have numbered 13. Are there any alterations or additions you wish to make to the written submission?

Ms Azoor Hughes—No.

CHAIRMAN—I invite you to make your opening statement, at the conclusion of which we will have some questions.

Ms Azoor Hughes—Thank you. Pitcher Partners is a large accounting firm comprising three independent partnerships with approximately 44 partners and 550 staff. We provide accounting, audit and advisory services to medium and large Australian based companies, including smaller listed entities and those wishing to enter capital markets. Our comments on the CLERP 9 legislation predominantly reflect issues arising in implementing the proposed legislation for entities in this segment of the marketplace, in contrast to those concerned with capital markets.

Overall, Pitcher Partners supports the draft legislation in CLERP 9 and the fact that, following consultation, many of the reporting requirements have been restricted to listed entities. We are disappointed that CLERP 9 does not attempt to address the regulation of large proprietary companies and we encourage the government to examine the regulation of large proprietary companies as a matter of urgency as there are many perhaps inadvertent flow-down consequences to this sector as a result of changes to the reporting framework. Pitcher Partners would be willing to provide consultation when this next stage of reforms is considered.

The nature and size of Pitcher Partners means that we are able to comply with the requirements of the proposed legislation. However, we have serious reservations regarding the impact of certain aspects of the legislation on the economy and on the structure of the auditing profession, in particular those aspects which address auditor independence and which impact on the ability of the smaller listed entity to access financial expertise. There are certain characteristics of both smaller listed entities and middle-sized accounting practices which we would like to bring to your attention. I will just go through some of those. Firstly, a majority of listed companies below the top 200 are not highly diversified and frequently operate in only one industry segment. Many of the smaller listed entities are still in their preliminary growth phase in terms of the life cycle of an entity and have not yet reached a level of complexity in either their operations or their reporting requirements. There is a high level of transparency in what they do, and reporting is largely transaction based. This fundamental characteristic impacts on the nature and extent of regulation appropriate to this segment of the market.

In contrast to large listed corporates, many of the smaller listed entities do not have dedicated resources for statutory financial reporting. They rely on their auditors to ensure that they comply

with the regulatory regime in which they operate. ASIC have put forward the view that they see auditors as coregulators, and the proposed legislation supports that role in terms of the expanded auditor duties. However, in this segment of the marketplace auditors have always acted as coregulators to ensure compliance with legislation and regulation.

Auditor rotation rules are designed to avoid issues of familiarity and, more importantly, fee dependence. We are not aware of excessive or high levels of either director remuneration or auditor remuneration being paid by smaller listed entities. The legislation does not consider the context as to why rotation is necessary. Listed entities with audit fees at minimum levels will be subject to auditor rotation, and the relative increase in costs will be significant for these smaller entities and for the middle-sized audit practices. We believe that auditor rotation rules will have an adverse impact on smaller audit firms, who will be forced to withdraw their offering of audit services to smaller listed entities. It will also have an adverse impact on smaller listed entities, who will not receive the same degree of monitoring if they are forced to go to a large audit practice.

We do not intend to deliver any criticism of large audit practices, but the reality of the marketplace is that any professional person must benchmark performance in relative terms based on both knowledge and experience. Larger audit firms are not primarily concerned with young, growing businesses. They may not be aware of the extent of regulatory support that is needed and will not be able to deliver the same standard of detailed examination, due to fee structures in these firms and the dominance of much larger clients. The level of audit fees paid by smaller listed entities is of a different scale to audit fees paid by our largest companies and publicised in the press. Frequently, fees are substantially less than $100,000 and often they are even below $20,000. Similarly, fees paid for non-audit services are at considerably lower levels.

Middle-tier firms are specifically structured to serve a large number of smaller clients. Consider, for example, a middle-tier audit partner with $1 million of fees and 20 clients at around $50,000 each. How dependent is that partner on any individual client? How willing would that partner be to compromise firm reputation for the sake of one client? We put forward the view that the risks are non-existent or minimal. In contrast, consider a partner with $1 million of fees and one client at $800,000. Fee dependence is a reality and partner rotation is important to mitigate those risks. Also consider a partner with one dominant client and a few smaller clients. It is human nature that the level of examination for those smaller clients will be at a lower level than the audit of the large client and in comparison to the level of examination afforded to a client by an audit partner who operates in that market.

As part of our practice management, Pitcher Partners does not accept clients who require what equates to full-time audit presence. Individual partners do not have one or even a few dominant clients that provide a majority of their fees. However, these partners will be subject to the same rotation rules as a partner who is predominantly employed on the audit of one client. The risk of familiarity is overcome by the rotation of audit managers over a period of time. Audit managers also have significant experience. We believe that the so-called familiarity that may be associated with a long-serving audit partner provides considerable knowledge of the business during the growth phase of the entity. Any reporting risks are further mitigated by the lack of complexity and high level of transparency in these entities.

Audit fees have been said to be used as a loss leader to compensate for higher non-audit services. Although in the tender process we are already undercut by bigger firms, Pitcher Partners will not enter into price discounting. Middle-tier firms cannot afford to carry loss leaders, as the scale of our operations and the market in which we operate are significantly different from non-audit services offered to the larger corporations.

CHAIRMAN—Thank you.

Senator CONROY—I have a couple of questions. We have had a couple of the big four before us already in the last 10 days. They passionately deny that fee dependence is an issue or that there is any such concept as loss leader. How would you respond if you were sitting where we are—other than laughing a lot?

Ms Azoor Hughes—I cannot answer for the big four firms. We are aware that in the tender process we are undercut on fees. But that may just reflect the way their fees are structured. Of course, there is a lot of media speculation as to those two aspects too.

Senator CONROY—You raised fee dependence specifically and said your firm could not be captured by that. Is that realistic? It was denied passionately in a lengthy discussion I had with KPMG and Deloittes. They just do not believe that happens.

Ms Azoor Hughes—At Pitcher Partners we mitigate any risk of that happening, whether or not it does happen in reality, simply by not having clients of that size. Any one partner would have numerous clients at lower levels and no one client that dominated a large percentage of their time. I cannot really comment on whether there is or is not fee dependence in larger practices.

Senator CONROY—It is just that you raised it, so you must have heard a rumour.

Ms Azoor Hughes—Certainly, in the press.

Senator CONROY—You know you cannot always believe everything in the press.

Ms Azoor Hughes—I should also say that fee dependence is addressed in professional statement F1 as a concern, but there may be safeguards in place to mitigate those risks in the big four practices.

Senator CONROY—Is there any work you believe that you should not audit—a valuation, say?

Ms Azoor Hughes—Absolutely not.

Senator CONROY—So you believe you can provide a valuation and then you—

Ms Azoor Hughes—No. It is a basic principle that you cannot audit work that you have prepared yourself. There is no independence there, so we are not able to provide a valuation service and then audit the valuation.

Senator CONROY—What are the other services that you would not provide on that basis?

Ms Azoor Hughes—Where we are acting as a spokesperson, an advocate, for the client. If it were a role that required you to step into the management position of the client and make those decisions, or to lead them in a certain direction, we could not take those services because it changes the whole way you look at the client. We operate from an independent position external to the client, and therefore the full range of options are available to us; whereas as soon as you take the position of management you have different priorities.

Senator MURRAY—To sum up what you have just said, you cannot work where you would be defending their views rather than defending your own.

Ms Azoor Hughes—Pretty much, yes.

Senator MURRAY—It seems to me, although I have not heard it said anywhere by anyone, that in a sense the government is hoping with respect to non-listed corporations that the rules and standards that apply to listed entities will result in the adoption through a trickle-down effect of these practices. Do you agree with that as a general observation?

Ms Azoor Hughes—Yes, absolutely.

Senator MURRAY—I have had long experience both here and internationally with banks as a businessman. I think the respect given to their expertise is somewhat overblown, from personal experience. What I mean by that is, when large proprietary companies put their financial statements before their lender—and there cannot be more than a handful of large proprietary companies that do not have a lender—the lender, or the officer who acts on behalf of the lender, is not necessarily acquainted with everything that should be required in financial statements. I have wondered whether a way around your difficulty, which I think is a difficulty, would be to require auditors of large proprietary companies—which, as you remarked, have a Corporations Law definition—to state in what respect the financial statements do not meet the requirements that apply to audits of listed companies' financial statements. That would flag to the lender where a different approach is being taken which otherwise may not be picked up. The reason for doing so is that it is the lender who is the most important market player, if you like, with respect to large proprietary companies. What would be the practical difficulties of imposing such an obligation on auditors?

Ms Azoor Hughes—That obligation already exists in that the accounts would be labelled as general purpose financial reports, in which case all the disclosures required by accounting standards would already be provided.

Senator MURRAY—My understanding is that it does not. My understanding is that that is a general requirement, not a specific one—in other words, you do not itemise those areas in which compliance does not occur.

Ms Azoor Hughes—If you are preparing general purpose financial reports, that means full compliance. If you prepare a special purpose financial report, you would list the accounting standards that are not being complied with. That already happens now.

Senator MURRAY—You do list every item?

Ms Azoor Hughes—Not by item but by accounting standard. For example, if the income taxes standard had not accounted for deferred tax, that item would be listen within the body of the accounts.

Senator MURRAY—The accounts I have seen do not go to enough specificity. The point I am making is that if you quote an accounting standard at lenders' officers or if you refer in a general sense to something they are not familiar with the detail of that. What I am looking for is greater explanation—a clearer signpost, if you like. As I understand it, your point is that you are concerned that the higher levels of integrity guaranteed through the system we are discussing here would not flow through to large proprietary companies, who matter enormously in the Australian context. My proposition to you is that perhaps you need very clear signposting as to whether that exists, so that those stakeholders in those large proprietary companies will be alerted to it. That might in some cases be venture capital shareholders or it might be suppliers who want to see the financial statements—there could be stakeholders apart from lenders, but I would think that a lender is the most important person.

Ms Azoor Hughes—One of the considerations when you are providing an audit report on a set of accounts is who those users are going to be. That applies whether you have a multinational or a large proprietary company. For a number of our clients the primary users will be the bank or finance provider. Therefore, it is a priority in our audit report to be sure that the user understands the basis of the accounts preparation and any exclusions that apply and ascertain if there are any issues that are going to impact on their understanding of what is in the accounts. That is a reality in our marketplace.

Senator MURRAY—Let me give it to you bluntly. I cannot speak for my colleagues on the committee, but I suspect that the committee would be unlikely to extend the provisions of the bill to large proprietary companies en masse. I suspect that that would be unlikely. Therefore, to accelerate the trickle-down effect you might want a mechanism. What I am putting to you is that perhaps you should go away and think about what I have put to you and see whether you can recommend to the committee better ways in which stakeholders can see signposts as to where large proprietary companies are not compliant with the listed company regime.

Ms Azoor Hughes—I am not sure if we are on the same wavelength.

Senator MURRAY—We might not be.

Ms Azoor Hughes—Our view in terms of large proprietary companies is that they are heavily overregulated at the moment, and so we are not looking for a trickle-down effect in any way. We are looking for a different reporting framework, recognising that we do not have investors in capital markets to whom they are accountable. They are accountable to their shareholders, which are often a closed group of people, and they are accountable to their finance providers. But many of the requirements for the listed companies or even just the large listed companies are unsuitable for and do not add benefits to either the large proprietaries or their finance providers. They are onerous.

Senator MURRAY—We are attacking things from a different direction. I do not have any sympathy with your view in that I am conscious that large proprietary companies are often much larger than listed entities. I think these protective mechanisms exist for all stakeholders and for society as a whole. It is important you understand my prejudices as well as yours. But what I am asking you to do—and you do not have to do it; it is up to you—is consider whether there should be better signposting for stakeholders as to where compliance does not occur.

Ms Azoor Hughes—Our clients cover a full range. Certainly with the large proprietaries—the ones that are as big as the listed or bigger—we would expect full disclosure in those accounts, simply because of their dominance in the marketplace. Remember, a large company might also be one with only $10 million in turnover and only $5 million in assets, which might just be one property. They are faced with those same reporting requirements as the extremely dominant proprietary company.

Senator CONROY—I want to follow up on that question of services that you would not provide. I got the sense you were drawing from the professional standard—F1, I think it is called.

Ms Azoor Hughes—Yes.

Senator CONROY—I will read a quote from ASIC's submission. It states:

> ... the provision of some non-audit services will always, or almost always, threaten the independence, or the appearance of independence, of auditors, regardless of the safeguards adopted. ... ASIC considers that the best approach is to prohibit the provision of such non-audit services through the Act, rather than through the ethical rules of the professional bodies.

It is clear from ASIC's statement that they do not trust the audit profession to remain independent when delivering certain non-audit services. If the regulator does not trust you, why should the parliament and shareholders?

Ms Azoor Hughes—I think ASIC has taken a very hardline approach, which is not practical. There are such a range of different non-audit services that might be offered, and drawing lines in between what is and what is not an audit is not easily distinguished. I will give you an example. When you go through the final stages of the audit and you are looking at accounts disclosures—the way the disclosures have been made in the accounts, perhaps as Senator Murray was referring to—there might be differences of opinion as to how items have presented and what the best presentation is. When an auditor engages in those conversations, are they providing an additional service by saying, 'That disclosure is inappropriate,' or is that the part of the audit process? If they give them a template or sample set of accounts, is that providing accounting services, or is that part of the audit process? I think it is very difficult to draw hard and fast lines between different services and say, 'This is audit, this is not audit; this is compatible, this is not compatible.' We need to look at—

Senator CONROY—But the professional standard does.

Ms Azoor Hughes—For listed companies, yes.

Senator CONROY—ASIC is saying fundamentally the same thing.

Senator WONG—In that situation, how do you bill them? Do you bill all those associated services as part of the audit service or otherwise? Do you draw the distinction in your firm?

Ms Azoor Hughes—We have to draw the distinction.

Senator WONG—So it is capable of being drawn.

Ms Azoor Hughes—But not in black and white. I think it is very difficult to establish a black and white line. It really depends on the circumstances. For example, a large proprietary or a small listed company may not have a good understanding of their requirements. Frequently, a small listed company does not have its own in-house expertise to deal with the interpretation of an accounting standard or whatever. We might speak more closely with them to go through the rules to explain them and say, 'This is what's required.' Except for the last three years when I have been with Pitcher Partners, I have worked with the big four and the larger end of town, and I know that in those circumstances we would hand over and say to the policy people, 'There is an issue with this standard; have a look.'

Senator CONROY—Is there much grey area around valuation?

Ms Azoor Hughes—I do not think so. Valuation is pretty black and white.

Senator WONG—So you believe that that should be prohibited?

Ms Azoor Hughes—We would not audit a valuation that we had conducted ourselves.

Senator WONG—I understand that. Sorry, Stephen, I am jumping in.

Senator CONROY—I appreciate that it depends on where you draw the line. You seem to be saying that you could not draw the line, but there are some things that are fairly clearly on one side of the line. There may be some grey areas in the middle.

Ms Azoor Hughes—I think it becomes very dangerous, though, to start being specific and say, 'Valuation services are prohibited,' because the marketplace—

Senator CONROY—You managed to do that quite successfully.

Ms Azoor Hughes—But the marketplace will respond to that black and white letter which says 'valuation services'. I can see that over time a new service will develop which is not called 'valuation services', so if someone wants to circumvent those rules they could do that.

Senator WONG—It is not necessarily an argument against regulation, that it is impossible—

Senator CONROY—We should just give up!

Ms Azoor Hughes—It is interesting that there was fierce debate 20 years ago about whether goodwill could be recognised in a statement of financial performance. In the end, yes, you could recognise goodwill but with an amortisation period. And over the last 20 or so years a whole range of intangibles have emerged, so that entities no longer have to recognise goodwill; they

have a different intangible asset and they do not have to amortise it. That is just one example of how black and white rules can be overcome over time. So I would be against a black and white prohibition. I think the principle is much more important.

Senator WONG—Any prohibition at all?

Ms Azoor Hughes—Prohibition on non-audit services that cause a conflict of interest. That is the principle. But I think to name auditing services would not be a good way to go.

Senator WONG—Who determines that there is a conflict of interest?

Ms Azoor Hughes—There are two sides to it—well, three sides.

Senator CONROY—The SEC seem to be willing to chance their arm in the US, and they are trying to explain it to NAB at the moment because NAB seemed to feel that it was a bit of a grey area. That is the largest capital market in the world.

Ms Azoor Hughes—Yes, absolutely. The market which the SEC operates in is completely different to the Australian market. The Australian capital market is less than two per cent of world markets. A number of our listed companies could not list in the US simply on size. Therefore, to impose the same level of legislation on companies that are still very much in their growth phase is detrimental to the economy.

Senator CONROY—Would you define NAB as in their growth phase?

Ms Azoor Hughes—Absolutely not.

Senator CONROY—They seem to be confused.

Senator WONG—I have another question on auditor rotation. Do I understand from your submission that you would support rotation off the audit of the lead auditor after five years but not the review auditor? Is that right?

Ms Azoor Hughes—That is not quite right. With the large corporates, the review auditor plays an integral part in the audit. They are involved in the planning, they meet with the client, they review the audit files and they have a large part in the audit. With the smaller entities, the review auditor has a very small part to play. They might only become involved if an issue needs a second opinion or to review the accounts from the external perspective. Therefore, it becomes onerous for the smaller listed entities if you need to rotate both partners.

Senator WONG—Why does it become onerous for the client? Isn't the argument that it is onerous for the audit firms?

Ms Azoor Hughes—Yes, that is what I am putting forward.

Senator WONG—That is what you are saying.

Ms Azoor Hughes—Yes.

Senator WONG—So are you suggesting that there would be some circumstances in which you would agree with the rotation of both lead and review auditor?

Ms Azoor Hughes—Certainly with the large listed corporates, the top 200 or so.

Senator WONG—And in relation to smaller publicly listed companies, you would envisage no rotation whatsoever?

Ms Azoor Hughes—I would prefer no rotation. I think there is less need for it because the accounts are transparent.

Senator WONG—As opposed to large publicly listed companies—the accounts are not transparent?

Ms Azoor Hughes—They are not as transparent because of the complexity involved. They use complex instruments, forms and structures.

Senator WONG—But so could a smaller listed company.

Ms Azoor Hughes—But they don't.

Senator WONG—But they could.

Ms Azoor Hughes—They could, but it does not happen. They are small because they are not diversified.

Senator WONG—So let me clarify: you would agree with the rotation of both lead and review auditors in large publicly listed companies.

Ms Azoor Hughes—Yes.

Senator WONG—In relation to smaller publicly listed companies, you would use the Corporations Law? How would you draw the distinction between large and small?

Ms Azoor Hughes—In terms of the listed companies?

Senator WONG—Yes.

Ms Azoor Hughes—I think you would need to determine the threshold. I understand that there are clear thresholds at 200, 300 and 500.

Senator WONG—That is right. With regard to the smaller publicly listed companies, are you saying that you do not see a need for any rotation whatsoever?

Ms Azoor Hughes—In most circumstances, no.

Senator WONG—Would a five- year rotation be such an issue for your firm?

Ms Azoor Hughes—We would comply with that. We can comply with that.

Senator WONG—You can comply with that?

Ms Azoor Hughes—Yes, we have enough audit partners to be able to do that, but it is compliance for compliance sake.

Senator WONG—We are going to disagree on that. But, just in terms of the practicalities, it would not preclude your firm from its current work profile?

Ms Azoor Hughes—No. But there are a number of other smaller practices where it certainly would.

CHAIRMAN—As there are no further questions, thank you very much for appearing before the committee.

[2.11 p.m.]

ADAM-SMITH, Mr Matthew Alexander, Partner, Grant Thornton Accountants

FENSOME, Mr Martin Edward, Partner, Grant Thornton Accountants

CHAIRMAN—Welcome. The committee prefers that all evidence be given in public, but if at any stage in your evidence or responses to questions you wish to respond in private you may request that of the committee and we will consider such a request to move in camera. We have before us your submission, which we have numbered 39. Are there any alterations or additions you wish to make to the written submission at this stage?

Mr Fensome—No.

CHAIRMAN—I invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Mr Fensome—Grant Thornton welcomes the opportunity to appear before the Joint Committee on Corporations and Financial Services for your hearings on CLERP 9. We are supportive of the review being conducted by the committee on CLERP 9 and support the introduction of CLERP 9 by 1 July 2004. We view this legislation as a major initiative in enhancing Australia's financial reporting regime, corporate governance processes and capital markets generally. We support the principles based approach that has been adopted in these reforms which, in our view, addresses the intent of the HIH royal commission recommendations.

By way of information, Grant Thornton is the fifth largest accounting organisation worldwide and is within the top 10 accounting groups within Australia. We are a leader in our chosen market, being the provision of accounting, tax, audit and business advisory services to owner managed and entrepreneurial businesses, including small and medium-sized listed public companies. Whilst we are part of a large worldwide network, we are not a worldwide partnership with independent member firms in each country. Indeed, in Australia we are of federation of five separately owned firms operating in each of the major state capitals. Hence, while we have spent significant amounts of time reviewing CLERP 9 over the last 18 months, since the original proposals, we do not have the same level of dedicated resources as the big four firms. Matt and I are both full-time audit partners juggling client work with other technical and management roles within our firms.

Grant Thornton lodged a submission with the committee in November 2003 that commented on the draft bill. Our submission outlined our support for the overall content of CLERP 9, but also focused on three areas of concern: auditor rotation, auditor independence and changes to the current section 311 of the Corporations Act in relation to auditors reporting to ASIC. We note that technical improvements to overcome practical difficulties have been incorporated in the bill which, in broad terms, address our previous concerns regarding auditor independence and section 311. Although supporting the overall thrust of the proposed legislation, we therefore take this opportunity to provide comments on auditor rotation—an area that will have significant

impact on our client base, being the small to medium-sized enterprise market that is the cornerstone of Australian business. Matt will now talk to you in relation to auditor rotation.

Mr Adam-Smith—We fully support the concept of the rotation of the lead audit partner after five years for all listed public company audits. This is a sensible approach to address the concerns over the perceived lack of independence arising from long-term auditor-client relationships. We note this simply represents a slight shortening of the current professional requirement for rotation after seven years, which was recently introduced in Australia by the professional accounting bodies as part of the harmonisation with the IFAC code of ethics. However, we believe the extension of this rotation to the review partner will have an adverse effect on the audits of small and medium-sized listed public companies. To comply, a firm would generally need four appropriately qualified audit partners to meet the lead audit partner and review partner rotation requirements.

Of the 120 or so organisations auditing approximately 1,400 ASX-listed companies, most will struggle to meet the rotation requirements. For example, in Adelaide and Perth, Grant Thornton is the fifth and sixth largest firm respectively, but each office only has two full-time audit partners appropriately skilled to perform audits of listed public companies. If one of the largest firms, such as Grant Thornton, in each of those regional capitals will struggle to cope with the requirements, it is likely that the vast majority of smaller firms will be even more adversely affected. Accordingly, we believe that this may result in many firms withdrawing from providing listed public company audits. As a consequence, this will result in the concentration of the auditing of ASX-listed companies with mainly the big four, resulting in reduced competition and therefore increased costs to small and medium-sized public companies.

The role of the review partner on the audit of small and medium-sized listed public companies is very different to that of the review partner of a large, say, top 100 ASX company—being really just an internal quality control process. Whilst the review partner on, say, the Telstra audit would be an integral part of the audit team, spending hundreds of hours a year involved with the audit and in face-to-face relationships with senior management and the board, a review partner on a typical audit client outside, say, the top 200 listed companies would generally spend between perhaps 10 and 20 hours a year on that client and would never even meet the client face to face. Indeed, the client probably would not even know the name of the review partner because they are an office based quality control procedure.

The review partner role in these cases involves reviewing the audit risks, strategy and approach at the planning stage, discussing the issues during the course of the work with the audit partner and reviewing key work papers, conclusions and draft accounts at the completion stage. As I said, it would represent perhaps 10 to 20 hours a year. Based on this level of involvement in the audit, we do not believe that the review partner is subject to the same risks of independence being compromised as the audit partner. We therefore consider that the review partner rotation is unnecessary and would cause significant reduction in competition, force smaller firms out of the business and result in increased costs to the small and medium-sized listeds.

We support the concept of the Australian requirements being as rigorous as world's best practice. However, the CLERP 9 legislation seeks to impose rules that are similar to the US rules under Sarbanes-Oxley across all Australian listed companies, without recognising the vast difference between our capital markets and those in the US. The rotation of audit and review

partner is only applicable for SEC registrants in the US—companies which are far larger than the majority of Australian listed public companies. Unlike in the US or the UK, in Australia we do not have a secondary board where smaller businesses can have access to capital markets. In the UK or the US those much smaller entities on the secondary markets are not subject to these one size fits all type of rules.

We strongly believe that the rotation of review partner for small and medium-sized listeds will have a detrimental effect and is not warranted. We would support the review partner rotation applying to, say, the top 200 or, at the very most, the top 500.

In conclusion, we reiterate our support for the overall thrust of the proposed legislation. However, we strongly believe that the rotation of review partner needs to be addressed in order to prevent unintended adverse consequences to small and medium-sized businesses. We thank the members of the committee for the opportunity to appear at the hearing, and both Martin and I will be pleased answer any questions you may have.

CHAIRMAN—Thank you very much, Mr Adam-Smith. You have raised audit partner rotation as an issue of concern for your firm. This committee has heard argument that if a firm cannot meet the rotation requirements it should not be auditing publicly listed companies. What is your response to that?

Mr Adam-Smith—I would guess that that is a big-four approach. My understanding is that even the big four, in specialist areas such as insurance and financial services where it is a specific industry skill base, would struggle to do that in regional capital cities such as Adelaide and Perth. To be suggesting that only the big four are capable of auditing very small listed public companies is not something I agree with at all.

CHAIRMAN—So would you agree with the University of Technology Sydney's Centre for Corporate Governance who say that they believe that in certain industries there is a limited expertise with regard to audit competence and that auditor rotation could in fact deprive companies in those industry sectors of auditors who have the required level of competence?

Mr Adam-Smith—Absolutely.

CHAIRMAN—Another issue that has been raised, perhaps on the other side of the coin of auditor rotation, is that mandatory firm rotation would be desirable because this would stimulate competition by opening up the audit business, which is currently concentrated in the hands of the big four, to other competitors. What is your view on mandatory firm rotation rather than partner rotation?

Mr Fensome—I think there are similar issues associated with partner rotation and with firm rotation. In terms of competition, we have made the comment that we certainly believe the review partner rotation is not necessarily appropriate. If you start to rotate audit firms across the various listed companies, again, there could be situations where firms are unable to undertake this type of work. You might also find—and I think you have raised this, Mr Chairman—that there might be some issues there in terms of experience. Notwithstanding that, my understanding is that there are no specific requirements, certainly from an Australian, US or UK perspective,

that require mandatory firm rotation. Therefore, to implement something like that would be well ahead of some of the larger capital markets in the world.

Mr Adam-Smith—I would like to add a couple of comments to that. In the countries that have had mandatory firm rotation in place, it is my understanding that there has not been any correlation between that and reduced corporate failure. In terms of your question about opening up current big-four audit clients to the non big-four firms, I think there is an acknowledgement that in the big end of town—the top 100 companies—really only the big four have adequate resources to deal with jobs of that size. Similarly, to echo the comments by Pitchers, the next tier of firms are set up very differently, where audit partners are not set up to have a single client, and our skills are in managing series of assignments across a wider client base.

Senator MURRAY—I want to challenge or test one of your propositions, and that is that this will have a negative impact on competition. Basic market economics says that if you change the parameters of a market you can create more competition, so the two components might be seen as promoting opportunities for new firms to be created. The first component is that auditor rotation may encourage firms to split or ambitious partners to go off and do their own thing, knowing there is a demand issue—which is essentially what you are saying—because the demand would be greater than supply. So a barrier to entry would be lowered and greater competition would be fostered—so the theory goes.

The second component in the bill which might challenge your cause and effect analysis is my assumption—and you might be able to challenge it—that, apart from economies of scale and natural concentrations, one of the reasons for the size and nature of the big accounting firms has been that only they can carry the costs, the liabilities and the risk. This bill in fact lowers risk by lowering liability and giving a fairer shake for auditors, who are typically targeted almost exclusively for corporate failure—again, I think, making it more possible for new firms to be created and go off on their own with perhaps less financial resources than you need when you are facing the risk that majors face. So I have a different sense of the effects of this legislation to those that you put, and I would like you to respond to my testing.

Mr Adam-Smith—The first part of your question, if I can recall it, was in relation to changing the market factors and increasing competition. Later on in your question you raised—

Senator MURRAY—Because greater demand is created.

Mr Adam-Smith—'Barriers to entry' were going to be the words I used. I think the changes will act as a barrier to entry rather than reducing the difficulty. Only very sizeable organisations will be able to meet that barrier to entry and hence I think it would have a detrimental effect.

Senator MURRAY—But why do you say that? I have put the alternative economic theory approach—that is, simply demand-led market stimuli—and the market stimulus is that a greater variety of independent organisations are needed because that is what the law says is needed. So why do you think it will be a barrier to entry rather than a provocation for perhaps splintering off of partners of the major firms?

Mr Adam-Smith—I think, to take a step back, the accounting profession has changed a lot over the last 10 years. The regulation has become more rigorous, and I am not saying that is a

bad thing. There has been a lot of change, from the GST to the international financial reporting standards and CLERP 9. There has been a constant change and there is a sort of information overload that I think a lot of people in the profession have found. It is not as easy a job to do as it might have been 20 or 30 years ago. That has the effect of reducing the number of people who are willing to run their own practices, so really there has been a conglomeration in those larger firms, which we have seen has had a detrimental effect on competition.

For example, at the moment, a lot of boards, in response to independence, are seeking to perhaps have one audit firm, a separate firm looking after tax—even though that is not required, they are choosing to do that—and a separate internal audit firm. This is at the big end of town. In a lot of circumstances where we have three of the big four firms that are the service providers, if they wish to put their audit out to tender there is only one other big-four firm to put it out to; none of the next level of firms operate in that market or have the skills to do that. So we are already struggling from a lack of competition because of the conglomeration effect. I still believe that increasing the rotation of review partner requirements will only serve to make that worse and will have a detrimental effect on the overall organisation of the accounting profession.

Senator MURRAY—I am not satisfied with your answer. I respect it, but I am not sure that it answers the question of cause and effect. If you increase demand, supply should be increased. That is the theory, and I cannot see why not. I then ask you to respond to the second testing proposition I put: that is, whether you would agree with me that this bill lowers the risk of liability that the former regime unfairly, I thought, put on auditors—the deep-pocket stuff.

Mr Fensome—In terms of maybe just their risk and liability, yes, we note and acknowledge that incorporated within the bill there is the opportunity for auditors to incorporate. That is moving away from the old style professional partnership type structure, and therefore some would argue maybe that that reduces the risk. Maybe the risk of litigation flows on if something were not to transpire in the way it should. Notwithstanding all of that, just from a professional perspective, operating as a partner in an accounting firm—under whatever structure you operate—I must stress that there is always risk in providing a professional service, whether it is in the accounting profession, the legal profession, as a doctor, or whatever. Yes, as a profession we welcome some of these proposals, but we acknowledge that risk is attached to the provision of that service. Yes, things have changed, but, whether it has a significant impact in terms of the risks for us, only time will tell.

Senator MURRAY—Essentially, the summary of our discourse is that the market effects that you or I envisage will be determined in due course, after a number of years.

Mr Fensome—Yes.

Senator MURRAY—Then the question really is: should the government take the risk of introducing this legislation if the market effects are as you foresee? My judgment is that it should, because I think the market effects will be as I foresee. If the consequences were in fact as you forecast, would you recommend that the government revisit this area and make adjustments?

Mr Adam-Smith—Certainly. I would agree with that. In terms of what Martin was talking about earlier and what you mentioned, the proportionate liability reforms obviously will help to reduce the risk and liability, but, as you said, only time will tell as to what the outcome of that

will be. Certainly in terms of the auditor rotation, I would recommend that the government reviews that.

Senator MURRAY—In what time frame would you suggest that it looks? How long would it take for the market effects to be evident, in your view?

Mr Adam-Smith—The legislation, as I understand it, has a two-year transition period in terms of the rotation. Because of that, we would not necessarily see the change in the first two years. It may be another couple of years out.

Senator MURRAY—Five years from the passage?

Mr Adam-Smith—Yes.

Senator MURRAY—I ask you this deliberately, not idly, because one of the processes that this committee undertakes is often to recommend to government to review process when introducing new concepts. I will move on to the issue of independence. We have tested this. If you had had time, which I doubt, you might have ploughed through the *Hansard* of the committee and would have found that we have tested the previous witnesses. The point that witnesses and I have made is that the independence that is established through the professional standards and so on does not deal with the clearest and most fundamental criteria which determine independence. They deal with it in part.

I will spell out the criteria. Firstly, the method of appointment should be fair and objective. Secondly, the remuneration should allow independence of operation and not a dependent circumstance, relative to the job concerned. As you know, one of the claims is that it is low-costed and, therefore, auditors are forced to get their profits from allied or associated services—nonaudit services. The third component is that there is sufficient tenure to ensure that return and risk are properly managed—that you have secured tenure to allow independence. The fourth component is that the method of separation or dismissal is fair and objective. The question is whether you think the legislation should require the professional standards to have regard to those aspects in determining independence.

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Mr Fensome—There are certainly mechanisms in place in the Corporations Act as it exists at the moment relating to auditor appointment, auditor removal and auditor resignation. Certainly, there are safeguards in place in the resignation process that require approval from ASIC for an auditor to resign as an auditor of a public company. Going back to the appointment process, we are all conscious of those appointment requirements in the Corporations Law. It is ultimately the responsibility of the shareholders to make that appointment. That is in essence what the Corporations Act specifically states.

Senator MURRAY—But your recommendation is that the independence criteria should be determined by the professions.

Mr Fensome—There are a couple of issues in relation to all of this. There is obviously the independence of the appointment and the tenure process, which may be one issue associated

with independence, but there is the other issue of your independence when you are acting as the auditor. The independence at that level can be addressed on two levels: one at an actual independence level and one at a perceived independence level. The actual independence is a relatively objective measure that to an extent can be measured; whereas the perception is very much in the eyes of the beholder, so your view of perceived independence may vary from my view of perceived independence, or from somebody else's. For example, if we take tenure fees and the like, as we indicated in our brief presentation at the start, Grant Thornton provides services to primarily the medium and small listed companies and the companies within that SME sector within the Australian economy. If you look at the fees that any one individual partner is deriving from any one client, it is economically insignificant in the scheme of things. From an actual independence perspective, I would suggest that it is very difficult to argue that our independence would be impaired. From a perceived independence, again you would look at the services that are provided—not just at the audit services but the other services. Again, it comes down to potential economic independence. From our perspective, with the size of the clients that we service we can demonstrate at the actual level that there is not that economic dependence on one client.

Senator MURRAY—Can I interrupt you. I think you are avoiding the question. I do not mean that rudely, but I am a direct sort of person. In your submission you said:

> We recommend that the legislation simply include a principles based requirement to comply with professional independence requirements, rather than the current prescriptive rules. We further recommend that any definition of independence be consistent with the IFAC and F1 definitions.

That is a very clear position.

Mr Fensome—Yes.

Mr Adam-Smith—Yes.

Senator MURRAY—We are very conscious that what we are debating here has real international ramifications to do with harmonisations, consistency, globalisation—all those 'isation' words. They are important matters, and in due course we have to come to uniformity of an international view. When this was tested last Thursday with a couple of very expert professors that the committee has regard to, they were very interested in what I had to say because they had not heard before in this framework that the hiring, the firing, what you pay to do the job and how long you can do the job for are essential components of independence expressed in that form. As we know, that is how judiciary independence is established.

If you are going to hang your hat ultimately on the best international measure of independence being the agreed professional standards dictated through the international bodies that come to it—and many of our companies have cross-border auditing circumstances—I do not think you can answer the question as you have. I think the law has to say that in any development of professional standards these at least are the things we want you to have regard to—a non-exhaustive list—and you have to go away and set those in the right framework. Again my question is: do you think that is what the law should be saying, because you have said that there are certain aspects of the law which are quite prescriptive in some of these areas? I am going back to principles and that is what I am asking you about.

Mr Adam-Smith—I have heard some of your views previously, or read them, and certainly have some sympathy towards some of those concepts. Whilst in the paper we have suggested that, rather than all these prescriptive rules in the law, the concept of independence should be put back into the professional standards, I think that it is important to consider the things that you are talking about—in terms of client acceptance and resignation, tenure et cetera—as part of the whole independence picture.

Senator MURRAY—I am right in saying that none of those items is in the professional standards at present?

Mr Adam-Smith—Correct.

Senator MURRAY—Why not? They are the essential components of independence.

Mr Adam-Smith—I will answer that by criticising a one-size-fits-all approach. They may be very important things in terms of the big end of town where those issues may well have influence but, as Martin commented, for the majority of auditors where an audit fee might be $50,000, regardless of your security of tenure or the exact level of the fee, the fees are of such a size that you would not compromise your independence or your professional career over the audit of one of those entities. I have a client base of $2 million that comprises perhaps 50 clients. No single client would be of any significance. Therefore, all of those things you talk about would be relevant in looking at, say, the Telstra audit but may not be important factors in terms of my independence on a much smaller job.

Senator MURRAY—But you are asking us to go down a principle based route and I am asking what should be the component parts of those principles? I am enunciating four at least which I think the standards should have regard to and I cannot get a clear response from you as to whether you think that is appropriate.

Mr Fensome—Can I just add that, without knowing specific references within the handbooks of the institute or the society, there are—and this is outside F1—some broad principles built in for members. I cannot talk for any of the other accounting bodies because I am not fully conversant with the requirements of those professional standards. In terms of fees, there are some broad principles for consideration of client acceptance. As part of the auditing standards, there is an auditing standard on quality control and I acknowledge that at some point in time the auditing standards may have the force of law, which has been proposed in the bill. That standard is not necessarily specific within that quality control standard but in essence it is implied that you have to go through certain quality control processes as an auditor not just to conduct the audit from go to whoa—that is, plan, execute, report and ensure that you have an appropriately qualified staff and the like—but also to ensure that you are considering the risks associated with that client and the tenure.

There are circumstances, even from a practical perspective, where firms believe that the risk attaching to an audit is so great that they make the commercial decision—and it is not due to any independence related or economic issues—that it is not appropriate for them to provide the services. It may be because they do not believe they have the adequate skills. Why have they determined that? They have determined that because they have considered all the professional literature that is contained within the accounting handbooks, which is principles based—it is not

prescriptive based—and made the conscious decision to move away, to resign, from that audit. I am going back to the principles contained within the professional literature.

Senator MURRAY—Let us pick out one of my four: remuneration. I would suggest to you that unless the international standards which you are asking us to ascribe to said that, with respect to remuneration, if the return or the viability of the job is dependent upon income being sourced from areas other than the audit then you are not independent; that is just a kind of judgment. I do not think the law can prescribe the circumstances. This is a matter of judgment. That is what professional standards are about. They say, 'Here are the Ten Commandments. You go away and fulfil those Ten Commandments and make a professional judgment, because you have been trained to do so.' My concern is that when you come to us with a recommendation like this you have to tell us what that means in reality, not simply say: 'A whole lot of clever people have worked this out.' We come back to you and say that from our experience, with judges and everybody else who you want to have true independence, these are the component parts which contribute to it. I picked those four deliberately, because my understanding is that that is a major issue.

Mr Adam-Smith—I guess the comment that was in the paper was really aimed at the specifics of what is already in CLERP 9—saying that some of the details on independence and specific rules were very prescriptive, rules based items. That did not deal with the areas that you have talked about but with whether there are cooling-off periods or relationships with spouses, dependent children and siblings et cetera. There were a number of very specific rules. I think there were 17 pages of draft legislation on independence. We were suggesting that that was not the way to go, because with a very prescriptive, rules based approach, as you have acknowledged, there can be loopholes. A principles based approach is much more robust in looking at these judgmental issues. Hence, we were saying that rather than have all of that detail we would support a one-liner referring to a more comprehensive threats and safeguards approach. I acknowledge your point that there may be some improvements to that threats and safeguards approach in some of the areas that might not be explicitly covered in them.

CHAIRMAN—Mr Adam-Smith, Mr Fensome, thank you very much for your appearance before the committee and for your contribution to our deliberations.

Mr Adam-Smith—Thank you.

Mr Fensome—Thank you.

[2.53 p.m.]

BAXT, Professor Bob, Chair, Law Committee, Australian Institute of Company Directors

EVANS, Mr Ralph, Chief Executive Officer, Australian Institute of Company Directors

GUY, Mr Andrew, Board Representative, Law Committee, Australian Institute of Company Directors

JOHNSON, Mr Mark, Deputy Chairman, Reporting Committee, Australian Institute of Company Directors

CHAIRMAN—Welcome. The committee prefers that all evidence be given in public but if at any stage of your evidence or response to questions you wish to respond in private, you may request that of the committee, and the committee would consider such a request to move in camera. We have before us the written submission from the AICD, which we have numbered 35. Are there any alterations or additions you wish to make to the written submission?

Mr Evans—No.

CHAIRMAN—I invite you to make an opening statement at the conclusion of which I am sure we will have questions.

Mr Evans—The AICD has 18,000 members Australia wide and, among other things, it is a major provider of education for company directors, with about 2,000 people successfully completing its company directors course last year. About 50 per cent of the directors and 70 per cent of the chairmen of the top 100 listed companies in Australia are members of our institute, but this is actually only a very small minority of our total membership—obviously, since we have 18,000 members. The vast majority are directors of smaller listed companies, unlisted or private companies, government bodies, super funds, charities and not-for-profit entities. In fact, they are to be found wherever the legal framework of being a company director exists. And there are some members who are aspirants who want to join major boards.

Our policy viewpoint stems from the belief that the company with shareholders, a board of directors and management has been an immensely flexible and productive device in the economy and is one of the pillars of the modern world. We want to help it to work well and productively now and in the future. We support a strong and sensible legal and regulatory environment for companies. We are, indeed, happy to see people and companies penalised under the law if they commit offences. We would prefer to see existing laws used to their full extent rather than have new laws created to cover circumstances for which there are already legal remedies.

In general, we are concerned by the increasing complexity in the legal and regulatory framework for companies and the increasing personal risk for directors. The limited liability system has worked well for centuries and has produced an enormous amount for mankind. Abuses and failures have occurred, but need to be kept in perspective. In particular, AICD is

concerned that the role of director is not well understood and that some regulatory bodies may have an unrealistic view as to what can be expected of directors.

I want to emphasise that we represent directors rather than executives. The two roles are often confused in the public mind, which is perhaps not surprising as many people are both. In Australia, unlike in Britain or the USA for instance, non-executive directors are very much in control of most companies. They represent the shareholders and, collectively, are the bosses of the CEOs, because somebody has to be. They are non-executives—that is, part time—often dividing their time across more than one board. They use their knowledge and experience collectively as a board to keep shareholder interests to the fore and ensure that executive managers run the companies well.

AICD has three committees to assist it in formulating its policy views. Each has members who are technical experts and others who are practising directors. The committees deal with the law, corporate reporting and corporate governance. They have a small staff supporting these committees, but the members are volunteers who give their time to what they see as a worthy cause. Here with me today is Professor Bob Baxt of Melbourne University Law School, Chairman of AICD's law committee, and another member of the law committee, Andrew Guy. Andrew is an experienced solicitor and director of several public companies as well as the AICD itself. Also here is Mark Johnson, Deputy Chairman of AICD's reporting committee. I would now like to hand over to Professor Baxt.

Prof. Baxt—Thank you very much for the opportunity to participate in this exercise, which I think is an excellent way of ensuring that complex issues such as those raised by the CLERP 9 bill are, in fact, adequately aired. As chairman of the law committee—and I have been chairman since I rejoined the practising side of the profession after three years as a regulator in a different area, trade practices—I could see first-hand the issues that I think are central to many of the principles that are behind this current legislation. I was able to appreciate even better than I had in the past that one of the great strengths of the Australian legal system is the fact that we do rely very heavily on the fact that we have regulators who are independent and who are given the adequate, and often not adequate, resources to ensure that the legislation is enforced. I think that this is the key point that we would like to emphasise in our submission.

We believe that the Corporations Act and legislation that is linked to it does provide in its current form, and without the necessity of many of the amendments in the CLERP 9 bill, adequate protection for Australian consumers, shareholders and companies as long as it is adequately and properly regulated. We are concerned that much in this legislation and in earlier legislation that has appeared chips away at one of the points that the Chief Executive Officer, Ralph Evans, has mentioned—that is, the concept of limited liability and the way in which it operates.

True, there have been times when the courts have been a bit slow in evaluating some of the legal principles that are at the heart of our Corporations Act, but just in the last few months we have seen Justice Austin in the New South Wales Supreme Court build on an earlier judgment of his in the ASIC v. Rich case and the ASIC v. Vines case to show that there are principles about the liabilities of directors et cetera in carrying out their obligations which can be enforced adequately in the courts. We are worried that the proposal in this bill to introduce a new system of infringement notices in relation to the operation of the continuous disclosure regime is but

another chink in the already very heavily pierced armour of limited liability and another very significant erosion of the principle that people are innocent until they are proven guilty.

What worries us as an organisation and what must worry the average Australian citizen is that we are moving more and more to a principle that we operate on the basis that, when things are tough to prove on the part of whoever it might be, whether it is a regulator or not, the onus is switched and the person who is charged is made to answer the charge that he or she is guilty and has to prove their innocence. That is what worries me and the institute about the infringement notice regime.

I should state straight away that I was a member of the Australian Law Reform Commission's consultative committee that looked at this issue over two years. What disappointed me, the AICD and many people was that the government has chosen not to look at the very sensible recommendations of the Australian Law Reform Commission in relation to the infringement notice regime in pursuing this proposal in its current form. We welcome the opportunity that will be given to us as a group and to the community generally to have another look at this—the Treasurer has promised that there will be a review of this legislation in two years—but we are concerned that it would be introduced in the first place. We see it as a precedent. We see it as an opportunity for other regulators to say, 'It's a bit hard to prove this and a bit hard to prove that. Why don't we introduce a system whereby the company or the individual has to show that he, she or it is innocent rather than the other way around?' We do not think that that is a proper way for our law to proceed.

If we switched it to general law and had it apply to criminal law, there would be total outrage in the community. We see it as a reaction to a situation. I believe there has been overreaction to some major company crashes, some of them due to people who have behaved badly. Those people should be pursued vigorously. There are provisions in the legislation and ASIC has additional resources to pursue those people vigorously. We have seen some very important cases in the courts recently involving One.Tel and HIH. But there will be cases where companies fail because of events that are totally outside the control of the directors. Those occasions are something that no legislation passed in this country or any other country will stop recurring in the future. We are concerned that some of this legislation appears to be reflecting the need to introduce changes that we believe will not achieve the intended results. I will give you a corresponding example that occurred in the 1980s. We had huge legislative change in relation to related party transactions, only to find that not too many years later most of it had to be dismantled and replaced by new legislation because it was only creating greater costs and was not achieving the intended results.

We are concerned that the initiative is one that is misplaced and should not be pursued. We know that there is very little chance that other parties will move away from it, but that does not mean that we do not believe that these issues need to be stated, and stated forcefully, in light of the ALRC report and various other arguments. We are concerned, though, that the current bill does not contain adequate safety mechanisms in the infringement notice regime, notwithstanding the improvement that has occurred since the discussion paper was produced. In our submission we have provided details of what we think those changes should be. We would hope that more changes would be introduced. We know that ASIC is going to put out a policy paper on how this is all going to operate but we think that that is just not adequate. We feel that that should be

enshrined in the legislation because otherwise we are left at the whim of the legislators in the context of a particular situation.

In this context I should point out that in the first place it is likely that the smaller companies—and there are many small companies that are listed on our stock exchange who are going to be covered by this regime—are the ones that are going to succumb to this legislation very quickly. The fact that we had, just as this legislation was being introduced into parliament, the successful litigation by ASIC in the Southcorp case and the published reasons for the judgment by Justice Kevin Lindgren show just how effective the current regime and the legislation could be if it were only pursued by the regulator. The regulator who complains that it is too hard, who is too lazy or who has too many other things on their plate who says, 'We should have the right to pursue these things in this way,' is not a very good precedent for our laws in general.

We are also concerned about the fact that the legislation targets individual directors in situations where they are left without appropriate protection. In this context, we think extending the continuous disclosure regime to apply to directors without adequate defences is a problem. I would like Andrew Guy to comment on this more specifically in the context of his real life experience as a practising director. The promise by the Treasurer that there will perhaps be amendments introduced into the Senate if necessary to deal with this matter is comforting, but we are concerned that this should be achieved by appropriate defensive regimes put in place that protect the innocent director in the appropriate circumstances. Andrew, I thought it might be useful for you to comment on that.

Mr Guy—I should start by saying that I do not think I have ever been conscious of any experience—whether as a director or an adviser as a lawyer to directors over a long period—of a company trying to mislead the market and hide information from the market. If they were to do it, why would they do it? I suppose that leads you straight to insider trading laws, which are not the subject of today's discussion. But it is not the case in my experience that that is something which directors seek to do. Part of the problem in this area is just how one determines when there is something to disclose.

Perhaps I can give a small example which I have made up—it is not based on a particular experience; it is a combination of events over years. Think of a company leading up to the time when it is about to publish its results. When it gets it together and gets the different divisional results, some of which might be international subsidiaries contributing, they find a few weeks before they are due to announce their results that their profit expectations are above what the market—all the brokers out there—is estimating. The stock exchange says that if that margin is more than 10 per cent they should come out and make a statement to the market. Invariably there is a profit warning when there is a downgrade, but maybe it is a profit warning when it is an upgrade as well. If they are about to announce their full results within a couple of weeks, should they then come out and make that announcement or not?

There is another layer you can add to that. If they are announcing to the market they have to also look at the value of the assets in the company at the same time. They have to verify that the basic assets of the company are carrying values that are correctly stated. If they are reviewing their non-current assets at the time, it is entirely possible that there may be a write-down of one of those assets despite the fact that the profits are up. If you take literally the legislation that requires the disclosure of each and every circumstance which may lead someone to buy or sell

shares, are you going to suddenly come out and say, 'Our profits are expected to be up by more than 10 per cent. We'll make an announcement today and then in a week's time, when we suddenly realise we're going to write down an asset, we'll come and make another announcement in a week or two's time that that is coming out'? And all this is before you come out with the annual results anyway. What is the position of the person who buys shares on the basis of a bit of good news only to find out the bad news, which is around the corner and which hasn't been disclosed?

To give another common example, what if a company is about to make an acquisition? At what stage when a company is negotiating to buy or sell something should they make an announcement to the market? Should they announce it when they have entered into discussions with someone? Should they announce it only when it is finally determined and conditional contracts have been entered into or when the conditional contract becomes unconditional? If you announce it too early it has the effect of pushing the price up, and then if it becomes unconditional and the price goes down, what of those who have in the meantime bought shares on the basis of the first announcement, even thought it might have been announced as conditional? The problem that arises here is that it is very difficult in practical circumstances to come out and determine for a board when it is, and to prescribe in a few words when announcements should made is difficult.

To then turn around and say that, if you get it wrong—it is not just directors; it is anyone who is involved, so it would probably be a lot of officers as well—particularly given the fact that directors meet once a month or, in some companies, once every two months, you are exposing those directors in these difficult circumstances and they have to make a decision. They will be liable and there will be a civil offence. And, if you follow the legislation through, they have personal liability to anyone who may have bought or sold shares and, as a consequence, suffered a loss. That loss, that liability, could be many times the fees the director is getting or, indeed, their net worth. This is in circumstances where a director or an officer cannot get insurance, because the insurance probably would not be valid because an offence—albeit a civil defence—has been committed under the Corporations Law.

This is where we become concerned that the consequences of some of these changes have not been thought through. We are greatly concerned. We welcome a due diligence defence or a business judgment defence of that type but we have not seen what it might be. When you apply the words in the relevant parts of the Corporations Law or the listing rules, there are times when some very real judgments will be made by directors. In my experience, directors seek to judge those as well as they can. Sometimes their decision not to make an announcement is in the belief that to make an announcement would mislead the market because other things are about to happen. Again, as I said, there might be a directors' meeting every month or every two months. Obviously they can meet between times. These things are difficult. I have not seen a lot of instances, and I have not seen anyone come out and say that there have been many instances, of deliberate misleading the market. We have concerns as a result of those things.

Prof. Baxt—I could add something in relation to that particular issue and then perhaps move on to the issue of the non-binding vote. The question of insurance is a critical one that we hope is now able to be argued in the High Court of Australia as a result of the Silberman case in the New South Wales Court of Appeal. The issues here are what companies can legally do under the terms of the Corporations Act to indemnify and properly protect directors who are charged with a

breach of the act. These are situations where the directors are not acting wilfully and recklessly, situations where the law would not permit an insurance policy to apply, but situations where there is a genuine dispute. In that particular case, the company chose not to provide money to the directors, so they could not argue the case. When they say they could not argue the case, they did not have the resources to argue their case properly. That is going to the High Court to see whether, in fact, the ability on the part of the insurance company to limit the ability of the directors to argue that particular issue was properly excluded by the insurance company in the context of not only the Corporations Act but, more specifically, the Insurance Act.

What we are concerned about is that the more of these rules are introduced into this legislation the more difficult it is going to be for directors to obtain any kind of insurance, let alone nominal insurance, to deal with these issues. I think that is going to drive away people who are concerned about the risks that are going to occur in the context of being a director of a company. One of the great benefits of our limited liability system—one of the wonderful benefits that we have gained from it over the last couple of hundred years—is that the entrepreneur, the risk taker, is continually encouraged by many judgments that you can read about in the courts. Clearly there is a fine line. There are going to be cases where people are rogues, not entrepreneurs. We say that the courts and the regulators have the task of targeting those particular persons in appropriate circumstances.

We have seen that our courts are capable of dealing with these issues. We have seen Justice Santow, Justice Austin and a number of other judges recently deal with these matters quickly and effectively. It may well be that there are cases which have not been dealt with effectively, and people get upset and say, 'My heavens, the system doesn't work,' but that is part of our system. It is part of the richness and the beauty of our system that we are going to have situations where there are going to be opportunities for people to argue their case and argue it properly. If we switch to the notion that we are going to make everyone guilty and get them to prove themselves innocent—just to repeat perhaps ad nauseam the point I was making earlier—would be an absolutely disastrous development as far as our community is concerned.

By the way, we believe that a lot of the recommendations in this legislation—perhaps most of them relate to the issues of accounting and auditors, and Mr Johnson will talk more about those in a moment—add significant cost for many smaller companies. I do not know how many thousands of companies we have listed that are affected by this legislation, but there are many, many companies. I think you, Andrew Guy, were telling me that there are as many in Australia as there are on the London market. Many of them are very small and are therefore going to be ones hardest hit by this legislation.

We have argued in our submission, we hope persuasively, about the non-binding vote. We know the writing is on the wall in relation to this. We have seen where the political parties are at in relation to this. Can we put this to you, because we believe this is an issue that should not just be taken for granted. Our corporate law system has operated very effectively in dealing with these particular issues over many years. We do not condone attempts by companies to stifle the appropriate level of debate at annual general meetings and those sorts of things. We are concerned about rules that are introduced that make it costly and difficult for companies to properly govern themselves. Whilst the Treasurer has indicated that the non-binding vote will not create a legally binding scenario in the context of the ability of the shareholder to sue, in

effect, if the company board does not choose to pursue that particular resolution, we again see this as a precedent that is going to create problems for us.

Again—and I make no apology for the fact that I refer for recent decisions, because I think they show just how much the legislation is working and how much the common law works in this particular area—I would like to refer members of the committee to a decision of the New South Wales Court of Appeal recently in a case dealing with this very issue about the division of power between the board and the company in general meeting. I do not seem to have brought the papers with me, but I will certainly pass them on to the committee. I think it is very important we do not lose sight of the fact that those issues are sensible issues that the law has recognised over many years and we should not throw them out very quickly. We believe that this is a precedent that has not been thought through effectively.

We saw the ASX corporate governance guidelines put in place less than a year ago. They have not been given an opportunity to operate and to show how effective they are going to be. The market responds sensibly to the pressures that are being put to bear by various leaders in the community, whether they are from the government, the companies or wherever. We think that this initiative on the part of the legislation is not well thought through. We are worried about the precedent it creates. We are worried about the next step being a non-binding vote or perhaps a semi-binding vote in another area. Before you know it, the whole system of our corporate regulation, which has worked so effectively for 200 years, will be put at risk. Andrew, again I would ask you and perhaps Mark to comment on this issue.

Mr Guy—I would only suggest that any issue that can be raised in a debate on a non-binding vote on shareholder remuneration can be held at the moment. There is provision in the Corporations Law for these issues to be raised at the annual meeting. The corporate governance guidelines prescribe that a report will cover these matters. We have a new 60-page accounting standard to cover disclosure. These things can be properly raised at the moment without the need for this particular provision requiring a vote at all. Those two provisions—the corporate guidelines and the new accounting standard—have not had the opportunity to run past one series of annual reports yet, because they come into full operation later this year. Why bring in another layer of legislation before what is in existence at the moment has been tested?

Senator CONROY—Is it correct that you refused to have the AICD logo on the corporate governance guidelines prior to their promulgation? In other words, you did not actually support the ASX guidelines.

Mr Guy—There are parts of the guidelines which were supported by the institute and parts of the guidelines which we thought were unnecessary and went too far. Yes, that is correct.

Senator CONROY—But you specifically had your logo removed from the circulated document—is that right?

Mr Guy—I do not think it was removed, it was just—

Senator CONROY—Just not allowed to be put on.

Mr Evans—It was just not applied. It was not removed; we did not take it off. We just did not put it on.

Senator CONROY—But you ensured it was not put on.

Mr Evans—That is right.

Senator CONROY—So you did not even support the guidelines as they now stand, but you are now asking us give them time to work. Yet you do not support them either.

Mr Evans—Let us explain the problem with them. While the preamble to the guidelines makes a strong statement that they are designed to encourage companies to develop their own corporate governance structure that will suit their circumstances by the exercise of the 'if not, why not?' provision, any one of their recommendations you can differ from if you can explain why your different approach is better in the interests of your company in fulfilling the principle under which that particular recommendation is stated. That is a good principle and we support it. It is of some standing—it comes from the Cadbury report in the UK in 1992. But they follow 28 very detailed recommendations and a whole series of things which are called best practice guidelines. The burden of all that creates the impression, I think, among many companies that if you differ more than a very few times from what is deemed to be best practice there is something wrong and you are not doing the right thing. The weighting of that is wrong. The 'if not, why not?' provision was correct; it is really the way the thing was expressed as much as the content. It seems in a way to contradict itself.

Mr Guy—That is right. It was not regarded as best practice by the institute but we do recognise that it has now been introduced and is therefore something with which listed companies must comply.

Senator CONROY—I have always been amused by your strength of passion against them, when they are the only set of guidelines I know of which you can meet by not complying with any of them.

Mr Guy—I do not think you should say that there is complete passion against them all. Some of those guidelines I personally think are an excellent idea, but to put it as a complete package and say, 'This is best practice,' was not considered at all by the industry to be best practice in many instances; in some, it is terrific.

Senator CONROY—I jumped in ahead there—I apologise, Chair.

CHAIRMAN—Have you finished your opening statements?

Prof. Baxt—I wanted to add the reference to that case, which I have now found among my papers. It is Massey and another v. Wales and others and I will provide a reference to it. It is a very recent decision of the Court of Appeal which emphasises again the fact that the rules about the way in which companies are managed in the context of the board of directors as against the general meeting and the obvious role of both is both a sensible and a very efficient way for companies to operate.

Senator CONROY—So your contention is that the non-binding vote undermines the very principle of limited liability?

Prof. Baxt—No, I did not say that. What we are worried about is that the non-binding vote may well create a new approach to the way in which companies should be managed. If that is the way in which the law moves so that we do not have that efficient operation of these rules—these rules have been developed over the years and they do operate efficiently—we will, I think, destroy the limited liability company as we now know it because it will operate on different sets of principles. You need a board of directors, you need shareholders and the ability of shareholders to raise matters and shareholders have the right to remove directors at appropriate times.

Mr Johnson—I think it is fair to say that we accept that there is a need for increased transparency and we support totally the corporate governance guidelines with respect to remuneration disclosure. Andrew has already mentioned the new accounting standard et cetera. We believe there is lots of transparency and extra disclosure. Why is this decision with respect to remuneration any different from all the other decisions that directors make on behalf of shareholders? We think disclosure and transparency are what is required, not an adjustment or an amendment to corporate governance and the roles and responsibilities of directors acting on behalf of shareholders.

Senator CONROY—Do you accept the view that out in the broader community there is a loss in faith that is probably most graphically described—this is one of my favourite quotes which I like to use—in the New York Stock Exchange case when the chairman of CalPERS said, 'We've got the pigs out of the trough; now we want to know who filled the trough'? That is probably the most graphic way to illustrate that loss of faith, not just in the broader community but more importantly in the owners of your companies, because they are the biggest pension funds in the world and their views are reflected around the world among many other pension funds and what we call super funds. Do you accept that there has been a loss of faith?

Mr Evans—I do not think necessarily so, particularly with regard to the professional investors. May I restate that they in particular are people that spend their lives doing this full time and they do have the option through their shareholding and through their attendance at general meetings to question and to examine the remuneration policies of companies.

Senator CONROY—So would you then agree with Hugh Morgan, who recently said, 'If you don't like the way we manage your company, you should sell your shares and get out?'

Mr Evans—He is right, of course, but I think he was taking a fairly extreme point of view.

Senator CONROY—You say, 'He's right, of course.' I am not sure if I heard you right then. I do not want to verbal you here.

Mr Evans—Of course he is right, but it is an extreme point of view.

Senator CONROY—You do not think it is a little unusual in the year 2004 for the employee to be telling the owner to rack off?

Mr Evans—I beg your pardon; I do not quite follow that.

Senator CONROY—The employees—that would be the directors and the management—telling the owners—that would be the shareholders—to rack off.

Mr Evans—Oh, I see; yes.

Prof. Baxt—That is one of the options, if I may butt in.

Senator CONROY—I am simply asking what you thought—

Prof. Baxt—That is one of the options; he does not have to follow that. He can gather some proxies together and build up a team and get rid of those directors and put new directors in. I do not understand what it is that is so magical about this idea that you cannot have a decent proxy contest in the context of an Australian company.

Senator CONROY—I am on your side, Professor Baxt.

Prof. Baxt—The fact that we do not have it is simply because we have some lethargy, perhaps, on the part of certain groups in the community, but that does not mean to say we should change the whole law and start creating a new system which has not been thought through, with respect, and will not work.

Senator CONROY—I could not agree with you more. If you look at the US, which has had probably 10 or 20 years longer of shareholder activism than we have had here, you can buy a newspaper in the US and open it up and there will be a full-page ad soliciting proxies for a proxy ballot. It might shake the foundations in Australia if something like that was to happen.

Mr Guy—They do happen occasionally.

Senator CONROY—When was the last one? Genuinely, I am only a relatively young bloke—

Mr Guy—There are quite a few proxy battles on—

Senator CONROY—Coles Myer was the most—

Mr Guy—with a couple of the smaller companies that do not perhaps get the headlines. There have been quite a few proxy battles where it gets down to the line of 46 per cent vote one way and 45 per cent vote another, and that can be for control of the company—not usually on issues of remuneration for management, but those things do happen. I might make the point that you can go to a meeting and you will get a shareholder who will stand up and he will be appalled by any amount that an executive might be paid. Last year there was one. He said, 'My taxable income this year was $30,000. Why should you be paid any more?' Now, that is an extreme example.

Senator CONROY—I personally get it all the time. I do not think you should feel that that is an extreme example. It happens to politicians all the time.

Mr Guy—No, but it is perhaps unusual that that person has some investments in equities, I guess.

Senator CONROY—They feel they have an investment in us; they pay our salaries.

Mr Guy—The point I make is that you will always have people offended by that, but I should draw one distinction between the US and Australia, and it is commonly in the press; that is, people seem to think that all directors are executives. They are not. The US does have invariably executive chairmen and many executive directors and the UK has the same. For us to blindly follow some of their examples is not correct, because we do not have to. Invariably in Australian companies there are very few, particularly these days, executive chairmen and very few where there are a majority of executive directors. The non-executive directors are not paid the millions of dollars. They are paid certain amounts of money, the limits of which must be approved every time it is increased. That is a listing rule that is complied with. That goes to shareholders each year and it has to be a positive vote if they wish to increase it. A lot of people will think that the non-executive payments are too high. If you go to a lot of other people, they will think they are too low. So perhaps it gets right somewhere along the line. But do not confuse the pigs at the trough, because I do not believe it is the non-executive directors, who dominate the boards in Australia, who are the pigs at the trough. I do not think that expression necessarily transfers.

Senator CONROY—I think at the Stock Exchange they were not just hunting Grasso; I think they want to remove all the directors—NEDs as well as management directors.

Mr Guy—It is a specific example. I remember following it and, like a lot of people, I was very surprised at his retirement payment.

Senator CONROY—No, no—that was going to be his salary. That was the problem. It then transferred into a retirement benefit, and subsequently a fair bit of it was clawed back.

Mr Guy—He was an executive chairman, wasn't he?

Senator CONROY—Yes.

Mr Guy—That is one of the difficulties with the US system, which we, fortunately, do not suffer.

Senator CONROY—The point I was trying to get to was that there seems to have evolved a disconnect between shareholders' views and directors' views. As the representative of directors and so on, all of you are there with them on a regular daily basis. Do you feel there is a sense of disconnect or frustration that grows from that?

Mr Guy—With regard to what subject, Senator?

Senator CONROY—Executive remuneration is probably the easiest one to talk about. That is the one that seems to generate the most amount of shareholder angst on a consistent basis.

Mr Guy—I think that is right, but I cannot think of one board of directors that wants to pay more for its executives than it believes it has to. They do not go out of their way to pay a lot more money than they have to. They do not want to and they believe that is wrong.

Prof. Baxt—One of the consequences of this legislation may well be very contrary to what everyone wants. For a start, the proposition that most people seem to ignore is that the disclosure is costless. Disclosure is very costly. It has to be passed on. It is passed on eventually to the consumer. Companies do not absorb the cost of disclosure and disclosure applies across the board. I am not arguing against disclosure—I am in favour of more disclosure. I am in favour of the views of Justice Brandis—as opposed to the views of one of the members of this committee, Senator Brandis—about sunlight being the best disinfectant. I think it is a very important principle. But as more disclosure occurs, you are going to see salaries increase, you are going to see greater competition for the best directors and as a result you are probably going to find that the directors are going to get paid more—not less.

Senator MURRAY—And executives.

Senator CONROY—I am always fascinated by that argument. Senator Murray has heard me on this issue before. I always do enjoy it. I had a debate with a director this morning at a breakfast I was at, and he made the very point that the ratcheting up of salaries occurs. He explained that the first thing they do is go and get a look at their rivals in about the same size companies, and they say, 'Right—that's what I want.' I have been for a long time a fan of comparative wage justice. Norm Gallagher and I have advanced it on many occasions. I welcome company directors taking that view, and business counsel, and people who want to argue comparative wage justice. Personally, I had moved on to enterprise bargaining as the framework that I was engaged in. It is novel to see that enterprise bargaining has not reached the boardroom yet.

Mr Evans—One thing it might be worth reminding people of is the number of people involved. The number of Australian companies valued at more than $1 billion is about 100. I think it is in that class where the very high salaries for chief executives have applied in recent years. So, given that there are two or three in a company like BHP Billiton, we may be talking about 200 or 300 people in Australia, in total. There are 1,600 listed companies on the ASX, but a good many of them are actually very small. For the great majority of them, these astronomic salaries that are causing community reaction and concern are not a part of their life at all. They do not even think about it. It is only at the top end, and quite a small number of people.

Senator CONROY—So the problem is a limited supply; is that what you are suggesting?

Mr Evans—The phenomenon is that the companies do comparisons each year, using remuneration consultants, of the range that they would expect to be paid for a particular job. They will generally want to say—because they have to do a lot of disclosure and explain themselves to the general meetings—'We, of course, are above average. Our CEO here is better than average.' So they pay him better than the median. Lo and behold, next year when the same survey is done, the median has gone up. I think that is the mechanism by which the escalation has occurred.

Senator CONROY—They do have an incentive to pitch a higher salary each time, though. They get a percentage, don't they? We have an inbuilt market mechanism that drives price upwards.

Mr Evans—Who is getting a percentage?

Senator CONROY—The remuneration consultant, if they successfully help place someone in a job. You go to a search firm—

Mr Guy—On a placement as opposed to the adviser.

Mr Evans—It is a different person.

Mr Guy—We are talking about the consultants who come and advise an existing company, not on placing someone new. They might come in and give advice to a committee on relative packages.

Mr Evans—And they will be paid on time.

Senator CONROY—On the argument about performance pay, which is what I would have thought most directors would certainly be interested in, are you familiar at all with recent academic surveys showing that there is no link—I repeat: no link—between performance of a company and size of salary? Are you familiar with those studies?

Prof. Baxt—I have seen some of the American studies that have been done.

Senator CONROY—There were a couple of recent Australian ones as well.

Prof. Baxt—Yes.

Senator CONROY—Do you think that helps fuel what I would describe as the disconnect between shareholders and boards?

Mr Guy—I have seen studies that say something contrary to that. For example, a proportion of executive remuneration is often performance based, and there are US studies which actually say the opposite, which is that companies generally perform better over a longer period where an incentive scheme is uncapped as opposed to one where the system is capped. So that is saying the contrary.

Senator CONROY—The last international study I saw in this area—it is a couple of years old now and I am sure there has been an updated one since then—had Australian CEOs ranked at third. It went: US, UK, Australia, then those minnows like France and Germany and on downwards. Isn't it remarkable that Australian CEOs are so much better comparatively than those German and French CEOs who run much bigger companies?

Mr Evans—I do not actually follow the point of the argument, Senator, and its relevance to our non-binding—

Senator CONROY—It is a comparative one, so it is based on the size of the company, the performance of the company and the salaries, and we seem to pay more than German companies.

Mr Evans—I do not know whether that is the case or not, but I am not sure that the proposal before us for a non-binding vote on the remuneration of the top 10 people in public companies will actually—if that is a problem—remedy it.

Senator CONROY—I am not advancing it as a reason. My argument in these areas is that often shareholders, the owners of the company, are being asked to approve equity packages, whether they be shares or options, and unless they have the ability to look at the total package of the individual, then those shareholders, the owners whose money it ultimately is, are unable to make an informed decision about the equity component. How are you able to make a proper informed vote if you have not got both parts of the package? It could be 80 per cent cash salary and 20 per cent remuneration. It could be a Gerry Harvey—the other way around: almost 100 per cent in equity. How can a shareholder make a genuinely informed vote if they do not have all the information?

Mr Guy—I agree with that; that has always been an issue. The only reason that the equity part has been referred to shareholders, of course, is because it has been a listing rule requirement—nothing to do with the Corporations Law. They were asked to approve that part of it because it has been part of the law that has been reserved for that particular reason. My view is that you should leave the whole package to the board, not to shareholders.

Senator CONROY—That is a fair and consistent position. I do not agree with it, obviously. On equity distributions, I think it is only fair that if you are going to dilute the wealth of the owners they are entitled to know by how much they are going to be diluting their own wealth.

Mr Guy—And that is the reason that the listing rule was introduced, I am sure, and that is why it has got to that particular stage.

Senator CONROY—Sure. But again what it comes back to, if you accept that that is the reason and that that is necessary so that shareholders who are diluting their own wealth in these distributions know how much they are doing it by, is that they need to make a judgment against the whole package.

Mr Guy—But it is only those allotments to directors not to executives—someone who is an executive but not a director does not form part of those rules.

Senator CONROY—To some degree what I am trying to have a discussion with you about is this disconnect with boards. Importantly, it is the shareholders who have come to the parliament and it is the shareholders who have championed this. IFSA, in particular, in 1998 were the driving force behind the individual disclosure. Senator Murray and I were on the floor of parliament; I moved and Senator Murray supported them—was that on 24 or 28 June 1998?

Senator MURRAY—And we warned them in March.

Senator CONROY—We told them beforehand.

Senator MURRAY—In June 1998, they came out and said, 'It is five minutes to midnight.' We reminded them in March to watch the minorities.

Senator CONROY—So you could say we were very passionate on it but the shareholders—the owners—were the drivers of this. Senator Murray and I did not go off on our own frolic; we were motivated because the owners of companies came to us and said, 'It is absurd that we do not have the information we need to make an informed decision.'

Mr Guy—The logic is simply that the board sets the remuneration of management and the board is limited in what it can do in setting its own remuneration. That is the reason why boards cannot increase directors' fees, and I am talking about non-executives at the moment—they are the ones paid directors' fees; executives are not paid them—without referral to the owners. Similarly, for the same reason, you cannot issue equity to directors without going to shareholders. Otherwise, they are sitting over it. We believe that running the company and setting the executive packages is what directors are for. It is the non-executives that are making that decision. Otherwise, the whole system would break down if the executive directors could do it on their own.

Senator CONROY—In my view, the thing that drives the system closer to the brink than most is the termination payment issue, so I want to briefly talk to you about that. We talk about pay for performance and whether there is a link, and studies show there is not, but the thing that seems to drive the owners wild is the termination payment issue. In relation to shareholder approval of termination payments, you say in your submission:

> Directors are already required to act in the best interests of the company and in accordance with the law in relation to such payments. It would be difficult in practice to obtain shareholder approval for these payments, failing which a potentially costly law suit which may not be in the best interests of the company would be inevitable.

How difficult is it currently for companies to obtain shareholder approval for termination payments?

Mr Evans—I think it is a question of practicality. When an occasion arises where the board considers that the chief executive must go, that is a moment of very considerable tension in any company. They are not necessarily in a position to go to shareholders to get approval, which would have to take place at a general meeting. So it is a question of practicality. Boards of directors were invented 400 years ago, because it was not possible to have all shareholders present at all times to make decisions, so they appointed these people as their delegates. That is the situation. What can be approved, though, is the structure of remuneration ahead of time on which those termination payments might be based.

Senator CONROY—Also going back a few hundred years there was a bloke called Adam Smith. I am a fan of his occasionally. Adam Smith wrote, 300-odd years ago, that wherever you are going to put an agent, a manager, in between you and your money it is always a good idea to keep a bit of an eye on them. Is that sage advice?

Prof. Baxt—I would say the Corporations Act does that.

Senator CONROY—I guess shareholders do not feel that at the moment—that is the problem.

Prof. Baxt—With due respect to the shareholders, that is because they have not studied the act and the law that it applies. If they studied it and applied it they would find there is plenty in it there that gives them the opportunity. In my view, they are not being well advised. The law provides you with adequate remedies and the ability to fight these matters, and cases recently have proved that—time and again. There will be disappointments for people looking at it from the shareholders' point of view, but there are many successes. What continues to surprise me is the lack of initiative on the part of regulators in this country. They are just not brave enough to run these cases. They seem to be like most of my clients: they only want to run cases that they are going to win. It seems to me that a regulator has a duty at times to run test cases.

Senator CONROY—Allan Fels has been criticised extensively for being able to win cases that he could not possibly win. I remember a crescendo about Allan in the last couple of years.

Prof. Baxt—We are talking about the Corporations Act. We are talking about a different area where there has been plenty of opportunity for ASIC to show that they have the ability to win cases, and they are now trying to do it.

Senator CONROY—So you think ASIC has been too timid?

Prof. Baxt—I believe it has been.

Senator CONROY—Could you advise the committee of approximately what percentage of determination payments made by companies are actually approved under the existing provisions?

Mr Evans—I do not know the answer to that.

Senator CONROY—Section 200G of the current Corporations Act has a formula—

Mr Guy—Yes, roughly seven times the final average salary—

Senator CONROY—In your experience, what percentage of termination payments have gone through and been approved by shareholders? It would be a one-digit round number, wouldn't it?

Mr Guy—I would have thought that many of them would be within that. There are two parts to it. One is the exceptions from that particular section, such as contracts entered into before the person took up the position and things of that nature, and the second thing is that most payments fall within it. I would suggest that by far the highest percentage of payments would fall within the limitations of that section.

Senator CONROY—I guess the notable ones recently are the ones that have drawn people's ire.

Mr Guy—There have been notable ones. Again, without going to specific exceptions, I think sometimes those notable ones have been mistranslated and have been tied to formulae for success in earlier days.

Senator CONROY—I guess it is always frustrating for a shareholder to see a formula for success used as the basis to terminate somebody.

Mr Guy—I agree with that.

Senator CONROY—I just want to discuss the proposal in the CLERP 9 bill for the CEO and CFO to sign off on the financial accounts. The ASX Corporate Governance Council guidelines require that the sign-off by the CEO and CFO should say that the statement 'is founded on a sound system of risk management and internal compliance and control which implements the policies adopted by the board' whereas CLERP 9 just requires a sign-off of the accounts. In your view, should the CEO and CFO sign-off under CLERP 9 be the same as the sign-off under the ASX Corporate Governance Council guidelines to ensure consistency, or is this one of the areas where you feel moderately passionately about the ASX guidelines? I understand that you have done some survey work and someone in an accounting firm has come back and said this has proven to be one of the more problematic areas of the guidelines.

Mr Evans—I suppose it would be our view that a sign-off of the financial accounts will require a level of comfort with respect to the internal controls that affect the financial statements. We believe it is appropriate that the legislation is narrow in that context and we would like to see how the operation of the ASX Corporate Governance Council guidelines unfolds. As you probably know, this is an area of developing practice around the world.

Senator CONROY—Sure, but what are companies going to comply with, in your view? Are they going to comply with the black-letter law in the Corporations Law or are they going to comply with the ASX guidelines, given that there is now an inconsistency that looks like it might develop?

Mr Guy—They will always comply with the Corporations Law.

Senator CONROY—I was afraid you were going to say that.

Mr Guy—I believe they will go beyond the Corporations Law.

Senator CONROY—That is what I wanted to hear.

Mr Guy—What I would say to you is that once again we have a set of practices, the first real test of which will be the annual reports that come out in September, October or November of this year, as the current reporting session comes through. What we do not need is new laws to come in—

Senator CONROY—Hopefully that will be accompanied by a non-binding vote on the remuneration report too.

Mr Guy—Let us wait and see what happens before we bring in new laws.

Prof. Baxt—Journalists are going to write about the companies that do go that step further and they are going to write about the companies that do not. There is going to be some interesting competition out there.

Senator CONROY—I live in hope that the meagre efforts that Andrew Murray and I are able to put into this are helping to drive a change in culture.

Mr Guy—I might just say there has been a huge change in culture from the corporate debate over the last two years.

Prof. Baxt—The thing that worries me is what will happen if it does not occur—

Senator CONROY—And you are stuck with Andrew Murray and me!

Prof. Baxt—Yes, and then you are stuck with further legislation, because you will think you need more legislation to do it. If we get on to that merry-go-round, we cannot get off.

Senator CONROY—Maybe you need to get in behind those ASX guidelines a bit harder than—

Prof. Baxt—You have a real problem here. I come back to my comment about ASIC. ASIC has certain powers. If it enforced those powers regularly and consistently and showed some leadership in this context, maybe we would not have needed the ASX guidelines.

Senator CONROY—I appreciate that you have made that point. Could you point us to a few of the areas, and give us some mock examples of where you think they are falling down, because I would like to put them to ASIC. We will be having ASIC before us.

Prof. Baxt—I think it is best for you to ask the ASX.

Senator CONROY—I am happy for you to take it on notice.

Prof. Baxt—I am happy to take it on notice, but I think you should ask that question of the ASX, because the ASX privately have said to me that they are very unhappy with the infringement notice regime. They believe it is a sop to ASIC. What ASIC has said consistently—I come back to this because this is part of the theme—is, 'It is too hard for us to run these cases. These cases are too difficult. These cases take too long.' The evidence, when it is there, is to the contrary. Southcorp—

Senator CONROY—What was the completion time—

Prof. Baxt—Very quick, for Southcorp. For AMP, within 12 months. The point is that ASIC could have put more pressure on these situations. If there is non-disclosure, what ASIC has to do is go to the court and say, 'This is a critical area, your Honour, and we have to get some movement here.' If the judge is persuaded, the judge will do something about it. If ASIC hasn't got a case, why would you shift the onus of responsibility back to the company? The infringement notice regime is going to take its time to work through the system as well, so you are not going to achieve the result. All you are doing is creating a bad precedent.

Senator CONROY—So in the case of the AMP charity donation of $100,000, you think ASIC did have the power?

Prof. Baxt—It obviously felt that it had the power, and AMP felt that it had the power, because they would not have given it unless they felt it.

Senator CONROY—I will rest there for the moment.

Mr Guy—I make one other point in relation to that. The mere fact that the continuous disclosure regime has now been extended into personal liability for those who have breached it will militate against the operation of that continuous disclosure and ASIC rules. You have to ask yourself, 'Will people agree to comply with that notification regime at a time when they might be putting their head in a noose?' I would say to you that the mere fact that you extend it to the personal liability of officers and directors who may be in breach will lead to an undermining of the regime that has been brought in.

Prof. Baxt—If I could just come back on the issue of the CLERP 9 notices, it would do well for everyone to study the ALRC report. There is some real wisdom in that in terms of the way the system operates, and the way the system should operate. If our courts are not equipped to deal with these matters—if that is the issue—then let us fix up the courts. Let us not start imposing additional burdens on companies, and eventually on consumers. There are different ways of achieving these issues. Unfortunately, what we see in this country from time to time is, 'Let's get a quick solution here because it is going to be the best way of getting some votes.'

Senator MURRAY—We have had another response and I appreciate we need to debate these issues more, but we are short of time, as you know. Mr Evans, starting with you on remuneration, first I would make a serious point to you, and I formally welcome you in your new role. The media—God bless them—and other organisations often do not read minority reports or pay attention to them. In March 1998 a minority report was written by me and another, I think, was written by Senator Conroy, which said we would do what we would do in June. In June your organisation screamed blue murder that at five minutes to midnight they were suddenly presented with a fait accompli on remuneration disclosure. There was a three-month warning, at least—never mind all the rhetoric that had gone before. So I would suggest to you that, when this report comes out, if there is a minority report, look at it.

Moving on from there, any threshold—apart from the Plimsoll line, I suppose—is arbitrary. The five-officer cut-off is arbitrary; so is the 10-officer cut-off. There have been criticisms of expanding it from five to 10. Given the certainty I have the government will not go back to nought, the question is whether the parliament should agree with the increase from five to 10 or whether it should suggest a further mechanism. This morning—you were not here—I said to a witness that the drive from the shareholder community and the community at large is the sense that, where there is an excess and where there is no obvious link between the remuneration package and the performance of the company or its size or value, there should be some mechanism for disclosure and perhaps restraint. It may be that a monetary threshold would be better. You must do your five, but unless, for instance, the remuneration—and I am talking about the total package, options and share and everything else—was in excess of $1 million—and I just offer that as a figure—you would not need to disclose it to anybody. I offer that as an alternative. I am well aware of small listed companies for which a 10-officer disclosure would be

ridiculous. But in a place like AMP it might pick up 14 or 15 officers, as opposed to just 10. You do not need to respond at once if you want to think about it, but it is an alternative route.

Mr Evans—I am glad you raised the question of five or 10. As far as we can understand, this idea came from Higgs in the UK. They introduced a nonbinding vote for the top five. But British practice, as Andrew Guy said earlier, is different from Australian practice. There, it is most common for several senior executives in a major company to be directors and on the board. As with many things in Britain, there is an element of rank in society. The five people they are looking at there are directors, who, being on the board, are potentially in the position of being empowered to reward themselves. That particular situation does not really apply here, because the most common thing here is to have a chief executive on the board and nobody else—sometimes a second one but generally not a large number of the executives. Mostly they are non-executives. So the 10 senior officers of the company will be executives, not directors. The logic of the thing which was invented in the UK—the purpose of it as it was invented there—does not seem to apply here at all. So there it is. It has been invented. I think that it potentially compromises the purposes of having directors appointed by the shareholders to run the company on their behalf and subject to them and accountable to them. It also potentially may lead, through the comparisons that are done daily by everybody in each different category—chief of marketing or something—to escalation, to the opposite of the restraint that you referred to. We might have escalation.

Senator MURRAY—If you want to come back to us, do; it is up to you. But the committee will be faced with a clear choice: to support the government's proposition, to reject the government's proposition or to put an alternative. To me, one of the alternatives is to address the fundamental issue. People are concerned with quantum, with excess, not with the normal remuneration of directors and executives in the sense that we understand it. I do not need much more of the discourse; I understand the AICD's position. But if you want to come back to us with some further thoughts on that, please do.

CHAIRMAN—Do you have more?

Senator MURRAY—Yes, I have—just briefly. The earlier interchange was quite lengthy. The second thing I would like you to think about—again, you do not have to come back to it but I would appreciate it if you would, if you thought it was worth it—is the issue of corporate political donations. You will recall that the HIH royal commission made some remarks with respect to philanthropic donations—namely, that they are the chairman and chief executive officer's largesse, at his discretion. This issue of corporate political donations is attracting notoriety worldwide: there is great concern in Great Britain, and legislation attached to it, and in America, Canada and other countries with which we have an attachment.

My own view is that shareholders should either approve political donations or approve the directors' policy that attaches to them. I have no objection to their delegating, but it is a situation of considerable sensitivity. I am contemplating—and I stress to you that I am contemplating the same thing with respect to union members—moving an amendment which would effectively require shareholders to approve a director policy with respect to donations to political parties. Again, as you have not had the opportunity to think about it, you might want to. If you decide you do not want to think about it and you do not want to tell us anything that is fine, but I am

giving you the opportunity to take a view on that. I would refer you to a recent report in this area by Graham Orr—you would know him, Professor Baxt—with the Gilbert and Tobin Centre.

The third area I want to address—and it is the last area, Mr Chairman—

CHAIRMAN—We are well over time, Senator Murray, so I ask you to be very succinct.

Senator MURRAY—You gave great leeway both to the witnesses and to Senator Conroy—

CHAIRMAN—Too much to Senator Conroy!

Senator MURRAY—so I will just test your patience one last time. It is really a philosophical question to you, Professor Baxt, in view of your long experience and expertise in the area. Politicians are sometimes, in my view, far too close to the real world—we are a bit like policemen: we see and hear many things we would rather not. One of the things we pick up is great community disquiet in the area of corporate behaviour. As you know, laws are designed for a minority but always affect the majority. But there is a sense that corporate crooks have been getting away with theft on a grand scale. That is a sort of barbecue, bar and kitchen view that comes back to many politicians. I would put it to you this way. Take a hypothetical case of a person who begins his corporate career as someone in a juvenile corrections centre for fraud, later gets involved with property, becomes an entrepreneur of great note, is lauded as a great Australian for his sporting contributions and all sorts of other achievements, builds mansions, makes a mockery of our corporate criminal and insolvency laws, has a brief spell in jail perhaps—

CHAIRMAN—Not naming any names, Senator Murray?

Senator MURRAY—and then wanders around the world, cooking up schemes which confirm to the world that Australia is the haven of awfully nice crooks, and just lives the life of Larry. The ordinary person sees that and says, 'The legal system does not work, the insolvency system does not work, we have got to get behind the corporate veil and we have got to erode the standard liberties which are provided by the common law because this is what happens.' That is the community view, generally expressed. You run counter to that by saying, 'The changes that are coming through go too far; the law works effectively,' and so on. You can see the tensions that we are faced with. The serious question to you is: do you honestly believe that the law needs no attention at all, given a history of quite a number of corporate crooks? And I am not suggesting, as you know, that that is at all the flavour that attaches to corporations in general, but quite a number of corporate crooks simply have got away with it, to put it in common parlance.

Prof. Baxt—I would certainly be happy to respond, giving the matter some further thought, but my general comment is one that I made before. I believe that our system is basically effective. I think there are some areas where it can be improved upon, and that is not changing the law but changing the way the law is enforced, the way the law is administered et cetera. I think we have paid scant attention to that area and far too much attention to changing the legislation. That simply creates a further burden on everyone, including the regulator, to deal with these new laws, trying to work out what they mean and trying to apply them. That is no benefit to anyone. I will take that question on board and I will have to provide you with a more thoughtful and perhaps a fuller answer.

Senator MURRAY—You can see that it drives the intent. I am not talking here in a partisan sense; I am talking about the whole of parliament having been affected by these community feelings.

Prof. Baxt—I understand that and, as I said, I will take it on board. I do believe that we have seen a change in the way in which the courts are starting to deal with some of these issues and we are seeing a more effective mechanism in place to deal with these situations. I would be very saddened by the fact that we would shift our whole legal system every time we have a breakdown in some area and change the burden.

Senator MURRAY—If you are saying that you think the regulator should do more, tell us how we can make the regulator do more. That is what we need to know.

Prof. Baxt—I will be happy to do that.

Senator MURRAY—Thank you.

Senator WONG—So do I understand that it is the position of the institute that you would support an increase in resources to ASIC to ensure that it could actually pursue enforcement actions under the current legislation?

Prof. Baxt—A sensible increase and appropriate accounting by ASIC of that increase regularly to parliament, yes.

Senator WONG—That is the position of the institute: more resources for ASIC for enforcement purposes?

Mr Guy—Under those conditions.

Senator WONG—On the civil liability issue, the extension of civil liability for continuous disclosure breaches, is there blanket opposition from the institute to this or would you agree with that extension in certain circumstances provided there is appropriate defence? What is your view on that?

Prof. Baxt—Our primary view is that we think it is inappropriate for liability to be imposed in this area.

Senator WONG—If you lose that argument, I presume you have an alternative view.

Prof. Baxt—If that is not going to be the position then the promise of a defence, as long as we get a chance to have a look at it and obviously make sensible comments on how it can be improved. We have talked to the government on this and we have made recommendations for changes to make the law stronger in certain areas—the whistleblowing area and certain other areas—to make them work more effectively. The institute has a very proactive, positive response to the way in which this legislation has been drafted.

Mr Guy—I also think debate goes on about how much a company can be fined and what is an appropriate fine for company for breaching it. But it does not really touch on the civil liability of

a particular person, and a director who is held responsible for that breach at the moment with very little defence could lose everything they own. That might say that is a fair compensation for breaching the law and someone else has lost, but in this instance the director does not gain anything from the breach. There is no personal gain to be made out of breaching that particular law.

Senator WONG—There might be.

Mr Guy—If there were, the insider trading provisions would deal with it, not out of this. This is simply nondisclosure; someone got something wrong. Yet their whole personal estate net worth is on the line because it might be a large company and someone might buy a large amount of shares and finally allege that they lost—

Senator WONG—So succinctly your position would be that you want some sort of defence and discussion about what penalties could apply, or a limit on the damages.

Mr Guy—They are the second and third levels. The first is to remove them.

Senator WONG—I appreciate that, but—

Mr Evans—Another argument about the principle is that it is a pretty hard and complicated job to be a director of a complex company and you want them to do their job on behalf of the shareholders and not to be managing their own risk all the time. If you expose them increasingly to personal risk, because the risk would be almost mortal they would have to pay a great deal of attention to that, to the potential detriment of the interests of the shareholders.

Senator WONG—The other argument is that you are actually requiring them to do something in accordance with the law—that it is not about management of risk.

Mr Guy—I think they do that anyway, because no director wants to be found in breach of the Corporations Law in this particular area. It is just the case. There are some very real, difficult judgmental areas on when one must disclose. I gave a few examples. That is the difficulty in this area. The risk-reward concept is right out of kilter.

Senator WONG—We are running out of time so I do not want to go down this track too far, but I suppose my response to that would be that it is an issue about the appropriate definition of continuous disclosure and the appropriate standards that should apply there, not whether or not that should be regulated per se.

Mr Guy—And they are determined—

Senator WONG—I am a little tired of arguments in this area to the effect that it is difficult to regulate and therefore we should not.

Mr Guy—But the breach is determined after the event.

Senator WONG—Correct.

Mr Guy—When someone has looked back and said, 'Well, that was obvious because that is what happened.'

Senator WONG—Yes. The last thing relates to the changes to section 311 regarding the requirement of auditors to report. I am a little surprised by your suggestion in your written submission that this would lead to an unnecessarily adversarial relationship. What is being proposed is report of suspected breaches of the law. I do not quite understand the gravamen of your submission there.

Mr Johnson—I think the submission was actually made in respect of the initial proposals and that the updated bill released in December dealt with our concerns.

Senator WONG—So that no longer is an issue?

Mr Johnson—Correct.

CHAIRMAN—There being no further questions, I thank each of your for your appearance before the committee and your contribution to our deliberations.

[4.12 p.m.]

HARRIS, Mr Geoff, National Executive Coordinator, Group of 100

STANHOPE, Mr John Victor , National President, Group of 100

CHAIRMAN—The committee prefers that all evidence be given in public, but if at any stage of your evidence or responses to questions you wish to respond in private you may request that of the committee and we will consider such a request to move into camera. We have before us your written submission, which we have numbered 46. Are there any alterations or additions you wish to make to the written submission at this stage?

Mr Stanhope—No.

CHAIRMAN—I invite you to make an opening statement, after which we will move to questions.

Mr Stanhope—Only to make it clear to senators that the Group of 100 represents almost 100 companies—

Senator CONROY—It is the group of 98 now, is it?

Mr Stanhope—It fluctuates. It is very close to a group of 100. We focus on the financial aspects of corporations. We have relationships with the BCA, but we are not part of the BCA. We have relationships with the Institute of Company Directors, but we focus on representing the CFO functions, if you like, of corporations. That is the essence of our submission—from the input from our corporate membership, heavily biased towards the financial aspects of the company.

Senator CONROY—I do not know if you were in the room when I asked the previous witnesses about the CEO-CFO sign off. Earlier in the week, we were given evidence that the ASX corporate governance guidelines, which are broader, as I think you heard in the discussion, than the legislation—that this was a problematical area of compliance with the corporate governance ASX guidelines. Are you aware of that? Could you give us any further information on that?

Mr Stanhope—Yes. I will let Geoff comment if I leave anything out. The Group of 100 saw in the ASX guidelines that it was unclear as to what was meant by efficient controls and what the controls covered. We wrote a guideline. In fact, I have it with me today.

Senator CONROY—So the problem is your guideline?

Mr Stanhope—No, not at all. It aims to clarify the situation. Our advice to our membership—as I said, primarily CFOs but it obviously will relate to CEOs under that requirement—is that they should be signing off on the financial controls and/or if the board of the company expands that risk then they should take all necessary steps to ensure that the control processes are in place

for risks beyond the set of financial statements. That is our advice, and we do have a guideline. I am happy to leave it with the committee.

Senator CONROY—So you can confirm that that is an area that is problematic for compliance with the ASX guidelines at the moment?

Mr Stanhope—It is problematic because the guideline itself is not expansive enough.

Senator CONROY—Your submission says that, given the expanded role the FRC will undertake in light of the bill, certain changes need to be made to the FRC. What changes need to be made to ensure that the FRC is acting in a transparent and accountable manner?

Mr Stanhope—We believe that the FRC should have an independent secretariat. It is the case today that the secretariat is in the Treasury, and we certainly believe that level of independence should be there. We also believe that the FRC should comprise experts and that they should not necessarily come from constituent groups. It should have the expertise on it that includes a good cross-section of preparers—people who understand the technicalities of standards. It should have a good mix of expertise rather than a selection from the Group of 100 or the CPA.

Senator CONROY—Any receivers?

Mr Stanhope—They may well add a level of expertise that should be there. That is another argument. Of course, we also argue that it is very important that the FRC be properly funded. We as a group have a concern that, as we move to adopt international accounting standards, Australia is still able to influence international accounting standards. One way of doing that is to make sure that, as we have been doing at this point in time on the intangibles standard, there is allocated research to be done. If that is not properly funded through funds into the Financial Reporting Council, then our ability to influence international accounting standards, and therefore its impact on Australian companies, would be limited.

Senator CONROY—As a matter of accountability and transparency, should the FRC hold its meetings in public, except on those occasions where they were selecting somebody and there might be a couple of critical areas of privacy? Should they meet in public, given the important role they are now being given?

Mr Stanhope—We see no reason why they should not meet in public. There will be the in camera situations that are required, as you suggest, but we do not see any reason why they should not meet.

Senator CONROY—You mentioned funding—and that has been a bit of a hot potato for the FRC. I know Mr Jeff Lucy has been knocking on the doors of a lot of your members and appears to have been unfortunately unsuccessful at soliciting large amounts of money towards the program.

Mr Stanhope—Or he has been selectively successful.

Senator CONROY—But not in a sustainable ongoing manner, I think it is fair to say. What would your preferred model be?

Mr Stanhope—We have put forward a preferred model. We prefer that it be funded through a collection of fees through ASIC—a company return type situation of annual fees. There have been other suggestions made—for example, through those sorts of fee collections and perhaps some listing charges—but it starts to get complex when you are asking two different bodies to collect the fees. A simpler model would be fee collection through ASIC. We have canvassed our membership about that and they feel comfortable with it.

Senator CONROY—The CLERP 9 bill requires the preparation of an operating and financial review. The explanatory memorandum says that the G100 guidelines may be used for the purpose of satisfying the legislative requirements. The ASX submission states that the provision should be more specific and should require a list of topics to be discussed. Does the ASX have a point?

Mr Stanhope—I will let Geoff elaborate, but our fundamental point of view is that our guidelines are meant to apply to all companies, not just listed companies, and to be very precise and specific you might be asking small companies for too onerous a reporting task. So our guidelines are really designed to be applicable across the board. To be too specific I think can place too much of a burden.

Mr Harris—The ASX Corporate Governance Council may not—even though it has endorsed the guide—have examined it in sufficient detail. I will indicate to you the types of heads that are identified in the guide for comment or explanation by the company: company overview and strategy, its objectives, performance indicators, dynamics of the business, review of operations, operating results for the period, shareholder returns, investments for future performance—so that is not just capital expenditure but promotional expenditure—review of financial condition, capital structure and treasury policy, cash from operations and other sources of cash, liquidity and funding, resources of the company, impact of legislation and other external requirements, and risk management.

Given that this was an update of a previous guide, we had some reference in there to corporate governance, but the reference in here to risk management and corporate governance refers to other requirements in respect of risk management and corporate governance rather than being incorporated within the review to operations and financial condition. So I think the guide is pretty extensive in terms of coverage of the area. Sure, it is not prescriptive, it was not intended to be prescriptive, but it does provide guidance, and it has been based on, originally, the Operating and Financial Review that was issued in the United Kingdom by the Accounting Standards Board.

Mr Stanhope—We are happy to give you a copy of that.

CHAIRMAN—You also believe that that should be included in the concise financial reports as well as the full report.

Mr Stanhope—Yes.

Mr Harris—A problem that companies have commented on in respect of the existing accounting standard on concise financial reports is that the accounting standard requires discussion and analysis. A director is to provide some discussion and analysis in the financial

report. Given that it is an accounting standard, that discussion and analysis is then subject to audit. The view has been put that the fact that it is subject to audit limits the extent to which management and directors might be expansive in their discussion and analysis of what is represented in the financial statements. What we suggested originally in the corporate law simplification days was that the concise financial report should comprise an MD&A type document plus concise financials. Basically that is the view that we are still putting, but if the requirements in the legislation in respect of concise reports required an operating and financial review, that would take that out of the potential audit regime and probably lead to the finance review/MD&A hopefully being a better and more informative document for the shareholders of those companies that issue concise reports.

Senator CONROY—Some commentators have said that the proposed section 299A can only be interpreted as including an obligation on public companies to report on significant environmental and social matters that could impact a company's future financial prospects—for example, climate change and greenhouse emissions issues. In your view, does section 299A require disclosure of environmental and social matters?

Mr Harris—I am not directly aware of the text of section 299A.

Mr Stanhope—Our position is that we encourage what is known as triple bottom line reporting. We encourage all our membership to report in a very robust, transparent way on their social activity, their environmental activity and their financials. We, again, have a guideline out on this topic. But we certainly encourage extensive reporting on environmental issues and how the company is addressing their impacts.

Senator CONROY—I am reading from the explanatory memorandum that accompanies the bill. On page 144 it says:

Operating and financial review

5.303 Proposed section 299A, which is included in the Corporations Act by item 6, sets out the requirements for the operating and financial review.

I am not sure that that provides a lot of extra information. We might need the actual bill. I am happy for you to take that on notice after you have had a chance to review it. That would be good.

Mr Stanhope—We will respond to that.

Senator CONROY—The scope of the reporting requirement in section 299A is extensive, as many different environmental and social issues have the potential to significantly impact a company's financial position. Have you considered what type of social issues may require disclosure under this provision? I am happy for you to take that on notice as well.

Mr Stanhope—We will take it on notice. We will let you know what we encourage our membership to do.

Senator CONROY—Thank you very much.

Senator MURRAY—I probably should have asked this question many years ago. Who does G100 actually represent? Is it the chairs of the boards or is it the boards?

Mr Stanhope—It is the CFOs and senior finance executives in companies. Our actual membership is the company, so—

Senator MURRAY—But the physical person is the CFO?

Mr Stanhope—Yes, it is—or the CFO's representative.

Senator MURRAY—The BCA, as you know, represents the chief executives. Is there a Chinese wall between these two bodies? Are we likely to get a different view from you, with finance officers having an independent viewpoint from their chief executives? In the case of a former Coles Myer financial officer that might be true, I guess.

Mr Stanhope—There is very close alignment between the BCA's position and Group of 100's position. Do we always agree on issues? No, not always, because an organisation representing the CEOs may have a different view on certain issues than a CFO might—on a financial topic perhaps.

Senator MURRAY—So it is just a question of focus.

Mr Stanhope—Exactly. So the alignment is usually 99 per cent.

Senator MURRAY—And the consultation? Is it on a committee nominee basis?

Mr Stanhope—Do you mean between us and the BCA?

Senator MURRAY—Yes. How do you reach the 100 CFOs?

Mr Stanhope—We have a state based organisation, so there are state councils of members, if you like. Some of those are on the national executive and then there are some national executive, and I am the national president of that national executive. They will be various CFOs or senior finance people from the banks and various other organisations—I am from Telstra. If an issue comes up on which we want to respond to government or whoever, we have got a well-oiled process that goes down into the organisation and back up to make sure that in what we are saying publicly or in responding to invitations to make submissions like CLERP 9 we have the views of our members.

Senator MURRAY—I am glad we have had that interchange because to my mind that means it has focused and targeted professional views and that therefore gives me a lot of confidence in asking this question and seeing that I will get a really well-informed view. What I want to ask about is the true and fair view issue. This is just fundamental to a CFO's responsibilities and views of matters. Mr Stanhope, I sat and still sit on the Joint Committee of Public Accounts and Audit and they produced report No. 391 into the independence of auditors. One of the areas that they thoroughly explored, and I agree with the recommendation—the whole report was unanimous—was that true and fair view should be restored in terms of its precedence and importance in the act. That recommendation came through in the draft exposure bill and has

been removed in the final bill. You may wish to take that on notice and ask questions again of your membership, and you may wish to go back to the Joint Committee of Public Accounts and Audit report to refresh your memory as to what that said. What is your attitude on this area?

Mr Stanhope—I would like to take the opportunity to go and revisit what has been said in that report. Geoff, do you have the most recent view of our membership?

Senator MURRAY—Let me help you with something before you respond, Mr Harris. It is possible—I do not know yet because the committee has not met—that either the committee or members of the committee may seek to pursue the Joint Committee of Public Accounts and Audit view when the legislation is before the Senate, in which case it would help to be informed as to your views. It really is a fundamentally seminal issue for your companies and your officers.

Mr Stanhope—I think that is right, and we will be only too pleased to respond. Looking through our submission, it was not an issue that we emphasised—

Senator MURRAY—No, you did not, and that is why I was asking.

Mr Stanhope—and I would like to take that opportunity. I do recall us having a discussion about it but I would like to give you a properly informed view.

Senator MURRAY—I will assist you further, if I may. A witness before the committee, Mr Geoff Dunsford—

CHAIRMAN—He appeared before us in Sydney on Tuesday.

Senator MURRAY—made these remarks. I was not there on Tuesday. He said:

... the Directors, CEO and CFO are unable to provide the above statement re "True and Fair View"—

of the financial position of a company—

unless they are able to provide a note setting out the current market or fair value of all assets and liabilities in a form which enables comparison with the values adopted under the Accounting Standards in the Statement of Financial Position.

That was his view, and that was a submission I think in conjunction with Professors Dean, Clark and Walker. You could find it in the *Hansard* record.

Mr Stanhope—Thank you. I understand that argument. A true and fair view is possible to be reached by a CFO, I would suggest, within the parameters of a set of accounting standards. If the suggestion there is that the current accounting standards do not permit you to provide a fair view of the assets, that is a different question.

CHAIRMAN—As I interpret what Mr Dunsford said to us on Tuesday, enlarging on his submission, which this quote is from, that was his view—that the accounting standards do not provide, in effect, a true current value; therefore, you cannot attest their true and fair value.

Mr Stanhope—Yes.

Mr Harris—It presumes that you would need to have current values to arrive at a true and fair view. That is not necessarily the case.

Senator MURRAY—The proposition has been put to me that internal auditors should report to the audit committee and not to the CFO or the chief executive. What is your view of that?

Mr Stanhope—Our view of that is that they should report to the CFO but have a very strong link to the chair of the audit committee.

Senator MURRAY—Does that mean that you are reporting?

Mr Stanhope—Yes, it does. It comes down to the practicalities of running a risk management or internal audit. It goes under both names—risk management assurance and internal audit functions. They tend to do more: they do risk assessments. The organisations themselves tend to do risk assessments and recommend risk mitigation actions, but they also do what I would call pure audit functions, internal audit functions. There is a question of whether they should do both, but in most organisations today you will find that those two functions are in the one organisation group. For practical reasons, the CFO is probably best placed in the organisation for that function to report. When I say for 'practical reasons', a convenor of the committee will quite often be on other boards and have other interests and you have to run these organisation functions on a day-to-day basis. So that is why I am suggesting a dual report. Take my own organisation, for example: the head or our internal audit will very often—and rightfully so—speak with the chairman of the audit committee on a regular basis without me present, and that is how it should work.

Senator MURRAY—Mr Stanhope, the reason I raise this is that I have been advised by some internal auditors that in some companies they are prevented by their senior executive, usually their CFO or the MD, or the CEO, from directly accessing the board or the board's audit committee, if that exists, and that they are required to route their reports through a formal reporting structure. Since the law does not deal with a dual reporting structure—there is no requirement in the act for a dual reporting function—I have wondered whether the act needs to say that they should report to the audit committee as well as the CFO. Perhaps I would ask you to give some thought to my question, and when you come back on the other material do so as to whether there is any way to stop bad practice, which is those which exclude the practice—and that is not typical—by making it absolutely clear that dual reporting is desirable.

Mr Stanhope—Certainly, I will do that. There are ways, I am sure, to do that. It could be part of an audit committee charter, for example.

Senator MURRAY—Perhaps you could give it some thought. I would suggest it is not typical of all companies that I know, but it is certainly some companies.

Mr Stanhope—They do have to watch out for the exception.

CHAIRMAN—Thank you for your appearance before the committee and for your contribution to our deliberations. It is much appreciated.

Committee adjourned at 4.40 p.m.