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10 November 2003

The General Manager
Corporations & Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600
By email: kwijeyewarden@treasury.gov.au

Dear Sir

Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Bill

Thank you for the opportunity to submit comments on the draft Bill.

The CLERP 9 draft legislation, including content resulting from the HIH Royal Commission, is of major significance to the accounting profession. Consequently, The Institute of Chartered Accountants in Australia and CPA Australia have prepared a joint response to your invitation to interested parties to respond with comments by 10 November 2003. We recognise that confidence in financial reporting needs to be restored and we have been working with industry, government and other stakeholders to achieve this. It is important that the legislative and professional response to restoring confidence be managed to ensure an outcome that is in the public interest and is beneficial to Australia's capital markets.

We have approached the four-week comment period seriously, organising an intensive clause-by-clause review of the draft legislation affecting our profession. This has involved a team of more than 30 professionals from our two accounting bodies, the six major auditing firms, and legislation advisers. We have also consulted widely with our membership in practice, commerce and government, and with some of the smaller audit practices especially in regional areas.

We undertook this major effort constructively and in good faith to assist the Government at this draft exposure stage. While we have previously presented views on the policy aspects of the CLERP 9 proposals, the recommendations contained in this submission address many points of detail and drafting, as well as ensuring wherever possible that the principles-based approach is not overtaken by unnecessarily prescriptive provisions. This applies particularly to provisions resulting from the HIH recommendations, which have not been subject to earlier dialogue or consultation. Our response includes an executive summary, followed by commentary on each provision together with drafting amendments.

We look forward to the opportunity of discussing the issues raised in our response with the appropriate Government officials.

Yours sincerely

Greg Larsen, FCPA
Chief Executive Officer
CPA Australia

Stephen Harrison, AO
Chief Executive Officer
The Institute of Chartered Accountants in Australia

c.c. The Hon. Peter Costello MP, Treasurer – mo'brien@treasury.gov.au
c.c. The Hon. Ross Cameron MP, Parliamentary Secretary to the Treasurer – ross.cameron.mp@aph.gov.au

Executive summary

The CLERP 9 draft legislation is of major consequence to Australian business and the accounting profession. The profession acknowledges that the primary purpose of this legislation is to restore confidence in financial reporting and enhance the operation of capital markets in Australia. We welcome changes to the legislation that will achieve these outcomes. The profession has therefore undertaken a major effort to provide constructive comments on areas of the draft legislation which need to be fine-tuned and enhanced in order to ensure effective and practical legislation, and also to assist its unhindered passage through the Senate.

We submit that the legislation can be improved by three aspects. First, in strongly supporting the Government's principles based approach, we have identified areas of drafting that may be unnecessarily prescriptive. Second, we have identified some unintended consequences that may lead to the legislation being unworkable in certain respects or in certain sectors. Third, in any situation of change there is a risk of undesired outcomes which will "undo" the proposed benefits. We have considered the risk aspect of the proposals and have suggested amendments to minimise those risks.

We welcome the recognition of proportionate liability

We strongly support and welcome the Government's recognition of the importance of liability reform for the future strength of the auditing profession.

We support the introduction of a Financial Reporting Panel

We welcome the introduction of a Financial Reporting Panel. The Panel should clearly be within the ambit of the Financial Reporting Council, along the lines of the AASB and AuASB. This would provide for a Minister-appointed chairman and for accountability through the Financial Reporting Council. We recommend that the legislation allow room for the Financial Reporting Panel to, at some stage, expand its activities beyond post-publication disputes. This will allow flexibility to meet the capital markets' requirements going forward.

We strongly support the Government's principles-based approach to corporate reform

We strongly support the Government's intended principles-based approach to achieve the CLERP 9 objectives of 'promoting transparency, accountability and shareholder rights'.

A principles-based approach was encouraged in the Ramsay Report, and has also been reflected in other Australian initiatives including the ASX Corporate Governance Council best practice recommendations and The Group of 100 material, such as their guidance for the Review of Operations and Financial Condition. It is also an approach adopted by, and proven effective in, many other major capital markets (as explained further in the attached submission). Such an approach provides for flexible law that takes account of changing business environments and places a clear focus on appropriate corporate behaviour.

We recommend some fine-tuning to ensure that a principles-based approach is achieved in practice

The draft legislation has as its foundation a principles-based approach to corporate reform. However, there are areas where the drafting has produced a level of prescription which is inconsistent with this approach to reform and, indeed, may be unworkable in practice.

These areas of prescription will result in Australia moving away from the principles-based approach and requirements of other major capital markets, which will in turn have an impact on the attractiveness of the Australian market to overseas investors and business, and increase the cost of capital of Australian securities:

- the rules are significantly more restrictive than in other jurisdictions, including the United States and United Kingdom, which may confuse international investors
- Australian companies will be unreasonably restricted from appointing the auditor of their choice in an already limited market place
- many individuals joining an audit firm, who have no influence on the outcome of an audit, will have restrictions placed on their investments, employment and business activities.

We note an impact on all Australian businesses, both large and small

Most of the media coverage and public debate relating to the CLERP 9 proposals has focused on the impact on large publicly listed corporations and the importance of these reforms to investor confidence. However, the draft Bill's "one size fits all" approach means that its proposals will have far-reaching effects with consequences for all Australian businesses. This approach is significantly different to the corporate law frameworks of other international jurisdictions (eg United States, United Kingdom), where size tests are used to differentiate requirements. The SME sector is the largest employer in Australia and the additional burden these proposals will place on that sector will have a flow-on effect on the economy as a whole.

In particular the draft CLERP 9 provisions do not differentiate with regard to:

- 'cooling off' periods (applicable to all companies other than small proprietary companies)
- auditor rotation (applicable to all listed companies regardless of size)
- expansion of auditor duties (Section 311 – applies to all audits).

As currently drafted, there is a risk that the provisions will have a significant impact on the SME sector. Auditors in regional and rural areas in particular, who act for incorporated entities of significance to their local communities (such as clubs and charities), have indicated that due to the difficulties that will be imposed on them by the current draft Bill, they will seriously consider withdrawing from auditing. Our proposed amendments recommend specific drafting changes, which will limit the unintended adverse impacts on the SME sector.

Risk management assessment

We submit that there are a number of areas of the draft legislation that should be reconsidered based on the risk of undesired outcomes. An example is the legislative backing for auditing standards achieved by way of disallowable instruments, which may adversely affect the ability of Australia to converge with international standards and consequently be out of step with other significant capital markets.

Specific examples of areas for amendment

• General definition of auditor independence

The independence of the external auditor is at the core of the accounting profession's rules and requirements and we support a general definition of auditor independence. We suggest it would be best if such a definition were consistent with international best practice, as is the case with the profession's current standard. As currently drafted, the draft Bill will mean that any circumstance which may impair judgement to a minimal degree could result in the company losing its auditor. It is arguable that the existence of a remuneration relationship between the company and auditor for the audit work would fall into this legal definition.

To ensure the achievement of the Government's principle that actual and perceived impairment is dealt with within the general definition, we propose amending the provision to cover circumstances that "significantly impair, or are likely to significantly impair, the ability of the auditor … to exercise objective and impartial judgement …". This matter is discussed in detail on pages 41 to 44 in the attached submission.

- **Auditors' reporting responsibilities** (pages 86 to 90 in the attached submission)

An appropriate working relationship between the auditor and senior management is vital to an effective audit. Such a relationship needs to ensure management is open and frank with auditors. Laws which unintentionally cast the auditor solely as a 'compliance policeman', such as the draft provision for every breach of law to be reported to ASIC within 7 days (which leaves little or no time for investigation), whether or not it has been dealt with properly by the board of directors, will impact on such a working relationship. The draft provision unintentionally reverses the principle of encouraging management to be open with auditors.

We recommend an amendment to the draft provision to ensure that the principle is not lost and that reporting responsibilities will be effective. This amendment requires the auditor to report to ASIC if the auditor believes that the conduct giving rise to the circumstances "has not been adequately dealt with after bringing it to the attention of the directors".

We recommend this report be made "within a reasonable time" after the auditor becomes aware of the circumstances. This ensures that the board of directors' fundamental duty to govern the company is followed, but allows for direct reporting by the auditor should the directors not fulfil their duty in this regard. It also ensures that the auditor's report is as timely as possible and not bound by an arbitrary, and in certain circumstances unachievable, period of time. For example a straightforward contravention not dealt with appropriately by the directors, or an attempt to interfere in the proper conduct of the audit, could be reported immediately by the auditor, whereas a circumstance requiring more investigation would be promptly followed through and reported as soon as the circumstances were clear (which may take a few more days).

- **Multiple former audit firm partners at a company** (pages 66 and 67 in the attached submission)

There appears to be a general concern about a large number of former audit firm partners at one company. The provision as currently drafted would cause serious issues for Australian businesses which, understandably, use audit firms as a pool to recruit deeply knowledgeable, financially experienced staff. If a company wishes to recruit such a person, it would have to change auditor (which might be difficult if it recruits staff from a range of audit firms), or require the incumbent director or employee to resign. In addition, as the provision covers the company and its subsidiaries, the restriction would extend worldwide. This would force resignations if there were, for example, a former partner from the audit firm on the board of an Australian multinational company and a former partner in an officer role in one of a multitude of overseas subsidiaries.

We believe that this proposal is impractical. We recommend that it be deleted and the general definition of independence be used to cover concerns about this issue. For example, three ex-audit partners on a board of four people of a small listed company could be a circumstance which "would give a person, with full knowledge of the facts and circumstances, reasonable grounds to conclude that the ability of the auditor ... to exercise objective and impartial judgement in relation to the conduct of [the] audit is, or is likely to be, significantly impaired". Hence this position would be subject to section 324CB of the revised Corporations Act.

- **Immediate family member** (pages 48 and 49 in the attached submission)

The draft provisions extend the definition of "immediate family member" to a wider range of individuals than in other countries. The result of this is that financial and employment restrictions will apply to a large number of individuals with no impact on the conduct of the audit and over whom the audit firm have little, or no, influence. This is unworkable in practice and has little value in protecting auditor independence. We recommend, therefore, replacing the definition of immediate family member with that adopted in overseas capital markets, that is spouse and dependants.

- **Cooling off periods prior to joining an audit client** (pages 63 to 69 in the attached submission)

The draft provision requires a four-year "cooling off" period for all members of the audit team going to any management role at the audit client, which includes the worldwide corporate group. A junior accountant may leave the audit firm, go overseas and three years later join a small subsidiary of the audit client as an officer of the subsidiary. The provision as drafted would mean the audit firm in Australia would not be independent despite the fact that this circumstance would not have any impact on the ability of the partner in Australia exercising objective and impartial judgement. This fact is reflected by the stance taken in other recent major capital markets reforms where the maximum period is two years and the restrictions relate to audit partners only.

Therefore, to ensure this provision is workable, we propose that the cooling-off period be two years for the partners and key senior members of the audit team.

- **Auditing standards** (pages 15 to 23 in the attached submission)

As we have stated in previous papers, we do not believe it is necessary to give auditing standards the force of law through the introduction of disallowable instruments. If this is the route to be taken in the final legislation, the provisions need to be amended to ensure it will be workable. Auditing standards are in a state of transition due to international harmonisation and clarification of the frameworks within which they are developed. We agree that there needs to be a two-year transitional period to work through the technical issues of making the standards legal instruments. It is inequitable to give standards legal force prior to this work being undertaken. Hence legal force should come into effect only once the standards are robust in law, that is for financial periods commencing after the two-year transitional period.

- **Auditor rotation** (pages 74 and 75 in the attached submission)

The rotation of lead and review audit partners for listed entities is an approach that has been adopted by the profession for some time. However, including a specific period in legislation for all listed companies regardless of size or circumstance introduces a level of prescription which will be difficult for companies and auditors to meet in lesser-populated areas. We recommend that the provision be slightly amended to restrict the five-year rotation period for review partners to those companies in the ASX All Ordinaries Index – recognised by the ASX Corporate Governance Council as having a higher level of resource available to them.

The remainder of our submission covers the commentary and recommendations arising from our clause-by-clause review of the draft legislation. We believe that the submission supports the fact that we have worked diligently and transparently to consider all aspects of the Bill. We are committed to achieving the desired outcomes of restoring confidence in financial reporting and enhancing the capital market. We will continue to work with Government officials to ensure the introduction of quality legislation to this end.