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13 November 2003

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

Dear Dr Dermody

CLERP (Audit Reform & Corporate Disclosure) Bill

We welcome the opportunity to provide our comments on the provisions contained in the CLERP 9 Bill as detailed below.

Pitcher Partners is a large accounting firm comprising three independent partnerships with approximately 44 partners and 550 staff. Pitcher Partners provides accounting, audit and advisory services to medium and large *Australian* based (ie. local) businesses (including smaller listed entities). Our comments predominantly reflect issues arising in implementing the proposed legislation on entities in this segment of the market place, in contrast to those primarily concerned with capital markets.

Summary of Issues

1. Confidence in financial reporting

We acknowledge that confidence in financial reporting has been severely shaken and that the Government must be seen to take action to restore belief in the regulatory system. However we have serious concerns as to whether it is possible to effectively control behaviour through structured relationships. For example, auditor independence is a state of mind that extends beyond any legal restrictions, and which cannot be assumed to be present within "approved" relationship structures. Similarly, the integrity of financial information depends not only on the financial reporting expertise, but an openness and commitment to transparency to convey intent. This also cannot be assumed simply because a board is structured a certain away or because the entity complies with certain accounting standards.

Overall we do not believe that the existing system is deficient. Corporate failures have arisen through a lack of integrity of certain individuals and their personal endeavours to manipulate outcomes. Misconduct by individuals will not be completely remedied through regulatory reforms. This is an important factor that must be understood prior to any future corporate scandals.

To provide early warning of corporate collapses the whole area of corporate governance needs to be considered. This includes consideration of the skills and ability of directors to identify business risks, establish management policies, and to respond to accountability relationships, in addition to their financial reporting responsibilities. Many of these issues are beyond the scope of a statutory financial statement audit. Given that corporate governance must be set in context, these issues should not be subject to a one-size-fits-all legislative response. The ASX Corporate Governance Council has already addressed corporate governance issues relating to listed companies. However, there is no equivalent body to consider corporate governance relating to other segments of the marketplace. There are also significant issues concerning the durability and scope of the financial reporting

2. Regulation and corporate governance regarding large proprietary companies

- We are disappointed to note that the proposed legislation does not attempt to address issues relating to the regulation of large proprietary companies. We have encountered a wide but popular miscomprehension that the regulation of proprietary companies is concerned with the regulation of SMEs. However, SMEs are not bound by legislative reporting requirements except in specific situations and are not the subject of our concern. Our concerns relate to *large* proprietary companies as defined in the Corporations Act 2001.
- The financial reporting regime is undergoing significant changes at this time in response to a global objective to improve corporate governance and accountability relationships. These reforms are generally appropriate and justifiable for those entities that operate in capital markets, which are accountable to investors for the way in which their funds are utilised.
- The corporate governance environment relating to proprietary companies is very different to the corporate governance environment in capital markets. Corporate governance issues relating to proprietary companies have not been fully researched and proposed reforms have not considered the issues arising in this segment of the marketplace separately. As a consequence, large proprietary companies become caught up in the regulation of large publicly listed entities and are burdened with onerous inappropriate reporting requirements. Research into these issues is urgently required.
- For example, it is our observation that the audit of proprietary companies is clearly beneficial to these entities, whereas preparation of lengthy disclosure notes to the financial statements has little relevance. Under the existing Corporations Act 2001 the preparation of a one-size-fits-all financial report is directly related to the audit requirement. We do not believe that this correlation produces the most beneficial results for the Australian economy.

- Although certain provisions in the CLERP 9 Bill relate only to listed entities, there are many others that apply to large proprietary companies by default, rather than as a true response to a consideration of the relevant issues.
- Large proprietary companies are a source of wealth to the Australian economy and have an important role in promoting entrepreneurial activity. Until these entities enter the public domain to seek external funding and become accountable to external investors, many of the accountability requirements imposed on their operations are superfluous to the actual accountability relationships that exist. Unfortunately these entities typically do not have the resources and expertise to lobby governments and regulators regarding their needs. The Government has a duty of care to ensure that this segment of the marketplace is not disadvantaged.
- The Government has not yet responded to the Parliamentary Joint Statutory Committee on Corporations and Securities "Report on Aspects of the Regulation of Proprietary Companies" issued in March 2001. Pitcher Partners would be willing to work with the Government to address the issues arising.

3. Expert Panels, Committees, Supervisory Bodies etc

As a general observation the number of "expert" bodies for direction, oversight, resolution etc continues to increase. These bodies include the FRC, AASB, AUASB, CALDB, and the FRP. Given that the market for high level technical expertise is not expansive in Australia, and considering conflict of interest issues arising with the Big 4 professional accounting firms, we consider that the ability to continue to replace members of these bodies with persons having suitable expertise is doubtful. In theory, the structures seem reasonable, whereas in practice we wonder whether they are workable.

4. Audit Oversight

Section 225(2)(A) and (B)

- We generally support oversight of the AuASB by the FRC, subject to the FRC having sufficient expertise to understand the audit process and recognise "expectation gap" issues. In the absence of appropriate expertise, there is a risk that oversight by the FRC will exasperate unrealistic expectations of auditors.

Section 227B(1)

- Auditing standards already carry the force of law under Common Law. In the event of litigation against auditors the courts have consistently referred to auditing standards to determine the appropriate standard of care required. It is difficult to perceive any *actual* change to practice as a consequence of this legislative change. However, while the *substance* of these auditing standards may not require amendment, there is a need for extensive changes to the use of language in these documents to re-format auditing standards as statutory instruments. This is a significant and time-consuming exercise and we question whether this is the best use of the resources available to the AuASB at this time.

AUS 210 "The Auditor's Responsibility to Consider Fraud and Error in an Audit of a Financial Report"

The auditor's consideration of fraud is a significant component of the "expectation gap"[1] and this auditing standard is open to misinterpretation by those with insufficient knowledge of the audit process.

- We have particular concerns regarding application of this standard under the force of law together with its interrelationship with auditor duties under both the existing and proposed section 311. There is a risk that ASIC may view some of the auditor's preliminary assessments as matters requiring reporting to ASIC under section 311 duties. In practical terms, this outcome is not workable as it is likely to divert attention away from the client's situation to a preoccupation with the work of the regulator. Further discussion of our concerns regarding expansion of auditor's duties under the proposed amendments to section 311 is provided below.

Section 307B

- We welcome the introduction of a seven year rule for the retention of audit working papers, to provide closure on auditor responsibilities after a reasonable passing of time.

5. Qualifications of Auditors

Section 1287A

- We question the need to provide annual statements to ASIC and support retention of tri-annual declarations as currently required.

6. Auditor appointment, independence and rotation requirements.

Section 307C

- Although we have no concerns in principal regarding annual auditor independence declarations, we do not consider that they are necessary for the audits of proprietary companies where there is a far higher level of transparency in relationships between auditors, directors and shareholders. Having regard to the corporate governance issues relevant to proprietary companies, this becomes an unnecessary administrative requirement, which is not justified.

Section 9 definition of "plays a significant role" and section 324AF "Lead and review auditors"

- These terms are important in the consideration of auditor independence issues. Although these terms are defined in the legislation they are presented here out of

[1] Being the difference between what stakeholders may expect from an audit and what the auditor is actually able to deliver within the terms of the engagement. External parties sometimes expect forensic examinations, which are not ordinarily part of the audit process.

context and their intended meaning is further confused as they are not defined or discussed in auditing standards.

- Depending on the size, nature and complexity of a client entity the role of a so-called "review auditor" can vary significantly. Traditionally the legal use of the term "auditor" has referred to the person who signs the audit report (usually a partner or sole practitioner). A common interpretation of "review auditor" would be in reference to the second partner assigned to the audit.
- However, even with listed company audits the role of the review (or second) partner can range from close involvement in the risk assessment process, review of working papers and attendance at meetings with the client etc, to minimal involvement limited to a technical review of the financial report. In some circumstances there may not be a second partner carrying out the role of review auditor. A technical review is concerned only with legislative and regulative compliance in the financial report not review of the audit per se.
- When a person carries out only a "technical review" as a "review auditor" there is no justification for rotating that auditor off the audit, as there is minimal contact with the client or audit issues.
- In order to fulfil the intent of the proposed legislation, as a practice we would need to clearly define these differing roles to identify where a second partner must rotate off the audit as a review auditor. The lack of clarity in the drafting could lead to each firm arriving at their own interpretation of the requirements. It would be preferable for the legislation to use terms already defined in auditing standards where the common meaning is already widely accepted.

Section 324DA

- We do not believe that it is beneficial to require both the lead and review auditors to rotate off the audit after 5 years. In practice the lead auditor often moves from that position to the role of review auditor. Knowledge of the business and the client situation is critical to an appropriate assessment of matters arising from an audit and therefore the continuing involvement of one senior auditor enhances audit quality.
- In the event of litigation against an audit firm, charges and disciplinary action are held against the engagement partner (the lead auditor) and not the review auditor. Therefore it is the lead auditor that carries the audit risk and perhaps the incentive to compromise independence (although this has not been proven). This factor also supports the rotation of only the lead auditor.
- We are also concerned that while this requirement arises as a consequence of the HIH recommendations there are a limited number of specialist auditors that operate in industries such as banking or insurance. Therefore, it is more likely that ASIC will need to grant concessions to auditors in these "high risk" industries. This means that the target of this proposed change will be relatively unaffected by its implementation while other entities take the additional cost of rotation.

Section 324CG and 324CH

These sections are onerous and not workable in practice for the following reasons:

- A waiting period of 4 years for members of the audit team is unduly onerous. A two-year waiting period for the lead and review auditor would be onerous but acceptable.
- When a person has not been involved in the audit there is no justification for imposing any waiting period before that person can become an officer of the audited body.
- This transfer of intellectual capital is beneficial to economic growth and necessary in a small market, such as Australia, where there are limited available resources. We are concerned that legislative requirements that hinder this free transfer of intellectual capital within Australia will lead to companies seeking high-ranking officers from overseas. We question whether this outcome would be beneficial to the Australian market.
- Through normal market practice for executive recruitment, senior personnel in audit firms may join client entities in high level positions. For example, under the proposed rules an HR partner leaving an audit firm would not be able to take up a similar position in an entity that was audited by that same audit firm. This restriction would apply even though as HR partner that person would not have been able to influence the audit, and as an officer of the entity would also not be able to influence the audit. This restriction could be detrimental for recruitment for executive positions.
- There is a difference between an entity being a firm audit client and a client of the member of the audit firm. Depending on the area of expertise of the audit partner, in the former scenario the partner may have no contact or knowledge of the audit client beyond that available in the public domain. In contrast, in the latter situation where a partner takes responsibility for the audit of that entity, the potential for a conflict of interest does exist and is possibly addressed through imposition of a waiting period.
- The four-year waiting period imposed on professional members of the audit team will have an adverse impact on recruitment of graduates entering and remaining in the auditing profession. Audit is often seen as a stepping stone to another career path. To prevent a free flow in employment opportunities will be detrimental to the profession.
- There are sufficient provisions in place that already address board responsibilities and auditor independence without the enforcement of long waiting periods before joining a client entity.

Auditor independence tables

- We have not had sufficient time to review these tables in detail. However our preliminary observations are that the auditor independence requirements in Division 3 lack clarity, which detracts from the substance of the legislation and its operability. Independence as a state of mind, is not captured by the prescriptive

descriptions of relationships. The tables and listings are not immediately useable but require deciphering to uncover the intent behind the structure.

- For example consider section 324CD

  An audit firm contravenes this subsection if the audit firm engages in audit activity at a particular time and the relevant item of the table in subsection 324CF(1) applies to a person specified in the table below.

  Considering item 4 from that table relating to a professional member of the audit team conducting the audit of the audited body. All sections of the table in subsection 324CF(1) apply except items 7, 13 and 14.

  This means that a professional member of the audit team:

  - *Is able* to provide remuneration to an officer or audit-critical employee of the audited body for acting as consultant to that professional member (item 7),
  - *Is able* to have an asset that is a material investment in an entity that has a controlling interest in the audited body (item 13) and
  - *Is able* to have a material beneficial interest in an investment in an entity that has a controlling interest in the audited body.

  In our opinion there are likely to be conflicts of interest in these situations that need to be investigated to determine whether an independence problem exists.

7. Expansion of auditors' duties

Section 311

- The changes to this section are the greatest cause of concern in the proposed legislation. Pitcher Partners and representatives from the profession and the AuASB have conferred with ASIC over the past 2-3 years regarding the operability of the current drafting of this section and to seek clarification. We had anticipated clarification in the redrafting, however the proposed changes create more difficulties.
- The seven day time-line to report suspected breaches is not workable. Seven days is an inadequate period to fully diagnose an issue and to consider how it has or will be addressed. Many accounting and auditing issues are based on application of principles to the specific context using professional judgment. For more complex issues there is often a need to carry out further research, and/or to consult with colleagues or experts, before agreeing on a final position. These processes will rarely be completed within a seven day period.
- The alternative action of reporting all *suspected* breaches without carrying out adequate investigations first, calls into question the professional standing of a person that is later proved to have reported inappropriately and secondly, will damage on-going audit-client relationships. "Wrong calls" will not only waste ASIC resources to investigate, but will build barriers in audit-client relationships.
- Given that accounting and auditing issues are based on application of principles to the specific context using professional judgment, almost any discussion with the client where there are different view points, could be deemed as attempts to

unduly influence, coerce, manipulate or mislead the auditor. If an issue arises, at what stage in the discussions can the auditor form a view that there is undue influence rather than informed discussion? It is unlikely that this view could be formed before all available evidence had been examined, which is likely to extend beyond a seven day period.

- We have serious concerns regarding the allocation of responsibility for reporting being extended beyond the lead auditor. During the course of an audit numerous judgments are made and overturned as new audit evidence is uncovered, and as part of the review process. It is inappropriate to intrude at an early point in the process to require reporting to ASIC.
- There is no suggestion that materiality or seriousness of a breach should be considered before reporting to ASIC. There is no provision for allowing the entity to correct an inadvertent breach, or for issues that can be dealt with by the directors, or in the financial report or audit report. The lack of boundaries will impact on the ability of auditors to notify all breaches, and for ASIC to take enforcement action.
- Auditors of proprietary companies will have a relatively greater awareness of any non-compliance in audit clients due to the size and nature of those entities. Due to the limited resources within these entities, in many cases proprietary companies depend on the audit firm to prompt them regarding matters of compliance with the law. For proprietary companies the audit itself is often a matter of *compliance* rather than *governance*, hence the "bundling" of these matters together. It is both impractical and non-beneficial for the auditors of proprietary companies to report breaches to ASIC rather than directing the client as to how to comply with the law. In this respect, the current drafting of section 311 is preferable.
- Further to our previous discussions with ASIC we understand that the primary objective of this section was to enable early detection of insolvent trading and going concern issues. If this is the objective, the section should be drafted more directly. In our experience with proprietary companies, going concern issues are often interrelated with the entity's ability to (re)negotiate finance, which in turn is dependent on the audit financial report. We believe that this section should:
  - retain reference to contraventions that have not been or will not be adequately dealt with by commenting on it in the auditor's report or bringing it to the attention of the directors or
  - when the audit has not been completed within two months of the due date for lodgement, the auditor should notify ASIC.

8. Financial Reporting Panel

We generally support the establishment of a Financial Reporting Panel and the scope of its activities. Our major concern is the availability of suitable members. There are relatively few financial reporting technical experts and an increasing number of committees, boards etc. The effectiveness of this Panel will depend on the ability to identify members that do not have a conflict of interest.

9. Proportionate Liability

We welcome the introduction of proportionate liability, which is long overdue.

Please contact Dianne Azoor Hughes (tel: 03 9289 9772 or dhughes@pitcher.com.au) regarding any issues arising from this submission.

Yours sincerely

Terry Benfold
PARTNER

S. Dianne Azoor Hughes
NATIONAL TECHNICAL DIRECTOR