Corporate Law Economic Reform Program No. 9

CLERP (Audit Reform & Corporate Disclosure) Bill

Submission to the Department of the Treasury

November 2003

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Introduction

CLERP9 reforms contained in the exposure draft of the Bill have, overall, arrived at a sensible balance between corporate disclosure, raising audit standards, and enhancing opportunities for shareholder engagement.

While company failures in Australia have not been of the same size as those overseas, the warning signals should not be ignored. This means reasonable controls need to be placed on the activities of a company, its management, its directors and its auditors. Stakeholders should be kept well informed through open and regular disclosure. And, stakeholders should be able to expect proper diligence from regulators and rating agencies as well as from company management, directors and auditors. There is a hierarchy of defence levels in governance that needs to operate effectively.

To guide us to good governance we need well thought through principles backed up by rules for those who veer towards the boundary of acceptable practice. CLERP9 is on the right track and will assist in keeping Australia at the forefront of ensuring a transparent, stable and vibrant business environment.

ANZ supports the general direction of the reforms contained in the Exposure Draft and offers further comment in the following submission about the practical implementation of some of the measures. In some areas, the successful adoption of the reforms will require a good working relationship between government, regulators, business, the courts and shareholders. Ensuring that the Bill enshrines a legislative framework that respects the best interests of these various stakeholders will be critical to the success of the CLERP 9 reforms.

Rules are a critical check and balance in good corporate governance. However, the first effective line of defence requires that management is capable, principled, trustworthy and well controlled. These things do not reduce the need for oversight but they do reduce the risks that it will need to be activated.

In its most basic sense, the foundation for avoiding large-scale problems inside companies is a strong, open culture and a value system that encourages inquiry. That responsibility rests with every company management.

1. Audit reform

1.1 Audit standards

ANZ supports the general direction of CLERP 9 reforms in relation to audit functions and in particular, supports legal backing for audit standards, the expansion of responsibilities for the Financial Reporting Council and the reconstitution of the AuASB. ANZ acknowledges Australia's move to adopt audit standards issued by the International Auditing and Assurance Standards Board (IAASB).

1.2 Financial Reporting Council

ANZ supports the expansion of the responsibilities of the Financial Reporting Council (FRC) and the reconstitution of the Auditing & Assurance Standards Board (AuASB). However, the expanded responsibilities of the FRC will require the membership of the FRC to be reviewed to ensure that it can effectively perform its expanded role. FRC members should be appointed based on merit rather than representing particular sectional interests. The expanded responsibilities of the FRC will also require that the FRC be provided with substantial additional resources. The funding arrangements for the FRC going forward need to be resolved as a matter of priority.

1.3 Qualifications of auditors

Although the Bill seeks comments on whether an hours-based practical audit experience requirement should be adopted over the more general years-based requirement currently set out in the regulations, we consider that neither "time-based" test (i.e. hours or years) to be a satisfactory basis on which to accept an application by an accountant for registration as a company auditor. Rather, we consider that the practical experience requirement for registration as a company auditor should be based solely on a competency based standard. A competency based standard, approved by ASIC, would provide greater comfort that a person seeking registration as a company auditor has the required competencies to discharge that role. By contrast, an accountant who satisfies the minimum number of hours or years may nevertheless lack the competencies required of a company auditor.

1.4 Auditor independence and rotation

ANZ supports the Bill's general thrust in relation to auditor appointment, independence and rotation requirements. With regard to its practical implementation we offer the following comments.

Conflict of interest

Section 324CA provides that an individual auditor, audit firm or audit company contravenes the general requirement for auditor independence where "a conflict of interest situation exists in relation to the audited body at that time". For the purposes of section 324CA, a conflict of interest situation arises where circumstances exist that impair or "might impair" the ability of the auditor or a professional member of the audit team to exercise objective and impartial judgment (alternatively, a conflict of

interest situation arises where in essence a fair-minded person would have reasonable grounds for concern that the ability of the auditor to exercise objective and impartial judgment is impaired or "might be" impaired). We consider that a test expressed in terms of "might" is too low a threshold at which to fairly and objectively determine audit independence. For example, some may argue that the provision of any non-audit service "might" impair audit independence. We prefer that the general requirement for auditor independence be stated in terms of a higher threshold such as "would" or "materially" give rise to a conflict of interest situation.

Rotation

ANZ supports mandatory auditor rotation after five consecutive years with a two-year cooling off period before a person who has played a "significant role" in the audit can be reassigned to that audited body. Further, we are pleased to see that the draft Bill has included a process whereby ASIC will be given a power to provide relief for smaller audit firms and those operating in rural and regional areas, allowing up to a seven year rotation.

Employment and financial relationships (waiting periods)

The Bill also contains a number of restrictions on specific employment and financial relationships between auditors and their clients. While supporting the underlying principles in the draft Bill, auditor independence can be maintained with shorter waiting periods and other less restrictive requirements, for example:

- A two-year waiting period would be sufficient before partners of an audit firm or directors of an audit company directly involved in the audit of the audited body could join the audited body as an officer
- No waiting period should be required before partners of an audit firm or directors of an audit client not directly involved in the audit of the audited body can become officers of the audited body. Similarly, a four-year waiting period is unnecessarily long before a professional member of an audit team can become an officer of the audited body. We would suggest a two-year period would be sufficient to achieve the reform's objective.
- Although only intended to operate prospectively, we do not support the prohibition on any more than one former partner of an audit firm, at any time, being a director of or taking a senior management position with the audited body.

In a practical sense, the Bill may benefit from a review of several of the restrictions. For example:

- The specific auditor independence rules are contravened where the immediate family member of a professional member of the audit team "has an asset that is an investment in the audited body" or "has an asset that is a beneficial interest in an investment in the audited body and has control over the asset" (section 324CF(1)). In practice, an auditor or audit firm may not have the means of knowing whether the immediate family member of an audit team member has an investment or beneficial interest in the audited body.
- A person who is a former member of the audit firm and is now an officer of the audited body or an "audit-critical" employee of the audited body contravenes the independence requirements where the person has rights against the firm, or the members of the firm, in relation to the person's former partnership interest in the firm. In practice, former audit partners may have interests in relation to their

former firm in relation to indemnity arrangements. This would seem to contravene the independence requirements.

Independence

We acknowledge that the Bill has developed requirements for auditors to meet a general standard of independence with reference to the recommendations of the HIH Royal Commission. We support auditors being required to provide directors with a declaration that they have complied with the auditor independence requirements in the law and relevant professional codes of conduct.

1.5 Non-audit services

We understand the potential for conflicts of interest, or even the perception of conflicts of interest, when an audit company also undertakes non-audit work for the companies it audits.

In April 2002 the ANZ Board announced measures to enhance ANZ's corporate governance procedures following a review of best practice by the ANZ Audit Committee.

ANZ's Audit Policy details clear definitions as to which services may or may not be provided by ANZ's auditor. These fall into three categories:

- The auditing firm may provide audit and audit-related services that, while outside the scope of the statutory audit, are consistent with the role of auditor.
- The auditing firm should not provide services that are perceived to be materially in conflict with the role of auditor.
- The auditing firm may be permitted to provide non-audit services that are not perceived to be materially in conflict with the role of auditor, subject to the approval of the ANZ Audit Committee.

The Audit policy on non-audit services sets in place a formal approval process regarding the provision of non-audit services, which are only considered where they are not perceived to be in conflict with the role of auditor. We can see no reason for an outright ban on the provision of non-audit services where a company adopts a comprehensive and transparently reported policy.

ANZ already discloses in its Annual Report types of non-audit services that are provided and has strict policies around the provision of non-audit services, requiring auditor independence.

ANZ therefore supports the provisions in the Bill relating to non-audit services and in particular those that will require:

- the board of directors of a listed company to provide a statement in the annual report that identifies all non-audit services provided by the audit firm and the fees applicable to each item of non-audit service;
- the report to include a statement by the directors that they are satisfied that the provision of non-audit services is compatible with the general standard of independence and an explanation of why those non-audit services do not compromise audit independence; and

- this statement to be made in accordance with advice provided by the audit committee, where a company has one.

1.6 Registration of authorised audit companies

ANZ supports proposals to allow auditors to incorporate. Incorporation of audit companies, together with other proposals in the Bill such as proportionate liability, constitute an important range of measures designed to address the current professional indemnity crisis in the profession.

Consideration could also be given to permitting incorporation through means other than a corporate structure. For example, in the United Kingdom and the United States, limited liability partnerships are accepted. Limited liability partnerships can combine the best features of partnerships (e.g. partnership culture) and companies (limited liability).

Proposed section 1299D provides that the company's registration as an authorised audit company is subject to "any other conditions or restrictions determined by ASIC". Furthermore, ASIC may determine such conditions or restrictions either at the time when the company is registered as an authorised audit company or subsequently. It is considered that this places significant discretion with ASIC. We recommend that the Bill further specify the nature of conditions or restrictions that may be imposed by ASIC. Alternatively, the Bill may encourage ASIC to develop policy guidelines as soon as possible after the enactment of the Bill setting out in further detail how it intends to exercise its powers under this section.

1.7 Auditors and AGMs

ANZ's auditor normally attends the AGM. We support inclusions in the Bill that would require company auditors (or their representative) to attend the AGM as well as facilitating shareholder participation by allowing them to ask questions of the company auditor about the contents of the audit report or the conduct of the audit, in writing before the AGM as well as orally at the AGM.

It is sensible that the auditor will be able to filter questions on the basis of the relevance to the audit report and to exclude those questions that are the same in substance as other questions. It is also feasible to require companies to make the list of questions provided by the auditor available to members attending the AGM.

It is also sensible that auditors have discretion about whether, how and where they answer questions, as is allowing the company discretion on how it makes available the list of questions provided by the auditor.

Qualified privilege is essential to cover auditors and their representatives in relation to answering questions at the AGM. ANZ supports the Bill extending the qualified privilege provision from individual auditors to registered company auditors acting on behalf of audit companies. This will further support auditor responsiveness to shareholder questions.

1.8 Reporting contraventions to ASIC

We do not support aspects of the proposed expansion of auditors' duties in relation to reporting contraventions of the Corporations Act.

The Bill proposes that if the auditor has reasonable grounds to suspect a contravention of the Corporations Act in the course of conducting an audit, the auditor must notify ASIC in writing of those circumstances no later than 7 days after the auditor becomes aware of those circumstances. The auditor is required to report to ASIC, regardless of whether the matter can be dealt with in the audit report or by bringing the matter to the attention of the directors, as is currently the case. This may result in relatively minor breaches of the Corporations Act being notified to ASIC which would otherwise have been rectified by bringing the matter to the attention of the directors and then appropriate remedial action being taken to remedy that breach. We recommend that the current provision, which allows the auditor to bring the matter to the attention of the directors, be retained.

The Bill proposes that any attempt by a person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit must also be reported in writing to ASIC no later than 7 days after the auditor becomes aware of those circumstances. In some situations, the behaviour may have occurred at a relatively junior level between the auditor and the company and can be satisfactorily resolved by bringing the matter to the attention of management or the directors. We therefore recommend that the current provision, which allows the auditor to bring the matter to the attention of the directors, be retained.

In addition, notification within 7 days may be too short a period, particularly where the auditor wishes to (for example) seek appropriate advice on the matter. We suggest that notification be permitted up to a maximum of 14 days.

2. Financial reporting

2.1 True and fair view

Whilst we support the amendments relating to ensuring that the annual financial statements and notes must provide a true and fair view, we note that the absence of a definition of "true and fair" may on occasion give rise to disagreement between reporting entities and auditors as to whether or what additional information is needed for the purpose of giving a true and fair view.

The Bill proposes that the directors will be required to include in the directors' report their reasons for forming their view that additional information is needed for the purpose of giving a true and fair view. We suggest that these reasons be provided in the same location as the true and fair information (i.e. the notes to the financial report) as this information provides the proper context to understand such reasons. The directors' report should merely state that additional information under the true and fair requirement has been provided in the financial report and where this information may be found.

2.2 CEO and CFO sign off

ANZ supports the introduction of a requirement for the Chief Executive and Chief Financial Officers of a listed entity to make a written declaration to the board of directors that the annual financial statements are in accordance with the Corporations Act and accounting standards; the statements present a true and fair view; and the financial records of the entity have been kept. To further ensure this is implemented correctly we also support the requirement that directors' must declare that they have received the declaration from the CEO and CFO when they make their declaration in respect of the entity's annual report.

However there are a number of practical issues that might also be usefully considered:

- In order to make a declaration regarding the integrity of the financial records and financial statements, we believe that the CEO and CFO should also be required to declare that they have evaluated the effectiveness of the company's internal controls and that they be required to report on their efficiency and effectiveness during the reporting period. This would be consistent with similar management certification requirements in the Sarbanes Oxley Act and in the ASX "Principles of corporate governance and best practice recommendations". Under ASX Best practice recommendation 7.2, it is recommended that the CEO and CFO declare to the Board that the financial statements are founded on a sound system of risk management and internal compliance and control which implements the Board's risk management policy, and that the risk management system is operating efficiently and effectively in all material respects.
- A practical difficulty with the proposal that the CEO and CFO make their sign off before the directors make their declaration under the Corporations Act is that the directors may make subsequent changes to the financial report which affect the basis on which the CEO/CFO made their sign off. The law should provide appropriate protections to the CEO/CFO (the latter who may not sit on the board) who make their sign off in good faith.
- Another matter is that directors of a listed company will only be required to declare that they have been given a declaration by the CEO/CFO in relation to the entity's financial statements. In the event that the declaration is materially qualified in some manner, there would appear to be no requirement that this qualification be referred to in the directors' declaration.

2.3 Content of Directors' report

We support the inclusion of an operating and financial review in the directors' report for a listed company, which provides information on the operations, financial position and business strategies, and future prospects of the company. ANZ agrees that, while such a report should be provided as best practice in corporate governance and high quality financial reporting, it is not information that readily lends itself to audit and as such should not be subject to audit. A number of issues need further consideration including:

- The Bill notes that it is expected that, in practice, the existing directors' report disclosure requirements (including the requirement that the directors' report contain a review of operations, details of any significant changes in the entity's state of affairs and the entity's principal activities and any significant change in the nature of those activities) will be addressed as part of the operating and financial review rather than being presented as a separate report. To avoid unnecessary confusion and duplication in requirements, we recommend that consideration be given to removing potential overlap between the existing Corporations Act directors' report disclosure requirements and proposed subsection 299A. For example, existing subsection 299(1)(a) requires a directors report to "contain a review of operations during the year of the entity reported on and the results of those operations" and proposed subsection 299A(1)(a) requires the directors' report of a listed public company to "contain information that members of the company would reasonably require to make an informed assessment of the operations of the entity reported on".
- Subsection 299(3) of the Corporations Act provides that the directors' report may omit material that would otherwise be included under subsection 299(1)(e) (i.e. likely developments in the entity's operations in future financial years and the expected results of those operations) if it is likely to result in unreasonable prejudice to the company or group. We recommend that subsection 299(3) be similarly extended to proposed subsection 299A(1)(c) relating to the entity's business strategies and its prospects for future financial years.

2.4 Financial Reporting Panel

ANZ supports the establishment of a Financial Reporting Panel that would adjudicate disputes on a non-binding basis between ASIC and companies on whether a company's financial statements have been prepared in accordance with the accounting standards and represent a true and fair view. This reform will provide another, less adversarial, process through which to resolve disputes. The level of expertise and breadth of experience of members of the FRP will be crucial to ensuring the credibility and effectiveness of the FRP. Further, it is important that the FRP be properly resourced. In this regard, it is unclear how the FRP will be funded and whether this will be adequate to fulfil the FRP's stated purpose. We agree that the Financial Reporting Council is the appropriate body to oversee the operation of the FRP.

It would be helpful if the role of the FRP was more clearly stated. Proposed subsection 239AD states "the Financial Reporting Panel has the functions and powers conferred on it by or under corporations legislation". It appears that the FRP will be restricted to hearing matters regarding compliance with accounting standards and the true and fair view requirement. This would therefore not seem to cover compliance with UIG Abstracts or other "financial reporting requirements".

The FRP should also have the ability to hear disputes between ASIC and companies concerning accounting treatments prior to finalisation of a company's financial report. This increases the likelihood that companies will accept the findings of the FRP and implement such findings in their financial reports.

In principle a company should be allowed to refer a matter to the FRP where there is a dispute between ASIC and the company regarding the company's application of accounting standards in its financial report. In practice, it would be expected that ASIC would refer such matters to the FRP. Indeed, unless ASIC is willing to participate in such proceedings, we see little point in providing that companies be allowed to refer matters to the FRP.

The precedent value of FRP decisions to other companies may be limited by the fact that the Panel cannot disclose in its report any confidential commercial information obtained by the Panel in the course of its consideration of the financial report. Whilst we are not advocating the public release of confidential commercial information, the application of accounting standards in a particular factual situation may require an understanding of all pertinent facts.

Pursuant to proposed subsection 323EH, a Court, or tribunal of fact, may have regard to the FRP's report in determining whether a financial report complied with the relevant financial reporting requirements. We query the extent to which a Court or tribunal of fact should have regard to a report of the FRP which does not include confidential information which was important to the FRP's determination.

3. Proportionate liability

3.1 Proportionate liability

ANZ acknowledges the work that has been done by the Commonwealth, State and Territory Ministers to develop a model of proportionate liability and that the CLERP9 Bill will implement the agreed model. On balance, we consider the proposal is fairer than the current framework in that the burden of liability for negligence is shared more fairly amongst the wrongdoers.

3.2 Capping liability

ANZ also supports capping liability. ANZ's earlier submission pointed to its desirability and since that time the Joint Committee on Public Accounts and Audit (JCPAA) supported capping liability.

Capping liability is essential if auditors are to be encouraged to go beyond the letter of the law and more fully deliver on the spirit of the law in terms of disclosure and their professional assessments.

4. Enforcement

4.1 Whistleblower protections

ANZ has adopted a Serious Complaints Policy that adopts the principles prescribed by the Sarbanes-Oxley Act and the CLERP9 proposals. We support the employee protection proposal, and are pleased to see that the Bill contains a requirement that complaints be made "in good faith". This will discourage malicious or unfounded complaints being made to ASIC as the "good faith" test to gain qualified privilege

would not be met. ANZ has advocated previously that it should be an offence to make false reports or to make a report other than in good faith and on reasonable grounds.

4.2 Disqualification of Directors

ANZ does not oppose the increased penalties related to the disqualification of Directors. The HIH Royal Commission's recommendations concerning the need to increase disqualification periods are well founded.

4.3 Civil penalty provisions

ANZ does not oppose the increase in the civil penalty provision for a body corporate from $200,000 to $1 million.

5. Remuneration of directors and executives

ANZ supports the CLERP 9 Bill's efforts to require greater transparency of remuneration policies to shareholders. We support remuneration disclosure that includes both the listed company and consolidated entity and that disclosure will be required for the five most highly remunerated senior managers, all the directors of the listed company and the top five senior managers in the consolidated entity. We note that the effect of this will be to require disclosure of the most highly remunerated 5-10 people in the entity.

Best practice disclosure demands that remuneration disclosures should be made in a clearly dedicated section of the annual directors' report. This should explain the basis on which the remuneration packages are structured and how this relates to corporate performance. There is no justification for large compensation packages that reward failure. Just as importantly, clearly defining what constitutes success is important if the corporate community is serious about its credibility amongst shareholders and the wider community. Requiring that the Annual report details the performance hurdles to which payment of options or long term incentives are subject, why such hurdles are appropriate and the methods used to determine whether performance hurdles are met are appropriately captured in the Bill.

However, we would prefer that the details of the remuneration to be disclosed be set out through accounting standards, which will have the force of law under the proposed legislation, rather than through regulations.

ANZ supports a UK-style approach to shareholder voting on remuneration. In the UK, companies are required to publish a report on directors' remuneration as part of the company's annual reporting. The report on directors' remuneration (as distinct from executive remuneration) is put to a non-binding vote of shareholders at the Annual General Meeting. The Board of a company is responsible for executive remuneration and is paid by the shareholders to discharge that duty effectively. This delineation of roles and responsibilities is not consistent with shareholders having a vote on it.

We support the Bill's provision whereby existing exemptions from the requirement to seek shareholder approval in respect of damages for breach of contract and

agreements entered into before a director agrees to hold office will no longer apply where the payments are over a certain limit.

In relation to a non-binding vote on the remuneration of directors and senior managers and on the board's policy on remuneration, as it is intended that there should be no legal consequences arising from the resolution, this should be made clear in amendments to the relevant section. The Bill should make clear that no legal consequences flow from the resolution for the company or its directors.

6. Continuous disclosure

6.1 Civil penalties

ANZ agrees that the extension of civil liability for contraventions of the continuous disclosure provisions of the Corporations Act will be a more credible deterrent than just imposing penalties on a body corporate. It is also important that the distinction has been made between those who aided, abetted, counselled or procured the contravention as opposed to those who simply pass on information produced elsewhere in the disclosing entity. The Bill quite rightly excludes this latter group from the extended reach of these provisions.

7. Disclosure rules

ANZ supports an obligation to present material in a clear and effective manner. However we have previously expressed caution about the definition of "concise". The complexity of some kinds of securities (e.g. ANZ's TrUEPrS – Trust Units Exchangeable for Preference Shares – offering) and business of some issuers can make the preparation of "concise" prospectuses difficult. This requirement could impose artificial limitations on those responsible for preparing prospectuses when considering the requirement not to mislead investors. While we note the Bill's explanatory notes indicate that the new provisions are not intended to limit the amount of information provided, reduce the quality of information, or force technical terms to be oversimplified, the "concise" requirement potentially undermines that intention. It is hoped that as this concept develops in practice that a clearer sense of what constitutes "ambiguous, vague or unclear" information develops.

8. Shareholder participation

8.1 Electronic distribution

ANZ strongly supports the facilitation and encouragement of electronic communications. The Internet is an effective channel for providing both retail investors and investors in different geographic locations with information in a timely, relatively low-cost, way. ANZ uses a variety of web-based communications including web-casting all results, AGMs and strategy briefings and posting of all material announcements on anz.com to reach smaller retail investors and larger investors located overseas. ANZ also supports the new provisions that would allow the electronic distribution of Annual Reports and notices.

8.2 Notification of directorships

ANZ supports the requirement that in respect of each director of a listed company, details of directorships of other listed companies held by the director in the three years prior must be included in the annual report.

9. Officers, senior managers and employees

We note the Bill's intention to clarify classes of personnel who have duties and responsibilities under the Act including adding the new class of 'senior manager'.

10. Management of conflict of interest by financial services licensees

The Bill introduces a specific licensing obligation for financial services licensees to have adequate arrangements for managing conflicts of interest. This will supplement the general duty to provide financial services "efficiently, honestly and fairly." ANZ agrees that this will provide a stronger legislative basis for ASIC to develop guidance and take enforcement action, while being consistent with a principles-based approach.

11. Review of CLERP reform program

The CLERP process has, and will continue, to deliver important progress in the area of corporate law. ANZ would support an in-depth analysis of the effectiveness of past and present reform. The outcome of such a review would be able to inform the future development of corporate law reform in Australia.