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Dr Kathleen Dermody
Secretary
Parliamentary Joint Committee on
Corporations and Financial Services
Suite SG.64, Parliament House
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By email: corporations.joint@aph.gov.au

Dear Dr Dermody

Exposure Draft - CLERP (Audit Reform & Corporate Disclosure) Bill

CPA Australia welcomes the opportunity to make this submission to the Parliamentary Joint Committee on Corporations and Financial Services.

The CLERP 9 draft legislation, including content resulting from the HIH Royal Commission, is of major significance to the accounting profession. As a result, CPA Australia and The Institute of Chartered Accountants in Australia lodged a joint submission with the Treasury on 10 November 2003 (see attached). The following submission by CPA Australia builds on this submission to Treasury highlighting the areas of most significance to our diverse membership.

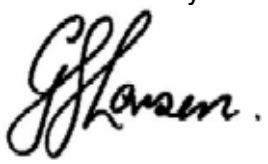
These areas include:
- Expansion of the FRC's powers.
- Force of law for auditing standards.
- Risk management assessment of the impact of the legislation.

CPA Australia recognises that confidence in financial reporting needs to be restored. Throughout the policy and legislative development of CLERP 9, we have been working closely with industry, government and other stakeholders to achieve this. It is important that the legislative and professional response to restoring confidence is astutely managed to ensure an outcome that is in the public interest and beneficial to Australia's capital markets.

The accounting profession has undertaken a significant effort to make submissions to the Treasury and the Parliamentary Joint Committee and this has been done constructively and in good faith to assist at this draft exposure stage. This applies particularly to provisions resulting from the HIH recommendations, which have not been subject to earlier dialogue or consultation.

We look forward to the opportunity of discussing the issues raised in our submission.

Yours sincerely



Greg Larsen, FCPA
Chief Executive
CPA Australia

EXECUTIVE SUMMARY

Introduction

CPA Australia represents more than 100,000 finance, accounting and business professionals, and is Australia's largest professional association and the world's sixth largest finance and accounting professional association.

More than 40,000 members of CPA Australia are in commerce, across large business and SMEs. Additionally approximately 20,000 members are in public practice, 10,000 in the public sector and government enterprises, 3,000 in academia, and 2,000 are employed in the not-for-profit sector. In addition CPA Australia's members are represented at all levels of business, with nearly 20,000 members in board and senior management roles.

CPA Australia draws on this substantial pool of knowledge and experience in developing its response to issues impacting on the finance, accounting and business environment.

The CLERP 9 draft legislation is of major consequence to Australian business and the accounting profession. The profession recognises that the primary purpose of this legislation is to restore confidence in financial reporting and enhance the operation of capital markets in Australia. CPA Australia welcomes changes to the legislation that will achieve these outcomes.

Commentary and recommendations

CPA Australia believes the legislation as currently drafted can be improved

We submit that the legislation as currently drafted can be improved by three aspects. First, in strongly supporting the 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.

CPA Australia welcome liability reforms

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

CPA Australia supports the introduction of the 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.

CPA Australia strongly supports a principles-based approach

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's 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. Such an approach provides for flexible law that takes account of changing business environments and places a clear focus on appropriate corporate behaviour.

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.

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 areas for amendment

- **Oversight Powers of FRC**

We recognise the concerns raised by the FRC in relation to the need for clarification of their powers under the new legislation. Further we note that in some instances the powers of FRC and ASIC are duplicated. We believe that this area should be reworked to ensure that there is clarification of the roles of both bodies within the framework for it to be effective and not lead to confusion of constituents of the financial reporting framework.

- **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 …".

- **Auditors' reporting responsibilities**

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**

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**

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**

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**

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**

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.

- **ASICs Powers in relation to continuous disclosure infringement notices**

Under the current drafting there is provision for the company to argue its case in a private hearing with ASIC however we note with concern that there are no rules surrounding the private hearing arrangements. The concern arises if these new powers are used as the ACCC originally used its Section 155 powers and set up a star chamber where people were questioned for 6 - 8 hours with no let up, toilet stops or coffee then there is significant reason for concern and no legal advisor present. As currently drafted the information gained in the private hearings can be used elsewhere as evidence of legislative breaches and to this end legal advice is vital to the person subject to the hearing process.

An entity faced with an infringement notice has something of a dilemma. Whether or not it agrees that there is an argument that it has failed to meet its continuous disclosure obligations, it may be inclined to comply with the notice so as to avoid the prospect of ASIC litigation and the accompanying distractions, expense and media scrutiny and potential for far greater pecuniary liability. By complying with the notice, however, an entity may guarantee itself unwanted attention. Despite the strict publicity restrictions of the draft CLERP 9 Bill and, in particular, the provisions stating that compliance is not an admission of liability, there is a risk that the market will take the opposite view. This could have serious implications for the entity's reputation.

Compliance with an infringement notice will only mean that the entity is protected from proceedings for a civil penalty and from criminal proceedings. Other actions are still available. In particular, third parties will be able to sue for compensation. Of course, those parties will still need to prove their case, but the action may never have arisen had it not been for the ASIC notice.

Refusing compliance, on the other hand, does not mean an entity will be protected from the publicity restrictions which regulate ASIC in publicising details of an infringement notice and an entity's compliance with it (although it is notable that the draft legislation does not attach any specific consequences where ASIC fails to observe the restrictions). ASIC will be free to continue its existing practice of issuing media releases when it commences or concludes a continuous disclosure investigation or launches proceedings.

A further concern is the issue of "personal liability'". Under the new proposals anyone from Directors, staff, external consultants could be found liable for the failure to disclose the information. We believe this is an unintended consequence of the current drafting particularly in relation to parties who have no control over the disclosure. The new arrangements should at least be tempered by a due diligence defence to provide some protection to parties who follow procedures and act honestly and reasonably in reaching their decision.

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