Submission on the draft provisions of the CLERP (Audit Reform & Corporate Disclosure) Bill

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Note on the format of the submission.

This submission reflects on a select number of parts of the Bill and as such addresses the issues by referring to the relevant schedule and the division in which the proposed amendment occurs. General comments on a relevant schedule will always precede specific comments on particular sections.
Some of those remarks reflect areas in my initial CLERP discussion paper submission that I believe still need attention.

Schedule 1—Audit Reform

General Comment:

This section of the reforms is inadequate. There is no coverage of governance regulations that cover a broader range of stakeholders and there appears to be a rather disproportionate focus on the auditing fraternity. My submission on the CLERP 9 discussion paper made mention of aspects of the discussion paper's weaknesses and I was disappointed the issues remained unresolved.

The role of the Financial Reporting Council (FRC) appears to be rather confused. On the one hand it exists to monitor independence, but independence is only one part of ensuring audits are done with adequate competence and care by those charged with the responsibility of either signing off on the audits or doing the initial work on which the audit opinion is based. The focus should be primarily on audit quality and the question of whether independence rules have been adhered to should be considered as a subset of audit quality. Focusing on independence matters alone can lead me to only one conclusion and that is the system is not being set up to review matters of substance, but only the cosmetic issues that arise with the observance of arbitrary, needlessly complex and, at times, unfair rules dealing with independence. Setting up a structure to do only half a job is an exercise a group of secondary school students could undertake as a mid-term assignment in legal studies. The draft Bill's provisions would be a stroke of genius if they came from secondary school students. The fact it took so long to get this draft Bill out of the starting blocks makes this effort an even greater disaster.

The oversight structure in CLERP 9 is poorly articulated and leaves many questions unanswered. What we understand from reading the draft Bill is the Financial Reporting Council is to receive a broader role within the regulatory framework that would involve some form of oversight of the areas of independence recommended by Professor Ian Ramsay as well as oversight of the setting auditing standards. This is rather neat and looks clean when proposals are graphically documented in a flow chart. It is, however, no less complex than what occurs now because it creates a string of new relationships – such as communications with the ASX corporate governance council – that do not reduce the size of what some refer to as 'spaghetti junction'. Neatness might be a desirable goal but it is undesirable to have a neat structure that fails to nurture a co-regulatory relationship in all instances. Nurturing such a relationship in the context of the stock exchange's corporate governance regime but not in the case of the audit standard setter is an inconsistency that must be remedied in the draft Bill.

Oversight bodies should oversee a regulatory function rather than a class of individuals such as auditors or company directors. If you enumerate 'what' needs oversight and not just 'who' must be overseen you might begin to improve the regulatory structure. While it is understandable for the government to move to try and sustain confidence in the market place moving most of the functions that regulate the accounting profession such as the audit board is unnecessary. Consideration must be given to an alternative model that ensures experts in the field are responsible for setting standards, but their performance in a role is overseen by a panel of respected individuals in a manner that fosters respect for self-regulation. The regime must also offer the general public the opportunity to have confidence in the system. Trying to make the regime fair on all participants is a challenge. I made this

point in my submission on the discussion paper. Unless I am told otherwise I will put this down to being an unfortunate, unintended and untimely oversight. This means there is time to fix parts of the legislation in order to give it a greater focus on generic issues rather than discriminating against the auditing and accounting fraternity.

Audit oversight: technical comments

- The definition of 'Australian auditor' captures all auditors irrespective of their seniority within the accounting profession and regardless of whether they are authorised to act as registered company auditors. This is probably fine from a regulatory point of view but I could understand this creating concerns in the context of other provisions related to conflicts of interest in general and the cooling off periods. This is particularly the case in circumstances where the provisions may relate to the younger people in the audit firm.
- Definition of 'international auditing standard' retains the flexibility to switch authorities if it becomes apparent that the International Auditing & Assurance Standards Board (IAASB) product is less appropriate than the material produced by the US auditing standard setter, which is now housed within the auspices of the Public Companies Accounting Oversight Board (PCOAB).
- Several technical amendments are necessary to make the law fly the way people would like it to. Amendments to Section 224 as outlined in the Bill really need to be kicked around in order to reflect the fact the audit is not about facilitating comparability. Financial accounting standards exist to facilitate comparability and in a perfect world there would be no options in accounting standards so that Nirvana would be reached rather quickly. Audit reports are – for want of a better word – a synthesis of the auditors' considerations related to the audit of the company's financial statements. The audit itself does not perform the function of facilitating comparability. It is, quite frankly, no difficult task to demonstrate the bizarre nature of this proposition of audits facilitating comparability. What is comparable about an audit report of the financial statements of two companies that have all of the same economic circumstances but they exercise the power to choose accounting treatments that result in a different picture for the two entities? There is nothing comparable about those audit reports because they are assessing the circumstances of those two entities individually. Those two words 'facilitating comparability' should be placed on the legislator's death row rather promptly, please.
- Subsection 225(2) is being repealed in order to put within the scope of the FRC's powers all that the government would like the body to oversee. The reason for this redrafting is understood, but this redrafting really does not show any evidence of the government nor the bureaucracy rethinking whether the provisions setting down the FRC's powers are at all effective. One area that must be amended as a part of this process is the redefinition of who is in charge of formulating the strategic direction for the standard setter coming under the oversight of the FRC. The functions as set down fo the accounting and auditing functions need to be amended to reflect the fact strategic direction should be set by the two standard setters. It can be the FRC's call as to whether the standard setter should do that within a specified deadline, but the standard setters should be responsible for setting the strategic direction. If there

is no appropriate reasoning or rationale given for the standard setting boards ignoring comments or feedback from the FRC then the ultimate power to strip all board members except the respective chairmen of their positions. The chairman are appointed by the Federal Treasurer and it would be up to the Treasurer with appropriate briefing and sufficient consultation to decide whether or not remove the chair. I anticipate such an action would occur only in the most extraordinary circumstances but there is no reason why the function of setting strategic direction should continue to remain with the council. Strategic direction setting is also incompatible with the restrictions on the FRC to dabble with the setting of a particular accounting standard. The law needs to be amended so that strategy for standard setting and the setting of standards is done by the same authority. To leave the situation as it presently standards maintains a less than pure situation as far as the independence of the standard setter is concerned. While it is unlikely the government would revisit the split between the powers of the FRC and the standard setters I would advocate that such a reconsideration needs to take place because not even the Financial Accounting Standards Board in the US is faced with a similar regime of decision making in relation to its agenda. It seems rather odd that CLERP 9 is about monitoring the observance by the auditing profession of independent guidelines when the standard setters operating under the present and proposed regime are less than independent.

- Information gathering powers Section 225A are inconsistent. There should be a provision that gives the FRC powers to demand information from Australian or overseas companies that have Australian subsidiaries in relation to their decision making processes in awarding contracts to audit firms and others to examine whether they are living up to their audit committee charters or board charters. The other side of the transaction, if you like, also needs to be examined by the FRC. I don't buy the argument that the ASX corproate governance guidelines deal with some of these types of disclosures. The law empowering the FRC should be able to capture companies as well as their advisers/auditors. This is another example of where the legislation reflects some inequities between the way the accounting profession is being treated when compared with others.
- Sections 227A and 227B deal adequately with the issue of establishing the auditing standards board and the matters of assurance raised in the comentary. There is sufficient scope for the audit board to issue assurance guidance without too much amendment to the present drafting in the Bill. If adding the word 'assurance' appeases some people arguing the present drafting does not permit guidance on assurance engagements other than statutory audits to be issued, I have no objection to the word being added. I do not necessarily agree that it is as critical an amendment to draft Bill as the others outlined above. The two questions posed in the commentary did nothing more than cause a ruckus that was somewhat unnecessary.
- Section 234A of the draft Bill advocates the purposive interpretation of the auditing and assurance pronouncements. The standards will need to be reconsidered in the light of this paragraph to determine whether they are drafted in such a way to meet the demands of this part of the law. Section 234A(2) also needs to be borne in mind when considering this particular concept. This will pose an interpretation issue for some people because they will not always understand what the transition to the law means.

- Section 234C (a) should be eliminated because in my reckoning the power or function of setting the strategic direction should fall within the balliwick of the accounting, auditing & assurance standard setters and not the FRC.
- Section 234D gives the minister the power to ultimately interfere in the independence of the setting of accounting and auditing standards. I am not in favor of government dabbling in standard setting tasks I believe are the domain of professional standard setters from the professions with some involvement from others.

Qualifications of auditors

The provisions contained in part two of Schedule 1 are generally supported. It is reasonable to request annual lodgments from auditors so the regulator has a good idea of the population of practising auditors.
As we move into a competency based framework for the registration of company auditors we must ensure the systems put in place for auditor training in the various practices are sufficiently robust before the competency framework is fully implemented. Such a system would also permit people that are 'fast learners' or prove themselves a suitable candidate early in their auditor training for registration to get their registration fast tracked. This would, of course, be on the basis that the individual has met all of the competency criteria.

Auditor appointment, independence and rotation requirements

- Conflict of interest rules embedded within the draft Bill are a classic piece of apartheid-style drafting designed to capture the accounting profession while generally allowing other professionals the scope to behave in any manner they desire after they leave their previous employer. It is a rather laughable proposition that market confidence rests in part on having lengthy provisions on the conduct of accountants and auditors and some of their associates that have some role in making judgment calls in the course of the conduct of an external audit. Where is the mention of lawyers, merchant bankers, investment analysts and members of any other profession that could equally jeopardise the governance of a company and lead it down a slippery slide to having a lower share price as a result of governance failure? No mention is made of the conflicts of interest that would be inherent in former partners of law firms that might end up reviewing the results of their former firm's legal advice. They might end up reviewing their own legal advice! Consider the role that could be played by an investment banker responsible for stitching up a complicated deal that could involve all sorts of linked financial arrangements on the board of or on the senior management team of a former client. This individual would be in a position to make decisions related to the transaction he or she was responsible for creating to begin with. It is a conflict of interest as far as I am concerned and the provisions related to the cooling off period should be extended to all professionals that have provided services to a particular company. This is the only way to convert the proposition of a cooling off period into a principle-based decision. The same should apply in the case of the 'no more than two partner' rule that exists in the draft Bill. A company should be required to reconsider who provides its

legal or other services if more than two former partners or senior executives of a law firm are on its board or in senior management. Lawyers and other professionals can compromise the governance of an entity just as much as accounting professionals. They should be accorded similar treatment in the legislation.

- Expanding the provisions in relation to the cooling off period and bans on former partners of accounting firms sitting on boards of companies to all the professions as outlined would also ensure the non-audit professionals within an accounting firm involved in the audit of a company are not discriminated against because they have chosen an accounting firm as an employer. It is important that all professionals are encouraged to behave ethically wherever they may be and limited such provisions to those serving in accounting firms will skew the law in a particular direction. Place the same provisions on all service providers so that no single class of individuals is perceived as being in need of more regulation than others. If good governance is a matter for all then have the bans apply to all and not just one class of individuals.
- The schedules dealing with relationships appear to complex for a piece of legislation that tries dealing with the governance matters in what the Federal Government says is a principle-based fashion. These are merely rules and nothing more. Principles as applied to all professions in my analysis above on cooling-off periods should be an adequate illustration of what is possible when a principles-based and non-discriminatory approach is taken.

Registration of authorised audit companies

I have no major difficulties with this part of the draft Bill. I find the concept of accounting firms incorporating a reasonable idea and view it as a reform that is a long-time coming in this country. Audit firms deserve the same kind of protection under the corporate veil as any other business. I do not see them as different from other businesses operating in the community even though they occupy an interesting place in our capital markets.

Auditors attendance at AGMs

These provisions are generally fine provided the companies always comply with the spirit of the law and pass the questions to and from the auditors with the adequate

Expansion of auditors' duties

The law should incorporate a provision whereby the audit firm is required by law to respond to any attack on it by an external audit client. The present situation is extremely unequal and the auditors should be in a position where they can defend themselves publicly. This can only happen if the law makes it an obligation on the part of the auditor to communicate on these maters

Companies Auditors and Liquidators Disciplinary Board

Provisions of this part of the legislation should ensure the meetings of this body are held in public rather than private. Otherwise these amendments are generally okay.

Financial reporting

True and fair view

These legislative provisions do force companies to discuss their accounting quibbles in more detail, but I do believe there is a risk the statutory profit, which is the basis for comparability, will be sidelined by companies wanting users to focus on another set of numbers entirely. This is rather odd from a Bill that actually articulates the belief that the audit report is a vehicle for comparability.

CEO and CFO declarations in relation to listed entity's financial report

This provision is fine. I have no concerns with this particular provision although I would have no problem if this provision was written up to mirror the Sarbanes-Oxley provisions.

Content of directors' report for listed public companies

The management discussion and analysis requirement is a reasonably good provision and should be kept in the final draft. Care needs to be taken that this does not become a 'boiler plated' requirement in practice.

Financial Reporting Panel

The meetings of this panel should be held in public. The panel must also not be used as a pre-vetting device or a pre-signing of audit report counseling service for auditors. Quite frankly, the accounting profession should establish its own committee to deal with support for practitioners in this area rather than being reliant on a government authority to deal with such issues. Companies should be permitted to put actions to the panel. The nature of the body should not be the same as the CALDB, which is ostensibly a body that receives referrals from the Australian Securities and Investments Commission.