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Mr Bob Charles MP
Chairman
Joint Committee of Public Accounts and Audit
Parliament House
Canberra
ACT 2600

Dear Bob,

A further opportunity to reflect on issues related to regulation by statute or self-regulation as they impact on the auditing profession has caused me to cement my views on several issues. There have also been various market place participants including the corporate regulator that have triggered additional thoughts and encouraged me to further develop some concepts in the initial submission.

This submission considers the following matters:

- Surveillance and enforcement,
- Truth and fairness and the impact on self-regulation,
- Auditing standards and who should set them, and,
- Disciplinary procedures and sundry matters.

The key contention throughout this supplementary submission is that an active and visible regulatory – a statutory authority – will assist in the success of any self-regulatory regime because there will be an increased fear in the business community of detection, punishment and loss of reputation. Self-regulation needs to be supplemented by a strong, guiding regulatory palm that will shepherd those under its gaze along the proper path. Unless, of course, there is a deliberate intent on the part of some individuals to break the law and professional standards to achieve a particular end, which will, upon detection, inevitably have to result in enforcement action. Fear is the grease that will keep the cogs of the capital markets turning smoothly and efficiently. The trick is administering just the right amount of statutory regulation in order to ensure the other elements that are the subject of self-regulatory regimes work in the best interests of the investing community. The objective of protecting the investor is the subject of this committee's attention. That is the underlying concern forming the basis for the core question being asked in the terms of reference. Auditors need the support of statutory regulators to effectively do their job as 'delegated regulators'.

Surveillance and enforcement

The initial submission focused in detail on a single issue – ensuring the corporate regulator has sufficient capabilities to monitor, detect and enforce the provisions of accounting pronouncements – and little has occurred since that submission was sent to the Committee. There is – if anything – further reason financial reporting surveillance backed by stricter sanctions and tougher penalties for directors and others involved in the preparation and audit of financial statements should be a significant focus for your committee, the Federal Parliament and, ultimately, the Federal Government. The responsibility for enhancing these elements of regulation is that of the Federal Government. Aspects of self-regulation that are more appropriately kept within the profession's quadrangle such as the development and promulgation of auditing standards are discussed later.

One idea that needs enunciation early on is the need to create an environment where there is sufficient fear amongst directors, company executives and professional advisers of detection and punitive action so that the accounting pronouncements are followed to the letter. It is difficult to see whether there is sufficient motivation for those already contemplating a dive into the dark side of financial reporting to refrain from pushing the envelope. Aggressive accounting practices will remain a concern for good corporate citizens and accounting advisers where there is no fear of detection and punitive action. Fear works. No company will want to have its name bandied around as being a bad corporate citizen nor will it want to be associated with undesirable reporting practices. It creates reputation risks and can impact on the entity's share price and also current and future business. Companies identified as engaging in unlawful activity would receive publicity through any court or regulatory action. Media coverage would expose the details of any case and the capital market will without doubt express its sentiments in its usual way. No entity can afford to have this sort of thing occur at any point in time.

This situation creates a need for all parties involved in the preparation and audit of financial statements. Company executives need to ensure that they follow the accounting rules in an environment with an enhanced opportunity for the detection of any transactions for which the accounting fails to comply with accounting standards. Boards of directors also need to bear in mind the reputation risk involved in being a director of a company that is seeking to adopt an aggressive stance on accounting matters. Some of the more prominent concerns in recent years have dealt with the inappropriate application of the lease accounting standard. In a recent feature published in CFO Magazine – a Fairfax Business Media publication – I outlined key concerns that exist in the market place related to the application of AASB 1008 'Leases'. A range of notable entities to engage in what are arguably innovative transactions designed to mask the real economic substance of what is going on. What is in its form a sale and leaseback may just be a rather fancy way of getting a loan for an investment bank with a range of financial reporting impacts. Sale and leasebacks provide an opportunity, for example, for a company to lose some weight from its balance sheet in the form of assets. Fewer assets on the balance sheet inevitably mean a better ratio calculation for return of assets. The Australian Securities and Investments Commission has expressed varying levels of concern about the accounting for leasing arrangements of several entities such as Cable & Wireless Optus, resource company BHP and has hinted at its concern with securitistaion arrangements involving property. In some circumstances the accounting treatment may be argued as having been structured to deliberately avoid the accounting for transactions that a mum and dad shareholder might think was intuitive. The corporate regulator needs greater powers to deal with such reporting issues in a similar manner to that possessed by the Securities and Exchange Commission in the United States in order to ensure accounting regulation may be kept at a necessary peak. A terrier with sharp teeth is probably likely to engender more respect that one without dentures. Dentureless watchdogs do not inspire fear within the business community and the capital market's innocence is protected less rigorously as a result.

Enhanced surveillance of financial statements will provide the auditors – frequently referred to by the ASIC as 'delegated regulators' – an additional support in the field. Surveillance by the regulator has in the past been used by auditors as a means of persuading clients to account for transactions in a manner that is more to the liking of the regulator. Media releases and information releases coming out of the Commission are seen as significant by people within the accounting profession, but there is scope for increased activity. A broader financial statement surveillance program that examines the quality of reporting and compliance with reporting requirements should be instituted and, indeed, required by the ASIC Act. There should be a requirement within the law itself that the Commission conducts an extensive review of financial statements of listed entities primarily in order to provide an incentive for companies to avoid aggressive accounting practices and for auditors to be tougher on clients. Every listed company should be subject to a review at least once every four or five years in order to place a detection risk before every company financial officer, chief executive officer, a member of the board of directors and the external auditor. The Commission's energies should be focused on the detailed reviews of financial statements and its resources replenished for it to be able to deal with those. Its present program that looks at a random selection of company reports to assess problems with reporting under new pronouncements or existing trouble spots should continue, but consideration should be given to conducting this more limited review in conjunction with either academic institutions or the two professional accounting bodies. One option may be to tap the academic network that was responsible for the publication of a survey of corporate compliance with accounting standards every two years during the 1990s. The results of their reviews was published in a document call 'Australian Company Financial Reporting'. Compliance with all effective accounting pronouncements was considered and individual academics were assigned a standard to deal with. Such an arrangement would also ensure relevant and timely academic contributions are made to both the financial reporting literature and corporate regulation in this country. The results of such surveillance reports will be available within a short time frame whereas any academic research on accounting matters that might be of some use takes much longer and may be less than useful to the market place.

When a set of regulatory eyes are monitoring with some care and greater frequency the financial reports being prepared by companies then the incentive to ensure self-regulatory mechanisms becomes greater by inference. The auditor has additional strength in negotiations with clients when it comes to arguing the case against aggressive accounting treatments. Companies have a range of risks such as risk of punitive action and a risk of loss of reputation and drop in market capitalisation if they conduct themselves improperly. Increasing the use of financial reporting surveillance and strengthening the hand of the regulator will help any self-regulatory measures within the accounting profession to be more successful. Instilling sufficient fear within the market place will ensure compliance. Not having a robust regime regulating financial reporting will make a virtue out of mediocrity.

True and fair overrides and self -regulation

It is often argued by some in the market place that Australia needs a return to the ‘true and fair override’ that was abused by Australian entities back in the late 1980s. An override of accounting standards is unnecessary and, in fact, would encourage non-compliance and a decline in the quality of work done by the auditing profession. Exceptions to accounting pronouncements should be dealt with by the corporate regulator with appropriate powers to dictate the appropriate accounting in the rare circumstances where departures to accounting rules are required. It is rather ironic the Commission chairman David Knott recently spoke in favor of a ‘true and fair’ override given the corporate regulator’s position of trust within the Australian community.

A return to a government-sanctioned non-compliance with accounting standards would merely result in a drop in the quality of financial reporting, the erosion of audit judgment and yet another loss of investor confidence in financial markets. Companies that do believe they are hard done by and feel their circumstances require some kind of relief from compliance with accounting standards can have meaningful discussions with the corporate regulator. If the Australian Securities and Investments Commission believes a company’s circumstance fits the very restricted criteria for granting relief from an accounting standard then it should be the arbiter. Corporations should not be given the option of flouting accounting standards whenever or wherever it suits. Some degree of certainty is necessary for users to have confidence in corporate reporting. Standards also ensure that auditors are able to assist in regulating the market. They have a critical role guiding clients to the right corner of the pen and away from the less virtuous path.

Continuing the present ban on a ‘true and fair override’ in this country also ensures the capital market is protected from frivolous departures from the reporting standards that are in existence to ensure some degree of relevance, reliability and comparability as well as other factors that are outlined with great clarity in Section 224 of Part 12 of the ASIC Act that deals with the accounting standard setting structure. A potential means by which some auditors could satisfy a pushy client is also moved out of harm’s way. The Corporations Act should never be changed to accommodate a return to the ‘true and fair override’. It is also of relevance to note that the International Accounting Standards Board (IASB) issued a recent exposure draft that explicitly leaves it up to individual jurisdictions and their regulators to deal with the issue of divergence from accepted accounting principles as embedded in accounting standards. The securities commission should publicly withdraw its suggestion for a return to that scourge of the capital market for it is inconsistent with the intent of the very standards to which the Commission believes Australia must bring itself closer. This committee is concerning itself with the quality of financial statements and the audit of the same. You cannot talk about the quality of audit without giving due consideration to the broader regulatory environment in which the audit is conducted.

Auditing standards setting: a professional obligation

It is with some disappointment I note the securities regulator in this country feels compelled to support the statutory backing of auditing standards. This would be an incredibly wasteful and cosmetic manoeuvre that has the potential to achieve not much more than make what is already a robust process of standards development more convoluted and less efficient. Statutory recognition of auditing standards already exists by inference because auditors must be registered to practice as registered company auditors. That is in the law. It is administered by the ASIC. Auditors are subject to statutory discipline if it is found they had failed to follow procedural standards that set down how an audit must be done. It is folly to assume as some appear to be doing at present that there is some greater benefit in making the standards delegated instruments in the same way as accounting standards are will make them any more enforceable under the Corporations Act. The ASIC's call for mandating auditing standards in the same manner would merely result in a cosmetic gesture with little benefit to either statutory regulator or the profession.

Auditing standards are presently set by a professional board, the Audit and Assurance Standards Board, that resides within the structure of the Australian Accounting Research Foundation. This is an institution recognised globally for the quality of its output and the push from some quarters to bring the auditing and accounting standard setting bodies within the auspices of one statutory structure would demolish a brand that has been significant in establishing this country as a world leader in the setting of accounting and auditing pronouncements. Having attended several public meetings of the AuASB I am satisfied the board behaves and conducts its role in a manner that ensures the rules are developed in a professional manner. The meetings are held in public and I would encourage those members of the Committee keen to see how the present system operates to avail themselves of the opportunity to see the board operate in public. It would be most impossible for committee members to judge whether the process is working as it should without spending time observing the AuASB in action. I have done so and believe the audit board as it presently exists should remain within the private sector. The professional bodies, CPA Australia and the Institute of Chartered Accountants in Australia, could consider having another one or two external representatives on the AuASB to offer an outsiders perspective on the process. It is something the profession could do in its own right and it has acted in the past 12 months to have an external person appointed to the audit board. That was a reasonably good initiative and the board needs to be given credit for the move to introduce an outsiders' perspective to the audit standard setting table.

The establishment of the Financial Reporting Council caused the accounting standard setting element of the AARF to be dismembered to bring the accounting portion of it into the statutory realm. It is argued by some that the auditing side should also live under the auspices of the FRC and permanently remove from the guardianship of the accounting profession. Doing this will cause the death of an internationally recognised institution to begin with and, secondly, be most imprudent. Auditing standards regulate how auditors should conduct their work. There are laws that allow actions to be taken against auditors if they fail to act in a manner consistent with the requirements set down in the Corporations Act. It is unnecessary to bring the auditing standards within the same fold. There are also other regulatory adornments that accompany accounting standard setting that slow the process down and auditing standards could do without those. Having regulatory impact statements attached to every document issued by the Australian Accounting Standards Board delays the process of finalising and issuing a document providing much needed guidance to the community related to the preparation of financial statements. It takes time to obtain approval from the Office of Regulation Review and speedy responses – particularly in an era where complicated transactions demand standard setters move with some degree of efficiency – to complex responses cannot be delivered despite the fact the market place demands answers on various accounting issues. The audit standard setter should not be encumbered by this time waster and should be left to do its job as it has done in the past few years. If there is a market place demand for there to be independent oversight of the audit board's processes then the Federal Government should use its influence to persuade the accounting bodies to set up their own independent oversight authority rather than folding it into a statutory board's procedures. The Federal Government could indicate as a preference that the profession handle the task of establishing independent oversight within a 12-month period. Failure to do so could stimulate further regulatory intervention from the Federal Government. At present there is no great urgency to dismantle the private sector arrangements and calls to do so from various quarters are forcing unnecessary regulatory intervention.

Disciplinary procedures

Proposals from CPA Australia dealing with a change in the financial reporting framework refer to a change in the manner in which auditors are disciplined. A joint disciplinary process is advocated by the professional body with the benefit of a 'one-stop' disciplinary action that obviates the need for the accounting bodies to take their own action against a member. I am in fundamental disagreement with this proposal. The present disciplinary regime in the statutory arena works reasonable well and the Companies Auditors and Liquidators Disciplinary Board is generally regarded as doing a good job. The report provided to the Federal Government by Professor Ian Ramsay last year sets down some recommendations to make the process more transparent and those must be actioned within the near future. The statutory process should be kept independent from the bodies themselves although those organisations could do some things of their own initiative. The professional bodies could – if they so desired – amend their disciplinary rules to automatically reprimand any member found by the CALDB to have breached auditing standards. This would improve the process and ensure the bodies are seen to be responding in a positive and public interest manner to the findings of a statutory regulator.

Please let me know whether you or your fellow committee members would like to discuss these issues further.

Kind Regards,

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