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Dr Kathleen Dermody,
Secretary,
Parliamentary Joint Committee on Corporations and Financial Services
Suite SG.64
Parliament House
Canberra ACT 2600

Dear Dr Dermody,

The legislation in draft form being considered by this parliamentary committee has shortcomings within it that, quite frankly, poses more questions than it answers about the thoroughness of our analysis of appropriate corporate governance regulation. It is also a discriminatory piece of drafting that places the accounting profession at within the cross hairs of a legislator's rifle without taking a broader view of the role of other professional advisers in the provision of goods and services to companies.

I have significant concerns about the lack of robustness in the legislative model set down for oversight. There is an inadequate provision of power to the Financial Reporting Council to investigate corporations and the way they use auditors and other advisers that is evidenced by the powers given to the FRC to seek information. There are also still difficulties in the manner in which the oversight of accounting and audit is being considered. What I have done below is spelt out some of the core concerns I have with the Bill. My submission has had a limited focus as a result of time constraints and the failure to mention any part of the Bill in the submission should not be taken as a sign of agreement at any stage.

Drafting in some parts a nonsense

It is obvious from the draft Bill that taxpayers funds on IT training for bureaucrats have been well spent. They are obviously well acquainted with Microsoft Word and have used the 'cut and paste' and 'find and replace' commands to great effect, producing some

ludicrous drafting that clearly demonstrates a failure of the legislators to comprehend what the function of an audit actually is and how to best structure the provisions on audit. An examination of one area in detail – amendments to Section 224 – are a classic case in point. Nobody is likely to contest the fact that bringing that amibitious goal of legislating auditing standards into reality is a complex, complicating and thankless task. It could, however, be executed in such a way as to achieve the actual aims of what the government would like to achieve. Flashing in neon lights very early in the draft is what must be the clearest example of what happens when you trust non-experts to draft laws in areas where they lack expertise.

The Australian Securities and Investments Commission Act 2001 is composed of various parts, or chapters, and each one deals with a particular part of the law. Part 12 is the section that covers accounting matters and will cover auditing issues when the law is actually effective. Section 224 of that part of the ASIC Act sets down the fundamental goals of that particular section. It should be regarded as the promise made by the legislators to the community. It presently promises the following. Section 224 tells us Part 12 says this part of the law exists to facilitate the development of accounting standards that require prepares to provide financial information that:

- Allows users to make and evaluate decision about allocating scarce resource; and
- Assists directors to discharge their obligations in relation to financial reporting; and
- Assists in assessing performance, financial position, financing and investment; and
- Is relevant and reliable; and
- Facilitates comparability; and
- Is readily understandable.

There are some more things including on accounting standards. Section 224 tells use Part 12 is also about facilitating the Australian economy by reducing the cost of capital, enabling Australian entities to compete effectively overseas and having accounting standards that are clearly stated. A further sentence in that section states Part 12 is all about maintaining investor confidence in the Australian economy, which, the legislators painstakingly point out, includes the capital markets.

Existing weaknesses in drafting

That is all very nice, but somebody forgot to tell the legislators that there is no such thing as 'facilitating the Australian economy'. An economy exists. It might be stable, volatile, good or bad, but the economy in its own right cannot be facilitated as such. You can facilitate economic activity, sure. Economic activity is what makes the world turn around. An economy, however, is something that cannot be facilitated by legislation. A parliament does not create an economy by legislating. It can improve it or cause it to decline. Not even parliament – the creator of laws – can create an economy or cause it to disappear. It can just make it operate better or badly depending on whether the risks a government takes in the setting of economic policy are appropriate.

We are heading in the same direction in terms of logical and meaningful and relevant legislative drafting as a result of legal experts dabbling in another professional domain. All-powerful accounting standards exist to facilitate the economy, apparently. Strap on your seat belts because the same kind of thing is happening with the drafting of provisions in the Bill

for auditing standards. The draft Bill states Part 12 of the ASIC Act exists to facilitate the development of auditing standards that:

- Provide Australian auditors with relevant and comprehensive guidance in forming an opinion about, and reporting on, whether financial reports comply with the requirements of the Corporations Act; and
- Require the preparation of auditors' reports that are relevant and reliable, facilitate comparability and are readily understandable by the users of the financial reports to which they relate;

The first of these provisions appears sensible. This provision is readily understandable in that the auditing standards are meant to provide guidance on how the audit process should be undertaken by auditors. It is the second of these provisions that should be treated warily because it is one that could arguably perpetuate or expand the audit expectation gap.

An initial concern is the concept of facilitating comparability is unclear in this provision. That wording – as is evidenced from the key words already encountered earlier on in this analysis – is directly drawn from the accounting standards provisions of Section 224. Those qualitative characteristics of financial reporting – relevance, reliability, comparability – are drawn from the various piece of professional literature such as the Statements of Accounting Concepts and, of course, the accounting policies standard. There is nothing wrong with those concepts and they have been critical in aiding practitioners and others determine how best to apply accounting standards and also choosing appropriate accounting treatments where a standard is absent.

Indiscriminate use of the accounting and auditing jargon, however, can lead to those terms meaning something completely different in the eyes of the those unfamiliar with that literature. It can be both confusing for those in the accounting profession and those outside it. The inclusion in professional literature of concepts does not in itself mean the words should be regarded as being suitable descriptors in a piece of law intended to state in plain English what the government and, indeed, the Federal Parliament intends with legislative provisions. An additional factor those in government need to remember is general members of the community are unlikely to have access to professional literature that might demystify what are poorly drafted provisions that by their present design could mislead the community into thinking auditing standards are designed to assist auditors in working miracles.

Facilitating comparability?

'Facilitating comparability' can then be taken to mean the audit report has some role in facilitating comparability between either the financial statements themselves or the audit reports. What is meant by facilitation of comparability in this instance? I can read it as meaning that audit reports are meant to facilitate comparability between financial statements because it refers to the users of financial reports. Are these audit reports, therefore, meant to secure some kind of comparability between financial statements? That concept would be a nonsensical one but it would be open for a person reading that provision to be able to walk away from that paragraph with the impression the audit report is there to facilitate comparability between financial reports.

It would be equally odd for the law to include those words in there in an environment where the financial reporting standards being implemented will have some options in them. Reading the words one way would then render the whole game meaningless because the legislation would give the impression more is being delivered by the audit report than is actually the case. An audit report will have to sign off on the fact a company's financial statement complies with international standards even though the two entities, which for argument's sake have all the same economic circumstances, are using different accounting treatments because the standards, or accounting laws, permit divergence in financial reporting to occur. Some people are interpreting the provision as saying the audit reports will be comparable between each other rather than facilitate the comparability of financial statements. If there were more words around that concept in those provisions then it might be possible for that interpretation to fly. At the present time it is more likely that interpretation will remain ground while a squadron of pigs takes off from the tarmac at Melbourne Airport.

Those words should be excised from the draft provision for another reason as well. As audits begin to encompass a wider range of considerations there will be fewer grounds to argue the audit reports CAN facilitate comparability. If a statutory audit eventually includes within its scope a detailed appraisal by the auditor in the auditor's report of the way a company is managing certain risks or dealing with financial reporting issues the notion that every audit report will be the same and drafted on a similar basis will be tested in practice. Each entity will have different circumstances and operate in a different industry. Managers of entities will not behave in the same way nor make accounting policy decisions in the same way as each other. It is unhelpful for the future growth of the statutory audit to have those words contained in the Bill as it presently stands. This creates unrealistic expectations of the audit & assurance standard setter and its ability to deliver on any notion to facilitate comparability.

Consider the implications of interpreting the draft Bill as saying the audit report should be comparable one to another. Any reporting innovation or market leadership could not survive because shareholder activists would then be able to accuse audit firms of breaching the ASIC Act 2001 by daring to be different and expanding the scope of the audit report in their own right. It could also have the impact of instilling in the auditing profession for the medium to long term an attitude of conservatism where accounting professionals generally and auditors in particular seek to minimise the risks of regulatory enforcement action by being different to others.

A solution to the comparability debacle

One option is for that section to be redrafted to say the law requires the "preparation of auditors' reports that are reliable and understandable by the users of the financial reports to which they relate".

The concept of reliability is a relevant concept to keep in that section because audits are reliable to the extent auditors perform sufficient work on a client to enable the provision of assurance. The sufficiency or otherwise of the work done in an external audit will determine how reliable the audit is. It is also a more legalistic surrogate for a very basic, everyday term that one might wish was able to be included in the law and that simple set of five-letters: 'trust'. In a perfect world the words would be written to state 'auditing standards issued under the Part of the law should result in audit reports users can trust and understand'. This is the essence of the matter and the present state of

play is a waste of words and unnecessary use of jargon that obfuscates the purpose of even having the law in the first place.

Understandability ties in with the pursuit of plain English audit reporting, which has been attempted to some degree within this jurisdiction. That is a laudable and valuable objective and it should remain within that provision. The qualitative characteristic of relevance does not need to remain in that legislative provision as the basis of the relevance of an audit and. of course, the resulting audit report is determined by the engagement letters that set down the breadth of an engagement That is already taken care of in the first of those two amendments to section 224 so its appearance in the second prong of the Section 224(a) amendments is a redundancy. Its deletion will also assist in making the paragraph that insists audit reports must be understandable more understandable in its own right. Are the audit reports results from this process supposed to be more comprehensive and comprehensible than the law that gives effect to this process of legal backing? The law applying to the audit reports and the practitioners that issue them to inform stakeholders should itself be written in plain comprehensible English before that plain English yardstick is applied to the accounting professionals that will need to comply with the provisions of an intrusive law.

Oversight model flawed

The oversight model advocated in both the CLERP 9 discussion paper and the draft Bill is flawed in the extreme and the government, Federal Opposition and the Australian Democrats must consider the ramifications of a model that is a bit like a QANTAS jet with one wing. All it will do at full speed is fairly quick and rather dangerous donuts on the tarmac without going places terribly fast. The zealotry underlying the move to siphon off professional standard setting from the accounting and auditing fraternity has so obviously distorted the perspective brought to bear in both the CLERP 9 discussion paper and the draft Bill. Missing from the oversight model are the two self-regulatory organisations living within the auspices of the Australian Stock Exchange: the listing rules committee and the corporate governance council. Both of these bodies have more of a place under the oversight of a body such as the Financial Reporting Council than the Auditing & Assurance Standards Board because they are key influences in the behavior of entities, their directors and associated professionals. It is the absence of those two authorities from the draft provisions amending the Australian Securities and Investments Commission Act 2001 that is one of the many manifestations of what is ostensibly an apartheid-style legislated discrimination against the accounting profession. Consider the bans on former partners serving on boards of companies either as a result of the ‘no more than one partner in a senior role or on the board of directors’ rule and the cooling off provisions. These are among the least sound provisions in the draft Bill and they create and unfortunate impression the government is placing an unreasonable burden on the accounting professionals of this country for even electing to join the profession. The general tone of the Bill and the powers related to information gathering, for example, create the impression it is only the auditors and accountants that need to have the benefit of the FRC’s close scrutiny. It is rather unfortunate the Bill is quite lopsided in this regard and the intensity of focus on independence of accountants and auditors is ridiculous given the lack of similar constraints on the behavior and conduct of other professionals.

Inconsistency in self-regulation

It is one thing to remove self-regulation from the accounting profession because some commentators perceive the profession to have a conflict of interest. It is completely another proposition to have the ASX – a body that is listed on itself – in a position where it is involved in the setting of both the corporate governance council recommendations and the listing rules. The ASX is itself subject to those two regimes and a reasonable observer may conclude it is too close to the setting of the bodies of literature with which the exchange itself must comply. The same argument has been mounted successfully by some commentators against the accounting profession and those commentators have for some unknown reason managed to persuade legislators that enacting restrictions on the accounting profession is an adequate response to some of the concerns raised regarding market confidence. That profession will no longer have the same degree of involvement in dealing with those issues because it has been deemed necessary to place the AuASB under the oversight of the FRC. I am yet to be convinced of the soundness of the argument to have the AuASB under the oversight of the Council when the comparable bodies operating under the auspices of the ASX remain associated with the organisation that must comply with the rules produced by the governance and listing rules bodies.

It is also somewhat ironic the AuASB holds public meetings and is a more transparent organisation than is the ASX corporate governance council or the ASX listing rules committee. It is open to and quite legitimate for members of the community to ask why it is a body that is open and transparent about its affairs is being hounded into subservience by legislation and other committees run by an entity with what must be seen as an equivalent conflict of interest is not subject to a similar takeover by the Federal Government. This cannot be regarded by any sensible person as being a fair and equitable set of arrangements. The government must review this area with urgency and place both bodies underneath the oversight of the FRC for the same reasons it is arguing the auditing standard setter must be overseen by the council. The same dangers and risks exist with the two regulators that are setting governance and listing rules from within the protective shell of the Australian Stock Exchange.

No revision or review of FRC powers

I am somewhat less than satisfied with the fact no action has been taken to clarify the powers of the Financial Reporting Council, or FRC, as they relate to both the accounting and auditing standard setters. Ambiguity in what is meant by strategic direction in Part 12 of the Australian Securities and Investments Commission Act 2001 has resulted in debate over whether the Australian Accounting Standards Board is responsible for the setting of strategic direction in the area of accounting standards. The law should be changed in order to leave the responsibility for the setting of strategic direction to the AASB and the Auditing & Assurance Standards Board, referred from this point on as the as the AuASB, with the responsibility for review resting with the FRC. If the explanations from either standard setter for the failure to act on FRC suggestions is inadequate then the oversight body should have the responsibility to refer the matter for the purposes of ministerial arbitration. The current situation blurs the authority of the two and creates the potential for unnecessary conflict.

Allowing the FRC the luxury of setting strategic directions places it too close to the task of the setting of the standards themselves. That is a fundamental breach of independence, real and perceived, because it an oversight body is then engaged by that very act in the setting of standards. They are setting the template within which the making of standards is to take place and by doing so they are violating the very concept of independence they are now supposedly so qualified to sit in judgment on as a part of the CLERP 9 expansion of the council's responsibilities. While the council as an entity is prohibited from interfering with the drafting of a specific standard it is allowed to dabble in the standard setting sphere by setting a specific strategic direction. This issue would be resolved by ensuring the strategic directions being set for the accounting and auditing standard setters are set by the standard setters themselves. The council will then be at arm's length and will not be attacked in the future for interfering in the technical content of financial reporting or auditing standards. Should the corporate governance council and listing rules authorities be brought under the oversight of the council then similar conditions should be accorded to those bodies. The council is an oversight body. Decision making related to strategic directions takes it over the line into territory in which I believe the FRC and its members should regard themselves as guests in somebody else's home. Disturbing the china and trophies on the mantle piece is, putting it mildly, bad form.

Public meetings of FRC missing

No active steps have been taken to legislate for the FRC to have public meetings. I continue to be puzzled by the fact the council still meets in private given that the topic area coming within its jurisdiction is related to maintaining a strong and transparent capital market. The absence of a legislated requirement for the FRC to meet in public means the oversight body will continue to be subject to claims it is operating in a secretive, club-like environment. Perceptions are deemed to be important by this government in other areas of CLERP 9 and it has pandered to the prejudices contained within the report of the HIH Royal Commission. These prejudices are based on the need to ensure companies and auditors are perceived as being independent by those outside the entities with which these individuals have some degree of involvement. I cannot understand why other perceptions and concerns remain unaddressed by this draft Bill, particularly given the fact that transparency and openness appear to be the buzzwords with which the government hopes some of the needlessly complex and irrelevant changes within CLERP 9 will be associated. If transparency and openness are to be the key feature of the capital market then those overseeing the audit firms and others in the name of the community must meet in public. They must have that veneer of public accountability and face the community with the same degree of integrity expected of the auditors and companies striving to comply with a host of audit, accounting, conflict of interest and continuous disclosure rules imposed on them by legislators of governance rules.

New definition of independence will change behavior

Draft provisions contained in CLERP 9 enunciate a definition of independence that creates an environment that will drive boards of directors to reject the notion of using their auditors to provide other services because the draft legislation creates a presumption that a company's

external auditor lacks independence if it does anything other than the external audit and, possibly, some regulatory compliance work such as APRA returns.

Section 324CB of the draft Bill sets down in words what has brought on some resentment and concern from the accounting and auditing fraternity.

"For the purposes of section 324CA, a ***conflict of interest situation*** exists in relation to an audited body at a particular time, if circumstances exist at that time that:

(a) impair, or might impair, the ability of the auditor, or a professional member of the audit team, to exercise objective and impartial judgment in relation to the conduct of an audit of the audited body; or
(b) would give a person, with full knowledge of the facts and circumstances, reasonable grounds for concern that the ability of the auditor, or a professional member of the audit team, to exercise objective and impartial judgment in relation to the conduct of an audit of the audited body is, or might be, impaired."

Consider the words for a moment. Even if no proof exists that audit judgment was impaired, for example, by a company engaging the audit firm as its preferred supplier of a particular purpose it could be argued the existence of that engagement might impair the judgment of the audit team on the external audit engagement.

I will have no proof an auditor's capacity to be objective and independent of thought has been impaired. Having proof of impaired judgment is not the critical part of the test in this instance.

All you have to do is have sufficient reason to believe the auditor may be under threat of having their capacity to exercise independent and objective judgment during the course of an audit impaired because of the existence of other audit-related or non-audit related services.

Perception is king in the present environment and any involvement with the external audit firm outside of the external audit will be seen by boards as posing a potential reputation risk to the entity and the credibility of its financial statements.

Why use your external auditor to provide a particular service if the entity's financial statements would have a pall cast upon them as a result? Why put up with questions related to independence when those questions could just as well be avoided by not using the external auditor to provide some services?

The critical word in this instance again is 'may'. Having another commercial relationship with the external audit firm may be considered by observers – well-informed or otherwise – as impairing the integrity of the numbers contained in the financial statements signed off by the external auditor. This has nothing to do with the argument of the provision of quality service to an entity. Service quality it less important in this scenario than the need to be perceived as having a clean nose as far as the financial statements are concerned.

Companies will want to look good irrespective of any preference they may have relating to providers of accounting or other types of advice. If looking good means the auditors get eliminated from the list of those suitable to take up the engagement, then, indeed, that will take place. The fact these issues will be in the law also means they become the benchmarks used by the various stakeholders to measure corporate compliance. It will lead to a checklist driven focus because shareholder groups and corporate governance activists in general will want answers from boards of directors about why they engage certain experts. Companies will probably err on the side of ensuring fewer questions are asked about the consultants hired for particular engagements as a result of these types of prescriptive measures being inserted in the law.

Whether the law is the best dwelling for provisions such as these needs further contemplation by the legislators within the Federal Parliament for exactly the same reasons outlined above.

Another interesting sideshow to the independence scenario is the fact only one former partner of an accounting firm can be on the board of an existing audit client of their former firm. Having two or more former partners of one accounting practice on a company board or in senior management is also rather uncool after the HIH collapse. After that one curious governance catastrophe the HIH Royal Commissioner decided it was a sensible idea to restrict an accounting firm from being able to be an external auditor in circumstances where more than one partner held some kind of directorship or was a senior member of staff. This means a firm wanting desperately to bid for a large audit may not be able to do so because of the presence of more than one former partner in the ranks of either the board or senior management of the entity tendering the audit.

It is a rather curious environment in which to even consider implementing this particular recommendation because there are only four big firms. What happens if one big firm has the external audit, another handles internal audit and yet another firm has a long-term contract to provide a particular type of advisory service but the former partners come from the firm that could take the audit over if it wasn't for them sitting on the board?

One or other of the former partners would need to move on from that particular company if in fact it was deemed necessary to change the external auditor.

Another option is that an audit could go to a second tier firm, but that would still be unlikely given the market power enjoyed by the Big Four in the listed end of town and the lack of market readiness on the part of some of the second tier players to take on a larger listed client.

Such rules on independence are unhelpful in a market that is already small and in which companies are struggling to cope with the compliance burdens that are fast becoming a reality with the overly complex tax consolidation system and the introduction of some rather demanding accounting standards as a result of the international financial reporting standards. These are, however, rules that are probably non-negotiable given the tide that has been rising against the accounting profession for a very lengthy period of time.

Cooling off periods and inconsistencies

One of the elements of the draft Bill needing greater attention is the concept that accountants working in accounting firms should be restricted in where they can move to if they choose to conclude their career with a firm. No such restriction is proposed for professionals that practice in areas other than accounting. It should be viewed as a puzzling anomaly in my view because the governance of an entity can be affected by the behavior of all kinds of people, which includes people in the accounting fraternity. This government has taken the recommendations of Justice Neville Owen and sought to implement them in an unthinking, less than robust fashion that would have the community believe conflicts of interest should only be a concern for auditors and accountants. This Bill that is presently the subject of review by this committee, I believe, can only be read as being a reaction to the opinions of one individual that have a bearing on one set of circumstances. To extrapolate the so-called lessons from the collapse of HIH to all entities by creating a blanket ban on accountants and auditors and not on other professions is, firstly, unfair and, secondly, places an unjustified overemphasis on the role of the accountant and auditor in these exercises.

The draft Bill, for example, fails to consider the role of lawyers in the provision of legal advice. Why would it be any more appropriate for a lawyer – assume it is a former partner of a law firm – to be able to move to a board of a former client after leaving the law firm? Why should there be no restrictions on merchant bankers, individuals that are responsible for creating confusion and accounting dilemmas, from potentially moving to boards of clients of their former firm? Name any profession that is a service provider to the corporate sector and ask yourselves why that profession should be exempt from similar cooling off period requirements. The answer in a principle-based environment – Australia is allegedly one of these environments – is that all service providers should be prohibited from joining the board or senior management of a client of their former employer or former firm for a specified period because they may end up reviewing a transaction or advice or general work done by their former firm. That, ipso facto, is a conflict of interest if one accepts the definition of independence as it is outlined both in the HIH Royal Commission report and the draft Bill. A failure to apply this definition to all professions embodies both a prejudice against the accounting profession in the law and leaves scope for some professions to engage in less than appropriate governance behavior. Legislative paranoia of a similar scale should follow other professionals into the boardroom rather than just those accountants that happen to be comfortable with the concept of serving on the board of a former client.

Audit firm rotation

Caution needs to accompany the requirements to have the rotation of auditors apply for five years across the board. Accounting firms in the regional areas of this country will have trouble in some circumstances having the number of audit professionals required to ensure rotation between audit partners can take place. Small firms with two or three partners, for example, will find it difficult to deal with such a rotation regime. In those circumstances the audit may well have to shift to another accounting practice every few years in order to meet the conditions of rotation. One of the unintended consequences of this legislation is the fact it may well cause audit firm rotation in the regional parts of Australia because smaller accounting firms will be unable to both meet the objectives of the legislation as well as maintain their audit client base. It could also be argued, however, that this situation is beneficial because the firms will be getting each other's clients over a period of time so the situation remains balanced. It is important for the committee to look carefully at the proposals in order to ensure there are no unintended consequences in this area. While rotation is possible, though still a major task to coordinate, in larger firms such as those making up the Big Four it can be an onerous undertaking for those in smaller scale practices.

Along with the issues I have raised above there is a schedule of some amendments I have sought to comment on in some more detail. Some of the issues may have been raised above, but as a result of time being somewhat cruel I have been unable to spend time deleting any duplication. Please advise the committee I am willing to come before it and present on any of the matters raised in this submission. I intend to send supplementary notes in case there are matters I see as being significant that I have previously failed to identify as being significant.

Kindest Regards

Tom Ravlic