The Institute of Chartered Accountants in Australia

17 November 2003

The Secretary
Parliamentary Joint Committee on Corporations and Financial Services,
Parliament House
Canberra. ACT 2600
Email: corporations.joint@aph.gov.au

Dear Sir,

Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Bill ('CLERP 9')

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to contribute to the Parliamentary Joint Committee on Corporations and Financial Services PJCCFS) 'Review of CLERP 9', and looks forward to providing further evidence in person to the Committee.

This submission is based on the earlier CLERP 9 submission to Treasury and has been updated via the Executive Summary to take into account further input from Members since the short deadline date of 10 November 2003 provided (4 weeks).

In addition this document contains examples of some of the comments received by members so that the Committee can better understand the practical issues and concerns of our members.

The proposed legislative changes are not based on a substantiated systemic failure of the audit profession in Australia. As such the proposals, which have been based on the recommendations of both the Ramsay Report and the HIH Commissioners Report, are, in certain respects, in their present form, considered excessive and will have unintended economic consequences.

Our members who are in smaller audit practices, in cities and regional areas of Australia, advise that the impact on both themselves and their clients will be significant. The extra costs as a result of the need to comply with the new legislation, given their limited financial and human resources, will have to be passed onto clients. Where the costs cannot be passed on they will cease providing audit services.

Because of their comparatively low cost structures these members provide audit services to local community organisations such as clubs, charities, not-for-profit organisations and the like. These organisations can least afford to be burdened with additional audit costs.

The Institute looks forward to meeting with the Committee when Public Hearings are being conducted, and proposes to provide a Supplementary Submission to the Committee once the Government introduces the CLERP 9 Bill into Parliament in early December 2003.

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If you require any further information at this time, please contact Bill Palmer (General Manager Standards & Public Affairs) or Keith Reilly (Technical Adviser) – Telephone: 02 9290 1344, E Mail: bill@icaa.org.au or keith@icaa.org.au.

Yours sincerely

Stephen Harrison AO

Chief Executive Officer
The Institute of Chartered Accountants in Australia

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Executive summary
17 November 2003

The CLERP 9 draft legislation is of major consequence to Australian business and the accounting profession. The Institute acknowledges that the primary purpose of this legislation is to restore confidence in financial reporting and enhance the operation of the capital markets in Australia. We welcome changes to legislation that will achieve these objectives.

The Institute undertook a major review 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. This document comprises the more significant aspects of the Executive Summary of the submission to Treasury dated 10 November 2003.

In addition this document contains examples of some of the comments received by members so that the Committee can better understand the practical issues and concerns of our members.

Future comments to be submitted

As detailed in the Covering Letter, we understand that the draft Bill, amended as a result of submissions received by Treasury, will be introduced into Parliament on or about 4 December 2003. Subject to the amendments to the draft legislation we intended to make a supplementary submission after we have fully considered the impact of the legislation that is introduced into Parliament.

Improvements to the draft legislation

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

Firstly, in strongly supporting the Government's principles based approach, we have in our Treasury submission, identified areas of drafting that may be unnecessarily prescriptive.

Secondly, we have identified both in our Treasury and this submission, some unintended consequences that may lead to the legislation being unworkable in certain respects or in certain sectors.

Thirdly, 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 both in our Treasury and this submission 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.

Comments by members in relation to the Financial Reporting Council ('FRC') and the Financial Reporting Panel ('Panel') include:

- Without appropriate expertise the newly structured FRC could exasperate unrealistic expectations of auditors
- FRC's information gathering powers in relation to assessing auditor independence must be by way of an initial request to the accounting bodies who must obtain clearance by the member before complying with FRC's request
- The FRC report to Parliament must not refer to individual auditors or audit firms without those parties being afforded natural justice and procedural fairness
- Matters should be capable of being brought to the Panel before financial reports are completed
- Matters must be capable of being brought to the Panel by auditors and companies

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

The policies adopted at the time of the introduction of CLERP 1 - 'Accounting Standards' is equally applicable to 'Audit Standards'. CLERP 1 stated that it should be made clear in legislation that accounting standards should be interpreted from a commercial perspective to promote compliance by preparers of accounts, not only with the black letter of the standard, but also its overall purpose. The principles-based approach adopted in CLERP 1 has not been adopted in CLERP 9.

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.

- The 'cooling off' period of 2 years in the original CLERP 9 proposal was increased from 2 years to 4 years for partners and a new provision of 4 years added for a professional member of an audit team as a result of the HIH Royal Commission Report. We do not consider that the specific and unique circumstances that applied to one entity should cause an increase in the 'cooling off' period to be introduced that will significantly affect the audit profession and all listed entities in Australia.
- Current Independence Standard – F1 contains a mandatory 2 year waiting period before a retired auditor can become a director of that client. This is consistent with International Standards.
- The proposed legislation requires that both the lead and review auditors have to rotate such that neither can hold those positions for more than 5 out of 7 successive years. Current Independence Standard – F1 requires the mandatory rotation of audit partners of listed entities every 7 years. Smaller audit practices with fewer than four registered company auditors will not be able to rotate audit work and are most likely to loose audit clients and audit work.
- Specific comments on large proprietary companies are set out below.

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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 of 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 …".

- On that basis the current internationally consistent Independence Standard – F1 should be the definition adopted in CLERP 9.

• 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).

- The 7 day reporting period is unworkable – it should be redefined as a 'reasonable time but no longer than 28 days' to enable all relevant matters to be properly considered before reporting to ASIC. In any case, prior to running off to ASIC for any breach of the Corporations Act, the auditor should firstly report to the company's Audit Committee for consideration, resolution and liaison with ASIC. If there is no audit committee, the Company's directors should be advised and the issue resolved prior to ASIC involvement.
- Reporting of attempts to unduly influence, coerce, manipulate or mislead the auditor must be determined at the lead audit partner level and be fully assessed prior to reporting to ASIC. The proposed legislation is very restrictive and unworkable from all perspectives – the auditor, the client and ASIC.

- As most of the legislation is aimed at listed entities the whistleblowing legislation should include a referral to the entity's Audit Committee before reporting to ASIC.

- For unlisted companies the auditor should, as with the current section 311, refer the matters of concern to the directors, before reporting to ASIC.

- The concept of materiality in relation to financial information should be included in the criteria under which matters are reported to ASIC

• Multiple former audit firm partners at a company

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.

- The proposed legislative appears to have been based on the findings of the HIH Commissioners Report. There is no other evidence to support such legislation.

• 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 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 to 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.

- Audit standards, based on litigation against auditors, already have the force of law under Common Law

- There is a risk that the detailed commentary in audit standards will be considered mandatory and form the basis of litigation – if audit standards become law one area of non-compliance can be the basis for disciplinary action by ASIC and can also be used as the basis for litigation.

- Audit standards are essentially guidance and not black letter law – 'best practice' will become 'minimum practice' and will become unworkable

- Audit standards in other countries do not have the force of law. What was once considered 'best practice' has now become black letter law and now 'minimum practice', leaving auditors to be prosecuted for minor breaches of overly prescription legislation.

- These proposals will surely lead to a further rapid
  - (a) increase in audit costs; and
  - (b) reduction in auditor registrations; and
  - (c) reduction of audit services in regional areas; and
  - (d) entities required to have audits not being able to find a replacement auditor

• 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 different level of resource available to them.

• Retention of audit working papers

The draft legislation requires that auditors must retain all documents (including audit working papers) prepared, considered or used by the auditor in accordance with the requirements of the auditing standard for a period of 7 years. We are concerned that the word ‘considered’ can be subject to a wide interpretation and require auditors to retain documents in excess of those required to be kept under current auditing standards.

- Proposed legislation has had no regard to the 10 National Privacy Principles which may prevent auditors from retaining information on audit files – in these circumstances an auditor runs the risk of an action from the Privacy Commission for retaining records on file; or an action from ASIC if records are not kept e.g. A1 Form in respect of medical records of patients which includes tax file numbers, Medicare numbers, medical condition etc

- This requirement is unworkable for those entities dealing in 'sensitive' data as defined in the National Privacy Principles (‘NPP’) e.g. Public Hospital system, ancillary support services (usually not-for-profit public companies, receiving Government funding) and financial services (Credit Unions, deposit and lending schemes).

- In order to audit, for example the revenue cycle and the 'completeness' assertion and the 'programme statement' and collection of data from the various types of services offered in a public health system, requires the auditor to access and collect sensitive personal data, retain this data as part of audit work papers, as sufficient appropriate audit evidence for audit opinion reliance. Auditors sight masses of such information. To retain all this, without the permission of the patient or other receiver of the services, puts the auditor in direct breach of the NPP guidelines.

- In respect of a credit provider, where say, the auditor is
  (a) reviewing the lending body's adherence to APRA's Prudential Standards; or
  (b) testing the quality of the loans portfolio,
  the auditor accesses and collect sensitive data relating to the borrower. To retain copies of all the documents sighted without the borrower's consent, places the auditor in breach of the NPP guidelines.

- The issue of retention of the type of document sighted and the ease of obtaining permission to access and collect needs further urgent addressing in light of requirements of other legislation for particular types of entities.

- Where an external auditor relies upon the work of the Internal Auditor they will be required to retain all the internal audit working papers for a period of 7 years.

Large proprietary companies

This matter was not included in the Treasury submission as the matter was not considered in the draft legislation. We have included comments in this submission following an overwhelming number of requests from our members to have the current legislation reviewed.

Subsection 45A(3) of the Corporations Act defines a large proprietary company if it satisfies at least 2 of the following:
(a) the consolidated gross revenue is $10 million or more;
(b) the value of the consolidated assets is $5 million or more;
(c) the company has more than 50 or more employees.

If deemed a large proprietary company the company's financial report has to be audited and lodged with ASIC.

- CLERP 9 legislation catches large proprietary companies and requires onerous and inappropriate financial reporting

- Parliament Joint Statutory Committee on Corporations and Securities 'Report on Aspects of the Regulation of Proprietary Companies' issued in March 2001 has not been addressed when drafting CLERP 9 legislation

- Thresholds that define large proprietary companies should be amended (preferably at least doubled) particularly as the effects of inflation over time will mean that small proprietary companies will become large.

- To suggest all CLERP 9 proposals are as applicable to large proprietary companies as other public companies (ignoring specific requirements applicable to listed entities) ignores the fact that most large proprietary companies (in the regional areas at least) are still closely controlled by a family or dominant related group of persons. Most of the prescriptive detail is simply irrelevant, unnecessary and ultimately, too costly to be of any real benefit.

- The Corporations Act has been strengthened in terms of director and officers duties. These responsibilities are applicable to all corporations and afford a level of protection to allow the above thresholds to be increased.