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Friday, 5 July 2002

Mr Adam Cunningham
Secretary
Joint Standing Committee on Public Accounts and Audit
Parliament House
Canberra ACT 2600

Dear Mr Cunningham

Review of Independent auditing by registered company auditors

Please find enclosed the Australian Consumers' Association (ACA) submission to this important inquiry, ahead of my appearance before this Committee on Monday, 8 July, 2002. For further information, please contact me on 02 9577 3349, or at cwolthuizen@choice.com.au.

Yours sincerely

Catherine Wolthuizen
Senior Policy Officer, Financial Services

1. Terms of Reference

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

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

2. About ACA

The Australian Consumers' Association (ACA) is an independent not-for-profit, non-party-political organisation established in 1959 to provide consumers with information and advice on goods, services, health and personal finances, and to help maintain and enhance the quality of life for consumers. Independent from government and industry, it lobbies and campaigns on behalf of consumers to advance their interests.

ACA does not regularly survey the attitudes of consumers to audit standards, and is unable to provide the committee with qualitative evidence of consumer opinions on such as issues as the efficacy of audit committees. However, more consumers are becoming investors, either directly, or through managed investments and superannuation. This submission sets out the consumer perspective audit standards and corporate governance, and a series of recommendations which we believe would start to address considerable consumer and investor concern at current regulatory deficiencies.

3. Executive Summary

This Inquiry takes place in the post-Enron, HIH and now WorldCom environment. For many consumers, the debate is not only shaped by these events, but by what is around the corner. Confidence has been shattered, demonstrated by the scrutiny to which many Arthur Andersen-audited companies are now subject.

The issue of audit standards is critical to consumers, as is the promotion of best-practice corporate governance. Auditors are expected to discover and disclose instances of poor corporate governance, but the responsibility of adhering to high standards ultimately rests with the directors of a company.

The causes of the recent spate of corporate collapses are not clear, but may include some or all of complacency, management fraud or incompetence, the emergence of weaknesses hidden by years of favourable market conditions and audit deficiencies.

Corporate failure is not new, but the stakes are getting higher, as more and more investors enter the market, lured by 'mum and dad' marketing and the need to grow sufficient funds for retirement, either through superannuation, or private investments.

In Australia, the need for a high standard of auditing is compounded by the recent large-scale privatisations of many previously public entities. While in public hands, these could be subject to the most rigorous inquiry and review, whereas the ongoing viability of many service providers will now be assessed by private auditors. An example of the consequences of inadequate governance and disclosure is the collapse of One.Tel, where hundreds of thousands of Australians lost access to phone and communications services.

Regardless of the combination of these factors, each points to systemic failing, and systemic reform is necessary to restore public and investor confidence.

ACA supports reforms in three key areas to promote:

- Improved corporate governance and accountability;
- Stronger and more accountable auditing systems; and
- Higher-quality information for investors.

The current system of corporate governance underpinned by two fundamental conflicts:

Directors: Between self-interest of promoting share price/market performance and fully disclosing the full financial state of the company.

Auditors: Between providing services, including audit services, in a client/provider relationship, while also expected to play a whistleblower function.

Every instance of failure to reconcile these competing interests reinforces investor and wider public scepticism of the robustness of corporate regulatory arrangements.

Moreover, reconciling these competing interests takes place in a relative vacuum of external regulation – the regulator's powers to set, monitor and enforce standards are very limited, given the potential impacts of breaches.

While this Inquiry appropriately focuses on some of the shortcomings with existing audit arrangements, particularly relating to independence, company directors must also be scrutinised, and where appropriate, regulation introduced to promote higher standards of corporate governance.

ACA welcomes other processes of review in place, notably the Ramsay Report and CLERP 9 review, which will also address these issues. We note the pace of attitudinal change within the community and the louder calls for a stricter approach. An example of how far thinking has progressed is that the International Federation of Accountants' Ethical Standard on Auditor Independence, though only 6 months old, is already subject to calls for review. While ACA does not support knee-jerk reform, it is more than a year since the collapse of HIH, and many reform proposals have been on the table for at least half as long.

ACA endorses comments by the Treasurer Peter Costello, that one of the purposes of the CLERP 9 reforms will be to ensure that the regulator 'is in front of the game to ensure that our stockmarkets are clean and promote confidence'.¹ Several recommendations, below, set out areas where ACA believes ASIC's powers should be enhanced, but also recognises that a well-resourced regulator is one of the best protections for investors and consumers. Appropriate funding and access to expertise will be critical if the regulatory expectations of the market and community are to be met.

4. Corporate governance and accountability

Individual responsibilities

Directors: Avoid dominant directors, which may lead to non-commercial transactions which favour the dominant director's interests over those of the company and its shareholders; insufficient disclosure or fraud. (An example being the recent decision of the NSW Supreme Court regarding a payment by HIH of \$10 million to a company of which Mr Adler was also a director). Ensure that shareholders are kept appropriately informed of the company's circumstances.

¹ The Hon. Peter Costello, Press Conference, 27.6.02

Non-executive directors: must be kept fully informed of the state of the company and be active in ensuring that directors and management are accountable.

It is not just directors who have responsibilities. Division 1 of Part 2D.1 of the Corporations Act sets out the duties of other officers and employees.

Senior executives: Also have a duty to report breaches or irregularities in the management of the company, or by the directors. Should be able to take such concerns to independent directors or audit committees. A recent example of a breach in this respect involves the actions of Mr Alan Hodgson, former CFO of Harris Scarfe, who pleaded guilty to numerous counts of failing to act honestly as an employee of the company, and of providing false information to the ASX.

Strong internal processes

Companies should develop appropriate internal processes to promote accurate record-keeping, efficiency and the prevention and detection of fraud or error.

Promote and protect whistleblowers

Whistle blowing should be promoted through more stringent and clear guidelines for corporate accountability, including nominating appropriate officers to discharge this responsibility, in line with current requirements on in-house actuaries within the insurance industry.

More regular communication between directors and auditors

Directors of listed companies to agree to the audit mandate and review audit issues with the auditors at least every six months.

Continuous disclosure

Continuous disclosure, rather than quarterly reporting to be promoted, with appropriate sanctions and reporting requirements to ensure the market is kept regularly up to date with company circumstances.

ACA welcomes recent comments by the Treasurer, Peter Costello, suggesting that continuous disclosure was a feature of the Australian corporate governance framework which made it more robust than that of the United States.²

Penalties – jail, not just disqualification

ACA refers the Committee to a recent decision of the NSW Supreme Court that three HIH directors had improperly exercised their powers as directors in making a payment of \$10 million to company on which one of them served as a director, which resulted in 20-year disqualifications. This is hardly sufficient. The misappropriation of \$10 million in any other context would result in likely imprisonment.

ACA strongly recommends jail terms as sanctions open to the courts to impose in instances of such breaches of directors duties.

If nothing else, the availability of such sanctions (and a few high-profile incarcerations) should concentrate the minds of other directors on where their responsibilities lie and the standards of behaviour expected of them.

² The Hon. Peter Costello, Press Conference, 27.6.02: "Let me make it clear, in the context of current events, that Australia's corporate disclosure regime is in many respects much more advanced than the United States. We operate a system of continuous disclosure as opposed to quarterly reporting."

5. Stronger and more accountable auditing systems.

Accounts must truly and fairly represent the financial circumstances of the company. As such, auditors must meet pre-set standards of competence and independence. The professional accounting bodies have done much to improve auditor competence through various programs of professional accreditation.

However, Australia does not have a genuinely independent audit system. This is critical to proper corporate governance and the provision of information to shareholders which paints a fair picture of a company's performance.

While generally supporting the recommendations of the Ramsay Report, ACA believes some areas require a stronger approach to ensure auditor independence.

Provision of non-audit services

In the context of rapidly disappearing faith in the industry's capacity to maintain independence while providing such services, ACA supports a ban on the provision of audit and non-audit services to the same client.

Prohibited services would include legal and tax advice, which are also capable of giving rise to self-review threats. Audit firms would still be allowed to engage in providing consultancy services, just not to audit clients.

We welcome the apparently stronger line being taken by the Treasurer, in his announcement of the CLERP 9 review, with respect to the effect on auditing firms of having to restructure their business:

“Well, that is something that they may have to deal with, and it is better dealing with problems in that than watching your business go out of business as happened in relation to Arthur Andersen.”

Audit committees

ASX Listing Rules be amended to require all listed companies to have an Audit Committee to oversee and ensure auditor independence. Is this enough? ACA believes further protections are also required, and that a stronger external body may be more appropriate.

Rotation of Auditors

ACA views this as stronger than partner rotation, which would still be subject to internal firm dynamics, and the willingness of partners to criticise each other.

Arguments against this proposal follow lines that knowledge and understanding of client companies would be lost, however, ACA considers this is a worthwhile cost, and that in fact, the audit process may well benefit from 'fresh eyes' looking at a company's finances.

Auditor Independence Supervisory Board

To oversee the implementation of any changes to the present audit framework and ongoing monitoring of its application. There is no doubt these functions are required, but the Committee should consider whether they could already be performed within the powers of existing bodies, such as ASIC.

International harmonisation of accounting standards to provide consistency of rigour and reliability across jurisdictions

Australia to continue to play a key role in promoting this harmonisation according to best-practice principles. In this context, we welcome the announcement by the Financial Reporting Council last week that Australia would formally endorse adoption of International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs) for Australian reporting entities by 1 January 2005, following recent

similar decisions by the EU and Canada. In this respect, ACA endorses the pursuit of a 'principles' approach over complex prescription as a step towards implementing a culture of best practice.

6. Investor information

Investors must have confidence in the reliability and accuracy of information, and that they have parity of access to other parties. Disclosure and reporting arrangements should foster this confidence.

Mandatory attendance of auditors at AGMs of listed companies and that they be available to answer shareholders' questions.

ACA's sees little argument against this requirement, which would provide a rare opportunity for shareholders to query the auditors directly over issues of concern.

Continuous disclosure

This should ensure that relevant information for shareholders and the market be disclosed and disseminated in timely fashion.

ASIC has detailed following instances of insufficient disclosure³:

- Delaying bad news until the company had some good news to 'balance it with';
- Delaying reporting a failure to meet a vital product development approval because they continued to accept management assurances that the technical difficulties were just about to be solved – this continued for nearly 12 months;
- Delaying disclosure, on the grounds it 'fuels media rumours'.

Shareholders need to be kept advised of strategies and risks being adopted by a company as part of continuous disclosure. This was a key problem with the collapse of Burns Philp – shareholders were not advised of the new strategies and risks associated with the herbs and spices part of that business.

ASIC powers and penalties

ASIC must be able to quickly respond to suspected breaches, and impose sanctions where appropriate. ACA welcomes recent ASIC interventions on fundraising documents with insufficient disclosure.

However, ACA is concerned that ASIC may lack sufficient powers under the Corporations Act, a situation which came to light in its consideration of action against Western Mining Corporation last October for its delayed announcement of takeover discussions with Alcoa, disclosure made only at the explicit request of the ASX.

The UK regulator, the Financial Services Authority has substantial powers, including the ability to levy considerable fines, and ACA supports ASIC obtaining similar powers.

³ Jillian Segal, 'Current areas of concern to ASIC regarding corporate disclosure', Address to the Australasian Investor relations Association, 20/3/02.