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The Secretary
Parliamentary Joint Committee on Corporations and Financial Services
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17 November 2003

Dear Sir / Madam

CLERP 9 (AUDIT REFORM & CORPORATE DISCLOSURE) BILL

We welcome the opportunity to provide the Joint Parliamentary Committee on Corporations and Financial Services with our comments on the above.

Background

Grant Thornton is the fifth largest accounting organisation worldwide and is within the Top Ten accounting groups in Australia. We are a leader in our chosen market, being the provision of accounting, tax, audit and business advisory services to owner-managed and entrepreneurial businesses, including small and medium sized listed public companies.

Over the last month Grant Thornton has been involved with five other major accounting groups in a team of around 30 professionals, which has worked with the Institute of Chartered Accountants in Australia (ICAA) and CPA Australia (CPAA) to review the draft CLERP 9 legislation in detail, culminating in the joint submission to Treasury by the ICAA and CPAA.

We fully support this joint submission but we take this opportunity to reiterate a number of the matters raised with Treasury, particularly those that affect our client base, being the SME market that is the cornerstone of Australian business.

Overview

We strongly support the main purpose of the legislation, being to restore public confidence in the financial reporting system in Australia and to enhance the operation of Australia's capital markets. We also support the principles based approach that has generally been taken in actioning these reforms.

However, we are concerned that in some areas the principles based approach has been replaced by overly prescriptive detailed rules that are unnecessarily onerous. We also believe that there may be unintended adverse consequences to small and medium sized business due to the "one size fits all" approach that has been taken in certain areas of the reforms.

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Whilst we support all of the recommendations made in the joint submission to Treasury by the ICAA and CPAA, we set out below further comments on three areas which are of particular concern to us.

Auditor rotation (Schedule 1, Part 3)

We support the concept of the rotation of the lead audit partner after five years for all listed public company audits. However, we believe that the extension of this rotation to the review partner will have an adverse affect on the audits of small and medium sized listed public companies.

Negative impact on competition

Currently there are approximately 120 organisations (ie sole practitioners or firms) auditing approximately 1400 ASX-listed public companies. Most of these firms will struggle to meet the rotation requirements as currently drafted. For example, in Adelaide and Perth, Grant Thornton is the fifth and six largest firms respectively but each office only has two full-time audit partners that are appropriately skilled to perform the audits of listed public companies. A firm will need four appropriately skilled audit partners to meet the lead auditor partner and review partner rotation requirements.

If one of the largest firms in these regional capitals such as Grant Thornton will struggle to cope with these requirements, it is likely that the vast majority of smaller firms will be even more adversely affected. We believe that the outcome of the current draft legislation will be that most small and medium-sized firms will choose to exit the listed public company audit market and it is likely that only a few of the larger firms will be left doing this work. This will reduce competition and increase costs significantly, particularly for small and medium-capital listed public companies.

Review partner role

On small and medium sized listed company audit engagements (which comprise the vast majority in number), the review partner will not have any direct interaction with the client and the review partner's role is principally one of quality control. Hence, with such listed company audit engagements, the review partner's professional judgement is less likely to be impaired through over-familiarity and therefore there is less of a need for review partner rotation.

Increased costs to business

The mandatory rotation of the lead and review audit partner will increase the compliance costs to business due to learning curve costs arising on each rotation. While such costs may be more readily borne by large listed entities, the draft legislation makes no distinction regarding size. Given the number of very small listed companies (eg junior explorers), these requirements will significantly increase the cost of audits.

Impact of audit quality

The rotation requirements for both the lead and review audit partner may reduce audit quality, particularly in relation to specialist industries or in smaller firms where less experienced auditors may be rotated on. Such a consequence would be contrary to the policy underlying the draft legislation.

Increased demand on a reduced pool of auditors

Requirements for auditor rotation are likely to create a need for an increase in the number of public company auditors. However, the proposed independence requirements on auditors is likely to reduce the number of public company auditors, as individuals and firms decide that the cost to comply with the independence requirements is too high. Therefore firms may decide to exit this part of their practice.

Recommendation

We suggest that the requirement to rotate the review partner should be limited to the entities included in the ASX All Ordinaries index to ease the burden on small and medium sized listed companies and regional business. To achieve this, the Section 9 definition of "play a significant role" should be amended to state that this section does not apply to the review partner for audits of companies outside the ASX All Ordinaries index.

Auditor independence (Schedule 1, Part 3)

We fully support the concept that auditor independence is fundamental to the integrity of the audit process. However, we are concerned that the principles based approach has not been adopted with some 17 pages of prescriptive legislation dealing with independence.

International consistency

Of particular concern is the fact that the overall definition of independence differs significantly from that used internationally. We strongly support international harmonisation of auditing and accounting standards and frameworks and we believe that the draft legislation is detrimental to that harmonisation by defining independence differently to the definitions in the ICAA's Professional Independence Statement, F1 which is consistent with the International Federation of Accountants (IFAC) Code of Ethics.

Independence definition

The independence definition in the draft legislation is based on the HIH Royal Commission Report, which has not been subject to a formal comment process, and uses terms such as "might" rather than "would reasonably conclude". Use of the term "might" could support an argument that, with companies paying auditors for the services provided, no auditor could meet the independence definition in the draft legislation!

Recommendation

We recommend that the legislation simply include a principles based requirement to comply with professional independence requirements, rather than the current prescriptive rules. We further recommend that any definition of independence be consistent with the IFAC and F1 definitions.

Section 311 – expansion of auditors' duties (Schedule 1, Part 7)

We believe that the current Section 311 is working effectively and that the proposed changes will result in numerous reports on minor matters being submitted to the Australian Securities and Investments Commission (ASIC), which will be of minimal benefit to the companies, auditors and ASIC.

Current S311

Under the current S311, the auditor must only report breaches of the law to ASIC if the breach cannot be adequately dealt with by commenting on it in the auditor's report or by bringing it to the attention of the directors.

This allows the auditor to apply professional judgement in relation to resolving such matters and reporting to ASIC is a last resort when breaches cannot be adequately dealt with by raising with the directors. It also allows for minor breaches (eg late lodgement of forms and reports with ASIC) to be dealt with without formal reporting of these matters (of which ASIC should already be aware in any case).

Reason for proposed changes

We understand that the driver behind the proposed changes is the view of ASIC that S311 is not effective due to the small number of reports that it is receiving. We disagree with this view. In our experience the "threat" of a S311 report to ASIC is used as a mechanism for the auditor to pressure directors to resolve potential breaches and hence matters are adequately dealt with without the need to report to ASIC.

Seven day deadline

In our view the seven day deadline for reporting breaches to ASIC is impractical. If a member of the audit team has reasonable grounds to believe that a breach of the law has occurred, this may well be a very subjective matter. Due process is extremely important, which will involve discussions with management, raising the matter with the lead audit partner and then discussions with the audit committee and/or the board prior to reporting to ASIC

Given due process, in our opinion a seven day deadline will result in factually incorrect reports being submitted to ASIC.

Recommendation

We recommend that the proposed S311 be amended to only be applicable where the auditor does not believe that matter has not been adequately dealt with by bringing it to the attention of the directors. We further recommend that the 7 day deadline be changed to "within a reasonable period".

Conclusion

We trust that our comments on the above three areas provide useful background information and suggestions for the Joint Parliamentary Committee. We reiterate our support for the overall intention of the proposed legislation and the majority of the reforms included. However, we strongly believe that the above matters need to be addressed in order to prevent unintended adverse consequences to small and medium sized businesses.

Yours faithfully
GRANT THORNTON

JOHN CLARK
National Chairman