Chapter 3

Review of annual reports of bodies established under Part 12 of the ASIC Act

Financial reporting framework

3.1 Part 12 of the *Australian Securities and Investments Commission Act 2001* (the ASIC Act) establishes Australia's financial reporting system. As outlined in section 224 of the ASIC Act, the objects of the financial reporting system include:

- facilitating the Australian economy;
- maintaining investor confidence in the Australian economy;
- developing accounting standards that require the provision of information that is relevant, reliable, easy to understand, allows investors to make and evaluate financial decisions, and assists directors to fulfil their statutory financial reporting obligations; and
- developing auditing and assurance standards that provide Australian auditors relevant and comprehensive guidance in determining whether financial reports comply with statutory requirements, and require auditors' reports to be reliable and capable of being readily understood by investors.[1]

3.2 Three agencies are established under Part 12 as the administrative arms of the financial reporting system; namely, the Financial Reporting Council (the FRC), the Australian Accounting Standards Board (AASB) and the Auditing and Assurance Standards Board (AUASB). All three bodies are to monitor their activities against the objects in section 224,[2] and to include in their annual reports an analysis of their achievements against the objects.[3]

3.3 While not established under Part 12 of the ASIC Act, the Australia Securities and Investments Commission (ASIC) is also integral to the administration of the financial reporting framework.[4] The Commission's contribution to the framework includes the enforcement of auditor independence and audit quality requirements.[5]

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1 *ASIC Act 2001*, s. 224.

2 *ASIC Act 2001*, s. 235B,s. 227, s. 227B.

3 *ASIC Act 2001*, s. 235B*; AASB, Annual report: 2011-12*, p. 13*; AUASB, Annual report: 2011–12*, p. 17.

4 *ASIC Act 2001*, Division 3, Part 3. For a detailed explanation of ASIC's role in the operation of Australia's financial reporting requirements see The Treasury, *Audit quality in Australia: A strategic review*, March 2010, Part 4, pp 26–30.

5 The Treasury, *Audit quality in Australia: A strategic review 2010*, p. 26.

The Financial Reporting Council

3.4 The FRC was established by section 225 of the *Australian Securities Commission Act 1989* (the ASC Act 1989)[6] and was re-established in 2001 by Part 12 of the ASIC Act.[7] As part of the financial reporting system, the FRC's role in the operation of Australia's corporations law is to:

- provide broad oversight of the processes for setting accounting standards and auditing standards in Australia;
- monitor the effectiveness of auditor independence requirements in Australia; and
- advise the Minister on these matters.[8]

3.5 The ASIC Act also confers on the FRC 'specific accounting standards functions', 'specific auditing standards functions', and 'specific auditor independence functions'. The FRC's specific auditor independence functions direct the FRC to monitor and advise the Minister about the effectiveness of Australia's auditor independence requirements. In undertaking this function, the FRC is to monitor international developments in auditor independence, assess the adequacy of the auditor independence requirements under the corporations legislation and professional codes of conduct. The FRC is also charged with assessing the overall adequacy of the investigation and disciplinary procedures of professional accounting bodies applying to Australian auditors.[9] The FRC's responsibilities do not extend to monitoring the disciplinary procedures of CALDB or the FRP.

3.6 The Council's specific accounting standards functions and the specific auditing standards functions recognise the position of Australia's financial system within the international economy. The functions also reflect the object in section 224 of 'facilitating the Australian economy by enabling Australian entities to compete effectively overseas'.[10] Accordingly, the FRC is required to:

- monitor developments in international accounting standards and auditing standards;
- further the development of a single set of accounting standards and auditing standards for world-wide use; and

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6 See Note, section 225, ASIC Act.

7 Section 261 of the ASIC Act directs that bodies established under the *Australian Securities Commission Act 1989* continue in existence as if they had been established under the ASIC Act.

8 *ASIC Act 2001*, ss. 225(1).

9 *ASIC Act 2001*, ss. 225(2B).

10 *ASIC Act 2001*, paragraph 224(b)(ii).

- promote the continued adoption of international best practice accounting standards and auditing standards if doing so would be in the best interests of the private and public sectors of the Australian economy.[11]

3.7 As detailed in the 2011–12 annual report, the FRC's view of its purpose and functions reflects its statutory responsibilities:

> The Financial Reporting Council (FRC) is the peak body responsible for overseeing the effectiveness of the financial reporting framework in Australia.
>
> Its key functions include the oversight of the accounting and auditing standards setting processes for the public and private sectors, monitoring the effectiveness of the auditor independence regime, and advising the Minister on these matters.[12]

3.8 The committee notes that towards the end of the financial year the FRC's functions were amended, with its auditor independence functions being repealed (see paragraph 3.22).

The Australian Accounting Standards Board

3.9 The AASB was established by section 226 of the ASC Act 1989,[13] and was re-established by Subdivision B, Division 1, Part 12 of the ASIC Act.[14] The AASB was established to raise the standards of accounting statements through developing accounting standards and 'a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards and international standards.'[15] Reflecting the object of promoting Australian entities in the international market,[16] the AASB is also tasked with contributing to the development of 'a single set of accounting standards for world-wide use'.[17] The ASIC Act also establishes the Office of the AASB, to provide the AASB administrative and technical support.[18]

3.10 As detailed in the 2011–12 annual report, the AASB's mission statement captures the Board's statutory responsibilities and role in Australia's financial reporting framework:

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11 *ASIC Act 2001*, ss225(2); ss225(2A).

12 FRC, *Annual report: 2011–12*, p. ix.

13 See Note 1, section 227, ASIC Act.

14 Section 261 of the ASIC Act directs that bodies established under the *Australian Securities Commission Act 1989* continue in existence as if they had been established under the ASIC Act.

15 *ASIC Act 2001*, s. 227.

16 *ASIC Act 2001*, s. 224.

17 *ASIC Act 2001*, s. 227.

18 *ASIC Act 2001*, s. 226A.

The mission of the AASB is to:

- develop and maintain high-quality financial reporting standards for all sectors of the Australian economy;
- develop and maintain a high quality accounting (i.e. financial reporting) standards for reporting entities in those sectors; and
- contribute, through thought leadership and participation, in the development of global financial reporting standards and standard-setting.[19]

The Auditing and Assurance Standards Board

3.11 The AUASB is established under Subdivision C, Division 1, Part 12 of the ASIC Act. Chief among the AUASB's responsibilities is the task of facilitating the objective of an Australian financial reporting system that provides clear guidance to auditors about auditing standards and requirements.[20] The AUASB formulates auditing standards, in the form of legislative instruments, that operate under the *Corporations Act 2001* (the Corporations Act).[21] Consistent with the object in section 224 to 'enable Australian entities to compete effectively overseas', the AUASB is also tasked with contributing to the 'development of a single set of auditing standards for world-wide use.'[22]

3.12 The ASIC Act also establishes the Office of the AUASB, which provides technical services and administrative support to the AUASB.[23] The Board's 2011–12 annual report provides further details of the functions of the Office of the AUASB:

> The Office of the AUASB is structured to meet one outcome: the formulation and making of auditing and assurance standards and guidance that are used by auditors of Australian entity financial reports or for other auditing and assurance engagements.[24]

3.13 The AUASB's statutory responsibilities are reflected in the Board's mission statement as contained in the 2011–12 annual report:

> The mission of the AUASB is to develop, in the public interest, high–quality auditing and assurance standards and related guidance, as a means to enhance the relevance, reliability and timeliness of information provided to users of audit and assurance services...
>
> The AUASB contributes to public confidence in the financial reporting and corporate governance frameworks by issuing auditing standards, which are

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19 AASB, *Annual report: 2011–12*, p. 14.

20 *ASIC Act 2001*, s. 224.

21 *ASIC Act 2001*, ss227B; *Corporations Act 2001*, s 336.

22 *ASIC Act 2001*, ss227B.

23 *ASIC Act 2001*, s. 227AB.

24 AUASB, *Annual report: 2011–12*, p. 55.

> legally enforceable for audits and reviews of financial reports required under the *Corporations Act 2001*, other auditing and assurance pronouncements and related guidance.
>
> The role of the AUASB also extends to liaison with other national standard setters and participating in standard setting initiatives of the IAASB [the International Auditing and Assurance Standards Board] to develop a single set of auditing standards for worldwide use. Such involvement seeks to contribute ultimately to the quality of AUASB pronouncements.[25]

Coordination between the FRC, the AASB and the AUASB

3.14 The ASIC Act also requires significant coordination between the three bodies responsible under Part 12 of the ASIC Act for the administration of the financial reporting framework. Accordingly, FRC's specific accounting standards functions and specific auditing standards functions also include oversight of certain activities of the AASB and the AUASB. The FRC is to:

- appoint members of the AASB and the AUASB, other than the Chair;
- determine the Boards' broad strategic direction;
- advise the AASB and the AUASB on the Boards' priorities, business plans and procedures;
- monitor the effectiveness of the Boards' consultative arrangements; and
- advise the Office of the AASB and the Office of the AUASB on the Offices' budgets and staffing arrangements.[26]

3.15 The ASIC Act requires the AASB and the AUASB to have regard to the FRC's advice concerning the bodies' priorities, business plans, procedures and strategic direction.[27]

3.16 However, as acknowledged in the FRC's annual report, in conducting its oversight duties the FRC is not permitted to undermine the independence of the AASB or the AUASB:

> The ASIC Act expressly limits the FRC's ability to become involved in the technical deliberations of the AASB and AUASB. In particular, it provides that the FRC does not have power to direct the AASB or AUASB in relation to the development, or making, of a particular standard, or to veto a standard formulated or recommended by the AASB or AUASB. This provision is designed to ensure the independence of the standard setters.[28]

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25 AUASB, *Annual report: 2011–12*, p. 18.

26 *ASIC Act 2001*, ss. 225(2).

27 *ASIC Act 2001*, s. 236AA, s. 236EA, s. 232.

28 FRC, *Annual report: 2011–12*, p. 35.

3.17 In addition to the oversight provided by the FRC, the interaction between the bodies is furthered by the administrative arrangements of the AASB and the AUASB. As is evident from the presentation and format of the agencies' annual reports, the AASB and AUASB share administrative resources. As detailed in the 2011–12 annual reports of both bodies, the AASB and the AUASB operate according to a shared service agreement under which seven of the AASB's eight administrative staff concurrently work for the AUASB.[29]

Review of the 2011–12 annual report of the Financial Reporting Council

3.18 The FRC noted in its 2011–12 annual report that its strategic plan had been in operation for a full year. The FRC Strategic Plan 2011–14 provides an action plan for the FRC against strategic issues relevant to the financial services sector.[30] The Strategic Plan will undergo a midterm review in 2012–13.[31]

3.19 The Strategic Plan includes a Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis of Australia's financial reporting framework, which identified the following areas of weakness in, and threats to, Australia's financial reporting system.

29 AASB, *Annual report: 2011–12*, p. 43; AUASB, *Annual report: 2011–12*, p. 40.

30 FRC, *Annual report: 2011–12*, p 1.

31 FRC, *Annual report: 2011–12*, p 4.

Figure 3.1: Extract from FRC's SWOT analysis of the financial reporting framework[32]

SWOT analysis – Financial Reporting Framework	
Weaknesses	**Threats**
• Not all areas given equal attention and priority in developing international standards	• Risk of fragmentation of the global IFRS [International Financial Reporting Standards] community
• Exclusive focus on financial reporting, neglecting to some extent the wider context in which economic entities operate	• Discussion of radical proposals to regulate audit practices, for example in the European Union
• Complexity and length of annual reports	• Failure of a big 4 accounting firm, potentially leading to a lack of competition in the audit market
• Level of financial literacy among users, including company directors, leading to issues such as expectation gaps for audit reports	• Plethora of narrow additional financial reporting burdens being advocated, for example as part of a Corporate Social Responsibility or Environmental, Social and Governance Agenda, without consideration as to their broader appropriateness
	• Complexity caused by Australia's federal structure

3.20 The annual report also provides further information about the state of Australia's financial reporting system. Notably, the FRC has concluded that the 'independence framework in Australia continues to operate effectively and will be further improved in light of recent audit developments'.[33] As the report elaborates:

> [T]he FRC did not become aware of deficiencies in the underlying systems and processes used by audit firms to ensure compliance with auditor independence requirements.[34]

3.21 The annual report also states that the FRC's key strategic issues include 'how to monitor the effectiveness of auditor independence and other audit quality drivers'.[35] The annual report notes that the veracity of audit reports is a topic of growing national and international interest:

> A key international and local focus affecting auditing and assurance over the past year has been the debate on auditing related issues following the global financial crisis. These issues include audit quality, the role of the auditor and auditor reporting. There is also a considerably heightened focus on the independence of auditors and greater scrutiny over the scepticism

32 FRC, *Annual report: 2011–12*, pp 43 – 44.

33 FRC, *Annual report: 2011–12*, p. 3.

34 FRC, *Annual report: 2011–12*, p. 22.

35 FRC, *Annual report: 2011–12*, p. 45.

> and professional judgement exercised by auditors, and as a consequence, growing international pressure for greater regulation of auditors.[36]

3.22 The report noted the commencement on 27 June 2012 of the *Corporations Legislation Amendment (Audit Enhancement) Act 2012*, which repealed the FRC's auditor independence function and related reporting requirements.[37] Instead, the FRC will provide a strategic policy role of advising the Minister while ASIC assumes the responsibility of monitoring auditor independence.[38] The impact of this will be reported in the 2012–13 period. The relevant Explanatory Memorandum notes that the requirements were repealed to improve efficiency, reduce administrative costs and streamline the functions of the FRC.[39]

Committee view

3.23 The committee is satisfied with the FRC's annual report. However, it emphasises that future annual reports would benefit from evaluating the priority projects under the strategic plan against the objects in section 244 of the ASIC Act. The committee notes that the 2012–13 financial year coincides with the start of a new direction for the FRC, with the repeal of its auditor independence functions. With the transfer of these functions to ASIC, coordination between ASIC and the FRC is essential. The committee stresses the importance of ongoing communication between ASIC and the FRC.

3.24 The committee notes the FRC's statement has not become aware of any evidence to suggest deficiencies used by audit firms to ensure compliance with auditor requirements. The committee will be calling the FRC to give evidence at the first ASIC oversight hearing of 2013 to give due consideration to the role of auditors in Australia's financial system. The committee draws the FRC's attention to ASIC's 2012 report *Audit Inspection Program Report for 2011–12* which highlights ASIC's concern with the performance of Australia's audit industry.[40] The committee looks forward to the FRC's response to ASIC's concerns.

3.25 The committee will monitor the effects of the repealed auditor independence functions of the FRC in order to determine if the FRC's functions are streamlined and effective.

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36 FRC, *Annual report: 2011–12*, p. 3.

37 FRC, *Annual report: 2011–12*, p. ix.

38 FRC, *Annual report: 2011–12*, p. 21.

39 Explanatory Memorandum, *Corporations Legislation Amendment (Audit Enhancement) Bill 2012*, p. 9

40 ASIC, *Audit Inspection Program Report for 2011–12*, December 2012, p. 9.

Review of the 2011-12 annual report of the Auditing and Assurance Standards Board

3.26 As the committee has previously noted, the 2009–10 financial year marked the introduction of the *Clarity* standards–43 revised auditing standards amended as part of a three-year review process.[41] The 2011–12 annual report notes that the AUASB continued to monitor and facilitate the implementation of the standards during the 2011–12 financial year.[42] However, the report does not contain an assessment of how the *Clarity* standards have measurably contributed to achieving a transparent and reliable financial reporting framework, although it is stated that the AUASB will ascertain whether the standards 'are being understood and applied consistently by auditors' and that feedback on the application of the standards will be supplied to the IAASB.[43]

3.27 From the information obtained in the annual report, it is evident that *Clarity* responds to, and is consistent with, international developments in auditing standards. As noted in the annual report:

> The AUASB released its current suite of auditing standards in 2009, operative for financial reporting periods that commenced on or after 1 January 2010. These auditing standards conform to the International Auditing Standards (ISAs) and significantly increased the requirements on auditors in a number of areas…[44]

3.28 While not referenced, the committee notes that this approach accords with the views of Treasury that 'global consistency is a critical goal that must always be borne in mind in considering any changes to the standard audit report'.[45] Treasury further concluded that 'it will be essential for the Auditing and Assurance Standards Board (in accordance with the FRC's strategic direction) to continue to base the Australian Auditing Standards on the standards issued by the International Auditing and Assurance Board'.[46] The committee also notes that Ms Merran Kelsall, Chairman, AUASB, as a member of the IAASB, participated in the Auditor Reporting Task Force.[47]

3.29 The AUASB did not report any concerns with the FRC's activities in setting the Board's strategic direction, procedures and priorities. The annual report does not

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41 Parliamentary Joint Committee on Corporations and Financial Services, *Report on the 2009–10 annual reports of bodies established under the ASIC Act*, February 2011, p. 3.

42 AUASB, *Annual report: 2011–12*, p. 55.

43 AUASB, *Annual report: 2011–12*, p. 11.

44 AUASB, *Annual report: 2011–12*, p. 4.

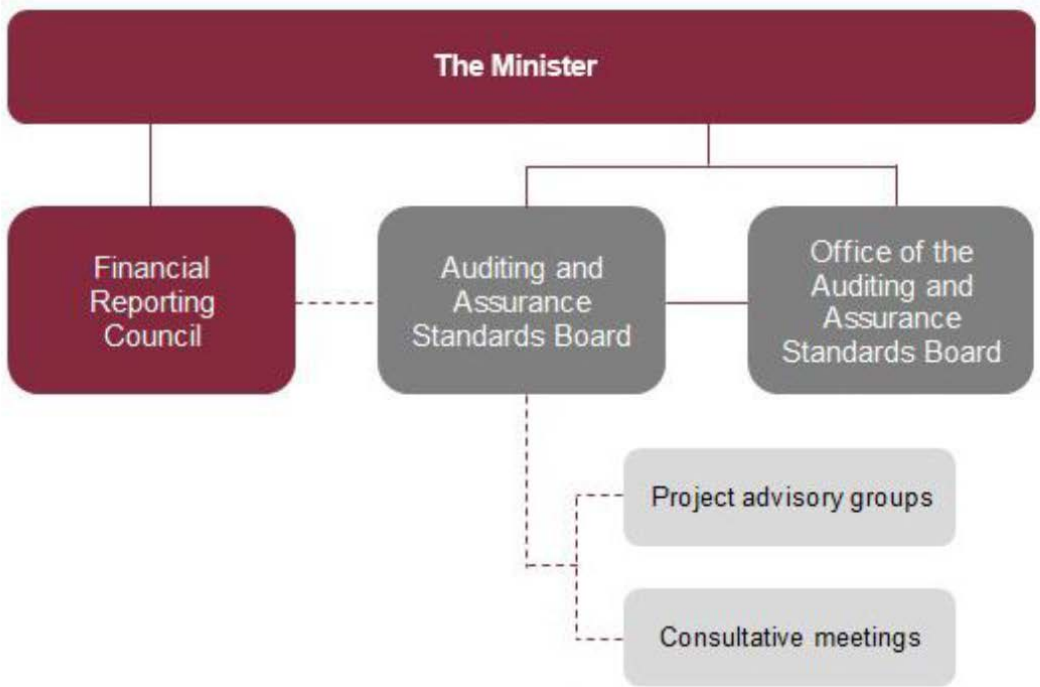
45 Treasury, *Audit quality in Australia: A strategic review 2010*, p. 52.

46 Treasury, *Audit quality in Australia: A strategic review 2010*, Key finding 20, p. 53.

47 AUASB, *Annual report: 2011-12*, p. 5.

provide an evaluation of the merit of the interaction between the FRC and the AUASB as contemplated under Part 12 of the ASIC Act. Part 12 sets out the FRC's and the AUASB's functions and powers and stipulates that the AUASB must have regard to the advice and feedback about its priorities, business plans and procedures that the FRC provides.[48] The annual report did, however, note that the FRC is integrated within the AUASB's broad organisational structure:

Figure 3.2: AUASB organisational structure[49]



3.30 The annual report also comments that during the 2011–12 financial year, there were no parliamentary committee reports relating to the Board's activities.[50]

Committee view

3.31 The committee is satisfied with the annual report of the AUASB. The committee expects that future annual reports will include an assessment of the achievements of the *Clarity* standards in promoting relevant and reliable auditor reports.

3.32 The committee draws the Board's attention to the reports on annual reports prepared by this committee and the Senate Economics Legislation Committee. It would be appropriate for these reports to be referred to in the discussion in the annual report regarding the external scrutiny of the AUASB. In addition, the committee

48 *Australians Securities and Investments Commission Act 2001*, part 12, s. 236EA.

49 AUASB, *Annual report: 2011-12*, p. 34.

50 AUASB, *Annual report: 2011-12*, p. 39.

referred directly to the AUASB in its report *Inquiry into the collapse of Trio Capital May 2012*. The AUASB provided answers to questions placed on notice as part of this inquiry.[51]

3.33 The committee is concerned with the divergence between auditors' statutory requirements and public expectations about auditors' role within Australia's financial services system.[52] It notes ASIC's 2012 report that signals the regulator's concerns with the audit industry. The committee draws to the AUASB's attention ASIC's advice in evidence before this committee that the auditing industry is 'on notice'.[53] The committee will call the AUASB to attend the first ASIC oversight hearing in 2013. It will seek the AUASB's response to ASIC's concerns and its views on whether the *Clarity* standards will address these concerns.

Review of the 2011–12 annual report of the Australian Accounting Standards Board

3.34 As Treasury noted in its consultation paper *Audit quality in Australia: A strategic review*, the implications of the global financial crisis extend to accounting standards at the domestic level:

> There have been a number of significant developments relating to accounting standards at the international level. The G-20 has requested that the two global accounting standard setters, the International Accounting Standards Board (IASB) based in London and the US Financial Accounting Standards Board (FASB), address a range of accounting issues that have arisen during the global financial crisis. These issues include fair value measurement, the simplification of the standard relating to financial instruments, the treatment of off-balance sheet exposures and enhanced disclosure of complex financial products. The G-20 has also urged the IASB and FASB to work towards a single set of global accounting standards.[54]

3.35 Consistent with the object of promoting Australian entities within international markets, the AASB's 2011–12 annual report notes that developments in domestic accounting standards have been shaped by events at the international level.[55] As documented in the annual report, the international community's response to the global financial crisis has influenced the responsibilities of the AASB in delivering accounting standards that promote transparent and reliable accounting reports:

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51 PJC on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, pp 98–99.

52 PJC on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, pp 130–131.

53 Mr Greg Medcraft, Chairman, ASIC, *Committee Hansard*, 3 December 2012, p. 12.

54 Treasury, *Audit quality in Australia: A strategic review 2010*, p. 23.

55 AASB, *Annual report: 2011-12*, p. 3.

> [M]ost of the Standards issued…were to maintain conformity with International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB). Many of these can be attributed to the IASB's ongoing response to the global financial crisis. Similarly, most of the AASB Exposure Drafts issued incorporated IASB proposals. During the year, the Board made submissions to proposals of both the IASB and the International Public Sector Accounting Standards Board (IPSASB). The AASB had regard to not–for–profit, including public sector, issues in the process of developing the new and revised Standards…[56]

3.36 The report refers to the input the AASB provided to the Asian Oceanian Standard Setters Group (AOSSG). The AASB helped establish the AOSSG as a regional body set to improve the input of the Asia-Oceania region to international accounting standard setting.[57]

3.37 As the committee has previously noted, during the 2009–10 financial year the AASB revised the accounting reporting framework for 'non-public accountable entities'.[58] The annual report does not present an analysis of the impact of the new framework, known as the 'Reduced Disclosure Regime'[59], as the standards are not due to commence until 2013.[60]

3.38 In detailing the AASB's management and accountability structures, the 2011–12 annual reports notes the statutory responsibilities of the FRC to appoint Board members and provide the Board strategic direction and advice. The annual report includes the following diagram showing the FRC's position within the Board's operational matrix:

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56 AASB, *Annual report: 2011-12*, p. 19.

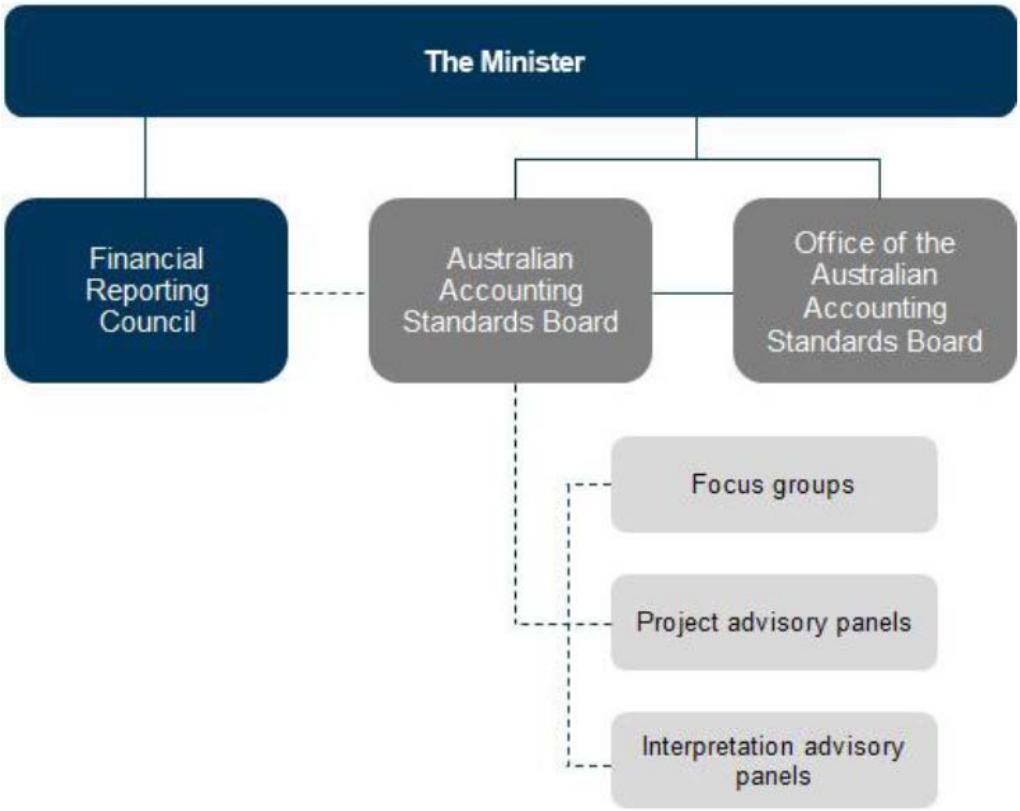
57 AASB, *Annual report: 2011-12*, p. 19.

58 Parliamentary Joint Committee on Financial Services, *Report on the 2009–10 annual reports of bodies established under the ASIC Act*, March 2011, p. 5.

59 AASB, *Annual report: 2011–12*, p. 5.

60 AASB, *Annual report: 2011–12*, p. 107.

Figure 3.3: AASB organisational structure[61]



3.39 The AASB did not report any concerns with the FRC's activities in setting the Board's strategic direction, procedures and priorities.[62]

3.40 The annual report also comments that during the 2011–12 financial year there were no parliamentary committee reports regarding the Board's activities.[63]

Committee view

3.41 The committee is satisfied with AASB's annual report. However, it draws the Board's attention to the reports on annual reports prepared by this committee and the Senate Economics Legislation Committee. Again, it would be appropriate for these reports to be referred to in the annual report's discussion of the external scrutiny of the Board.

3.42 The committee expects that as the AASB moves to improve and implement accounting standards to take account of the issues raised by the global financial crisis, future annual reports will include an assessment of the contribution that these standards have made to promoting reliable accounting practices and, ultimately,

61 AASB, *Annual report: 2011–12*, p. 36.

62 AASB, *Annual report: 2011–12*, p. 37.

63 AASB, *Annual report: 2011–12*, p. 42.

commercial certainty. The committee seeks the AASB's advice about measures the AASB has taken to support the transition to the new standards.

Ms Deborah O'Neill
Chair