

CORPORATE GOVERNANCE

Background

2.1 Effective Corporate Governance should be an essential part of the modern corporate entity. Public and private sector organisations will ultimately be judged by how well they direct, control and deliver their corporate objectives, as well as by the integrity of their accountability mechanisms.

2.2 The importance of good corporate governance in the global and domestic economic environment has been stressed by the Organisation for Economic Cooperation and Development (OECD):

If countries are to reap the full benefits of the global capital market, and if they are to attract long-term “patient” capital, corporate governance arrangements must be credible and well understood across borders. Even if companies do not rely primarily on foreign sources of capital, adherence to good corporate governance practices will help improve the confidence of domestic investors, may reduce the cost of capital, and ultimately induce more stable sources of financing.¹

2.3 For the purposes of this report, corporate governance is broadly understood as:

...the process by which organisations are directed, controlled and held to account. It encompasses authority, accountability,

1 *Principles of Corporate Governance*, Organisation for Economic Cooperation and Development, SG / CG(99)5, 1999, p.3

stewardship, leadership, direction and control exercised in the organisation.²

- 2.4 Deficient corporate governance culture inhibits the conduct of comprehensive and independent audits. Conversely, good corporate governance should lead to accountable, transparent and independent accounting and auditing practices. Ernst & Young drew attention to the close relationship between corporate governance and audit independence, commenting that ‘the most effective way to achieve genuine reform of the audit process is at the company-to-auditor level, as an integral component of best practice corporate governance’.³
- 2.5 In exploring the issue of corporate governance as it related to audit independence in this report, the Committee will focus on corporate governance requirements in publicly listed companies and audit firms. The key issues to be addressed are:
- ensuring Board effectiveness;
 - enhancing the internal audit function;
 - developing mechanisms to provide assurance of corporate governance practices;
 - enhancing the effectiveness of audit committees; and
 - increasing the public accountability of audit firms.

Report 372: Corporate Governance and Accountability arrangements for Commonwealth Government Business Enterprises.

- 2.6 In 1999, the Committee tabled a comprehensive report, *Report 372: Corporate Governance and Accountability arrangements for Commonwealth Government Business Enterprises*. The Committee made a range of recommendations aimed at addressing conflicts of interest on Boards of government business enterprises, enhancing transparency and accountability, and improving the education and training of government business enterprise Board members.⁴ The Committee maintains that the principles underlying Report 372 and the subsequent recommendations are generally applicable to the private sector.

2 Joint Committee of Public Accounts and Audit, Report 372, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*, Canberra, Canprint, 1999, p. 7

3 Ernst & Young, *Submission No.32*, p.S277

4 Joint Committee of Public Accounts and Audit, Report 372, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*, Canberra, Canprint, 1999

- 2.7 Table 2 contains a summary of the recommendations made in Report 372 and an indication of the status of the Government's response.

Table 2 Summary of JCPAA Report No. 372

Recommendation	Government's Response
1. The Minister for Finance and Administration review the applicability of administrative law to current and future GBEs.	Supported in the Executive Minute of 18 May 2000
2. Portfolio Ministers be removed from their government business enterprise shareholder responsibilities but remain as the responsible Minister under the GBEs' enabling legislation.	Government has not responded to date
3. The Minister for Finance and Administration amend the <i>1997 Governance Arrangements for Commonwealth GBEs</i> to require that all Ministerial directions to GBE boards should in writing and tabled in both Houses of Parliament.	Government has not responded to date
4. The Minister for Finance and Administration amend the <i>1997 Governance Arrangements for Commonwealth GBEs</i> to require that GBE boards ensure that appropriate and effective induction, education and training programs are offered to new and existing board directors.	Supported in the Executive Minute of 18 May 2000
5. The Minister for Finance and Administration amend the <i>1997 Governance Arrangements for Commonwealth GBEs</i> to require confidential board and director performance appraisal.	Supported in the Executive Minute of 18 May 2000
6. The Minister for Finance and Administration develop draft guidelines for scrutiny by Parliamentary Committees of commercially confidential issues relating to GBEs.	Government has not responded to date
7. The Minister for Finance and Administration amend the <i>1997 Governance Arrangements for Commonwealth GBEs</i> to set out the risk management responsibilities of audit committees.	Supported in the Executive Minute of 18 May 2000

Source JCPAA

Corporate governance in publicly listed companies

- 2.8 A cursory investigation of companies involved in recent corporate failures and fraud would reveal that they may have exhibited the trappings of good corporate governance, such as an audit committee, a statement of corporate governance practices in the annual report, and the existence of non-executive directors on the Board.

- 2.9 Outward compliance with good corporate governance principles is not sufficient guarantee of their effective operation.
- 2.10 In recognition of the relationship between independent auditing and corporate governance, the Committee is interested in strengthening the corporate governance framework in order to give greater effect to the practices that most companies profess to follow. Such practices should be transparent and demonstrable, not mere window dressing. The areas of concern to the Committee in this section are the role and responsibilities of the Board and Directors, developing a mechanism for providing assurance of corporate governance practices, and more effective audit committees.

The Board and Directors: role and responsibilities

- 2.11 Boards are a central part of corporate governance. Boards are responsible and accountable to shareholders and other stakeholders for delivering policies that promote shareholder and investor interests and for ensuring that the enterprise is operating as efficiently and effectively as possible. The Committee's focus is on the organisational performance of Boards, reflecting Professor Hilmer's statement that the 'key role of boards should be to ensure that corporate management is continuously and effectively striving for above-average performance, taking account of risk'.⁵
- 2.12 Boards have a range of duties and responsibilities. The Australian Institute of Company Directors (AICD) broadly defines the responsibilities of a Board as:
- *Strategy*: to participate with management in setting goals, strategies and performance targets for the enterprise;
 - *Resources*: to make available to management the resources to achieve the strategic plan;
 - *Performance*: to monitor the performance of the enterprise against its business strategies and target, with the objective of enhancing its prosperity over the long term;
 - *Conformance*: to ensure there are processes in place to conform with legal requirements and corporate governance standards, and that risk exposures are adequately managed;

5 Hilmer, F.G., *Strictly Boardroom, Improving Governance to Enhance Company Performance*, 2nd Edition, Information Australia, Melbourne, 1998, p.5

- *Accountability to shareholders*: to report progress to the shareholders as their appointed representatives, and seek to align the collective interests of shareholders, boards and management.⁶
- 2.13 Taking these criteria as a guide, evidence emerging from cases of corporate failure and fraud in Australia and overseas suggests a significant breakdown in the performance of Boards in the private sector. This has resulted in increasingly negative public perceptions with potentially serious economic consequences.
- 2.14 While much of the debate on audit independence has focused on the external audit function, the external auditor's responsibilities need to be balanced against the responsibilities of management and, importantly, the Board of Directors.⁷ Audit failure notwithstanding, those with the ultimate responsibility for the audit and financial statements are the directors of a company.
- ...it is the Board that must bear full responsibility for the financial statements and as a result the outcome of the audit and be responsible to the shareholders (who appoint the auditor) for the decisions that it takes.⁸
- 2.15 The Committee's Report 372 addressed a range of issues associated with Board performance and effectiveness, including Board independence, the selection and appointment of directors, induction, education and training for directors, performance appraisal, assessment of individual directors and director remuneration. Similar issues arose in the course of the Committee's current inquiry.

Director education and competency

- 2.16 Boards need to have the appropriate skills, experience and support mechanisms to effectively analyse and verify information in order to be able to ask the right questions and make well-considered decisions. At the same time, there must be a focus on continuous improvement by the board in general and by individual directors.
- 2.17 Mr Rob Elliot of the AICD outlined to the Committee the range of corporate governance courses run by the AICD, including the company director course and purpose built courses such as the role of the chairman

6 Dunlop, Ian, 'Broadening the Boardroom', *Address to the Federation of Australian Scientific and Technological Societies Forum*, National Press Club, Canberra, 2 August 2000.

7 AuASB, *Submission No.12*, p.S96

8 AICD, *Submission No.26*, p.S219

and the selection of the board.⁹ The Committee is aware that record numbers of directors and executives are reportedly enrolling in corporate governance courses.¹⁰ While somewhat belated, this trend is to be encouraged and we urge all publicly listed company Boards to pay close attention to the on-going induction, education and training needs of directors.

- 2.18 The Committee also notes that the Nasdaq has gone as far as mandating director continuing education and has directed the Nasdaq Listing and Hearing Review Council to develop appropriate rules.¹¹
- 2.19 The Committee reiterates the view, made in Report 372, that boards ensure that effective and on-going induction, education and training programs are offered to new and existing Board directors.¹²

The selection, appointment and independence of Directors

- 2.20 A company's performance depends largely on the capabilities and performance of its executive management and its board. In turn, the skills, experience and qualifications of individual directors influence the overall ability and performance of the board. In this regard, a lack of strong election processes, including the existence of patronage and weak selection mechanisms create a risk that boards may be 'captured' by management or other factions thus reducing the board's ability and willingness to question and oversee management.¹³ In addition, a collegiate focus or cooperative attitude is important to foster a good working relationship in boards.
- 2.21 Both the *Corporations Act 2001* and the ASX Listing Rules are relatively quiet on the issue of what qualities, skills and experience a director should have. Section 201B of the *Corporations Act 2001* merely states that:
- (1) Only an individual who is at least 18 may be appointed as a director of a company.
 - (2) A person who is disqualified from managing corporations under Part 2D.6 may only be appointed as director of a company if

9 Mr Rob Elliot, *Transcript*, pa.173

10 'Directors Sent back to School', *The Australian Financial Review*, 5 July, pp.1 and 17.

11 *Corporate Law Bulletin*, No 59, July 2002

12 Joint Committee of Public Accounts and Audit, Report 372, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*, Canberra, Canprint, 1999, p.66

13 For example, See Hilmer, F.G, *Strictly Boardroom, Improving Governance to Enhance Company Performance*, 2nd Edition, Information Australia, Melbourne, 1998

the appointment is made with permission granted by ASIC under section 206F or leave granted by the Court under section 206G.¹⁴

- 2.22 A number of submissions raised the issue of how a board should be composed in order to protect and enhance basic audit independence and good governance, including a focus on independent non-executive directors. Mr Rodney Bennett submitted a range of requirements for the composition of a Board, including:
- all former auditors of an entity be banned from being directors of that entity for a period of two years;
 - that there be a maximum number of directors representing major shareholdings;
 - that the Corporations Law require that all listed entity boards include a certain number of independent non-executive directors; and
 - that an independent director be a person who has no existing commercial links with the company and would be allowed to own minimal shareholding in the company.¹⁵
- 2.23 Mr Stephen LaGreca commented that independent directors underpin best practice corporate governance, but that Australia lags behind international best practice by not requiring listed companies to appoint a majority of independent non-executive directors.¹⁶
- 2.24 In terms of the process of electing independent directors the Committee raised the issue of ‘one-vote-one shareholder’ as one way of ensuring independence from management. While the Australian Consumers’ Association saw advantages in such an approach, particularly for disenfranchised smaller investors¹⁷, in general, however, the evidence was not supportive of the proposal. PricewaterhouseCoopers told the Committee that such a proposal would not be a ‘fair reflection of the economic interest or entitlement that the broad shareholder group clearly have in the corporate entity’.¹⁸ Deloitte Touche Tohmatsu stated that the current mechanisms were adequate and that ‘at the end of the day, the quality of the directors on boards is really the issue’.¹⁹

14 Section 201B, *Corporations Act 2001*. Part 2D.6 and Section 206F of the Act refer to ASIC’s power of disqualification from managing corporations.

15 Mr Rodney Bennett, *Submission No.4*, p.S49

16 Mr Stephen LaGreca, *Submission No.14*, p.S105

17 Ms Catherine Wolthuizen, *Transcript*, pa.149

18 Mr Tony Harrington, *Transcript*, pa.142

19 Mr Robert Wylie, *Transcript*, pa.188

- 2.25 In response to a proposal put forward by the Committee that ASIC and the ASX develop a best practice guide for the election of directors, what criteria should be met and what kind of training and experience directors should have, Ernst & Young replied that the ASX should be responsible for developing a guidance note on the processes for the election of directors and that there is precedent for this measure in the UK Listing Rules.²⁰
- 2.26 The AICD submitted that their organisation has a wide range of products and services that cover, amongst other things, the election of directors and the appropriate mix of attributes required by board members.²¹ Ultimately, it is the shareholder that elects independent directors, which may not always result in the desired outcome. As the AICD pointed out to the Committee:
- There could well be a potential conflict between what might be logically and demonstrably best practice and, if you like, the almost sovereign right of shareholders who own a company to pick the directors they want anyway'.²²

Selection of the external auditor

- 2.27 Given the importance of the audit function, the process of selecting the external auditor is an important aspect in ensuring independence and good corporate governance. The process must be transparent and accountable.
- 2.28 The Association of Chartered Certified Accountants (ACCA) submitted that 'although in theory this process is a matter for shareholders, in practice the appointment is controlled by management.' The ACCA suggested that non-executive directors and corporate audit committees should have a much higher profile role in the auditor appointment process.²³
- 2.29 In response to the claim that management had too much influence over the appointment of the external auditor, the ASX argued that management did not have any role in selecting the external auditor, commenting that 'if that were the practice, it is an inappropriate practice'. The ASX did agree to a proposal put to them by the Committee that the constitution of a

20 Ernst & Young, *Correspondence*, 19 July 2002

21 Mr Rob Elliott, *Transcript*, pa.173

22 Mr Gavin Campbell, *Transcript*, pa.173

23 ACCA, *Submission* No.8, p. S68

company must have a mechanism for ensuring that the appointment and management of the external auditor was independent.²⁴

- 2.30 **As discussed in the context of audit committees in this chapter, the function of selecting and monitoring the external auditor is generally agreed to belong to a properly functioning audit committee reporting to the board.**

Director's remuneration

- 2.31 The issue of director remuneration in government business enterprises was discussed in Report 372. At that time it was the Committee's view that director remuneration is an important element in attracting top applicants to Boards. The practice of providing share options as part of the remuneration package was considered to increase 'the likelihood of directors interests being aligned with those of other shareholders'. This view requires revision, with some commentators arguing that 'the options culture of the 1990s is dead'.²⁵
- 2.32 In the wake of corporate collapses such as One-Tel and HIH, the issue of director and executive remuneration is under the spotlight. The practice of providing share options as part of the directors' and executives' remuneration packages has been an alleged catalyst for corrupt behaviour such as the manipulation of profit figures to boost share prices, and thus the value of share options. There have been examples of highly paid directors and senior executives cashing in their share options and receiving substantial performance bonuses prior to the company collapse. The Committee is concerned that excessively generous remuneration packages, often incorporating share options, have led to a growth in short-term reasoning and have not necessarily improved the performance of Boards or individual directors, particularly over the medium to long term.
- 2.33 Professor Houghton saw the problem of remuneration partly in the context of the conflict between the short-term interests of management and the longer-term interests of shareholders, which he termed the 'time horizon' problem. He argued that the difference between the two 'does give rise to different incentives for the different stakeholders'.²⁶ The difficulty in arriving at suitable remuneration packages for managers and directors that align their interests with the interests of shareholders was highlighted by Professor Houghton:

24 Mr Richard Humphry, *Transcript*, pa.49

25 'Sun sets on once lucrative stock options', *Australian Financial Review*, 23 July 2002, p.37

26 Professor Keith Houghton, *Transcript*, pa.6

If you have an incentive structure for management that focuses largely on the immediate, then they will respond to that. The alignment of the management interest with the shareholder interest is, in theory, an appropriate way of proceeding, but the actual practical implementation of that is extraordinarily hard.²⁷

- 2.34 PricewaterhouseCoopers commented that generous share options and schemes distort the focus of management:

Those managing companies now have the real prospect of making themselves seriously wealthy through generous share and option schemes. This prospect has created an overemphasis on managing the share price and the drivers of share price.²⁸

- 2.35 Brian Long of Ernst & Young argued that appropriate equity based compensation packages can be formulated which align the interests of executives with the interests of shareholders. He also recognised that equity based compensation arrangements may also disalign management and shareholder interests.²⁹

- 2.36 In terms of setting the boundaries or guidelines for remuneration Ernst & Young argued against legislation, stating that this is a corporate governance issue for boards of directors:

They have the skills and competence to exercise judgment in those areas. If you look at the fundamental premise of why you are rewarding executives and at mechanisms and determine whether or not those mechanisms are effective, to me that is the heart of corporate governance.³⁰

- 2.37 PricewaterhouseCoopers suggested that Boards reconsider remuneration arrangements so that:

...executives are only rewarded for actual wealth accumulated by the companies they are managing rather than simply reaching a target share price on a fixed date.³¹

- 2.38 On the related question of how to improve the transparency and accountability of remuneration arrangements, Ernst & Young submitted that 'the fresh air of disclosure is usually the best disinfectant to a problem' and that enhancing disclosure of remuneration arrangements

27 Professor Keith Houghton, *Transcript*, pa.6

28 Mr Rob Wylie, *Transcript*, pa.182

29 Mr Brian Long, *Transcript*, pa.91

30 Mr Brian Long, *Transcript*, pa.91

31 Mr Rob Wylie, *Transcript*, pa.182

may well be the best answer.³² The Committee has examined the issues associated with the accounting for share options in Chapter 3.

- 2.39 It was recently reported that several of Australia's leading corporations had, or were likely to review the practice of granting share options to their executives. For example, the Commonwealth Bank recently announced that it has eliminated the use of share options from the remuneration packages available to its executives.³³
- 2.40 Arriving at suitable remuneration packages for directors and senior executives is a matter for the Board and shareholders. As discussed in Report 372, a rigorous performance appraisal system, in association with identified incentives, will help develop a competitive and performance oriented culture.
- 2.41 **Appropriate remuneration will always be required to attract qualified people. Recent events and public disquiet regarding what are seen to be excessive levels of remuneration highlights the need for Boards to arrive at remuneration criteria that are fair, transparent, open to performance appraisal and reflect the interests of shareholders. The criteria upon which the remuneration of directors and executive management is based, the level of remuneration and any performance appraisal system should be fully disclosed as a matter of good corporate governance.**

Management perception of the audit function

- 2.42 Competent, transparent and independent auditing practices and processes are critical in the efficient operation of mature financial markets and the value of quality audits cannot be overstated. Evidence submitted to the Committee suggests, however, that companies do not see audits as value-adding to their business and 'all too often' audits are seen as 'another cost subject to reduction where possible'.³⁴ A key indicator of the value placed on audits is the fee allocated to audits.
- 2.43 The Australian Chamber of Commerce and Industry (ACCI) told the Committee that most businesses would view audits as an essential compliance mechanism. In this context the audit merely states that a business is compliant with the law and meeting its obligations. Mr Davis

32 Mr Brian Long, *Transcript*, pa.98

33 Commonwealth Bank, Media Release, 21 August 2002

34 Mr John Shanahan, *Submission* No.35, p.S317

of ACCI said that ‘a lot of firms would treat it like that. I think most firms would regard it as just part of their business affairs.’³⁵

- 2.44 Mr John Shanahan told the Committee that while audit firms have developed effective and efficient systems for dealing with large volume and systematic transactions these are not suited to more complex auditing situations. Most audit firms also have more costly risk-based approaches for dealing with unusual or complex transactions and accounting treatments. However, companies, in seeking to minimise costs, tend to prefer low cost audits that, while appropriate for low risk areas, are not adequate for auditing high risk areas.³⁶
- 2.45 Mr Shanahan asserted that as transactions become more complex companies should be prepared to pay more to ensure higher risk areas are properly addressed. As such, rather than audits being a cost to be minimised, ‘more effective audits will require an increase in the level of audit fees paid’.³⁷
- 2.46 It was suggested by the Committee that ASIC or ASX should set a minimum level for audit fees sufficient to ensure an audit of adequate breadth and depth. In response, CPA Australia told the Committee that setting minimum fees is difficult and in any case there is always a minimum fee level with any particular audit. CPA Australia explained that fees for undertaking an audit were based on varied criteria such as the complexity of the organisation, the risks of the organisation, diversity, international spread, geographic locations and different underlying forms of business’. Therefore, ‘it is very hard to talk in generalities about fee floors’.³⁸
- 2.47 A key question in regard to audit fees is ascertaining where responsibility lies for ensuring that the audit fee adequately reflects the audit requirements of the company and the interests of shareholders. A low-cost audit may accord with management’s objective to reduce costs but not be in accordance with shareholders interests in having a full and complete audit, particularly in regard to areas of high risk. In evidence to the Committee, CPA Australia highlighted the obligations of the Board in ensuring strong audits:

We have heard how important it is to have strong corporate governance and strong audits and we have heard about research

35 Mr Brent Davis, *Transcript*, pa.69

36 Mr John Shanahan, *Submission No.35*, p.S317

37 Mr John Shanahan, *Submission No.35*, p.S317

38 Mr Brian Blood, CPA Australia, *Transcript*, pa.23

on what that does in terms of share price. So one would think that, if the audit committees and boards were acting for the shareholders, that would be a matter they would take on board and, therefore, the fees would be set at the appropriate level.³⁹

- 2.48 It is precisely the high-risk areas of a company's transactions that need to be identified and audited properly. Moreover, the audit fee should reflect the depth and breadth of the audit being undertaken. Rather than mandating minimum fees for audits, the Committee believes that like many issues faced in this inquiry, arriving at the appropriate audit fee is a risk management issue and a critical part of the corporate governance obligations and responsibilities to which the Board and the audit committee should be held.

Conclusion

- 2.49 Corporate governance embodies processes and systems by which corporate enterprises are directed, controlled and held to account. Good corporate governance should also lead to accountable, transparent and independent accounting and auditing practices. Boards, therefore, are a central part of corporate governance. Boards of publicly listed companies are accountable to shareholders for delivering policy objectives and ensuring that the enterprise is operating as efficiently and effectively as possible. As discussed below, a well constituted and independent audit committee reporting to the board can play a very important role in ensuring good corporate governance.
- 2.50 In the Committee's report on corporate governance in government business enterprises, two recommendations were made in relation to the operation of and government business enterprise boards. We recommended that the *1997 Governance Arrangements for Commonwealth GBEs* be amended to include:
- a requirement that government business enterprise boards ensure that there are appropriate and effective induction, education and training programs offered to new and existing board directors; and
 - a section requiring confidential board and director performance appraisal.
- 2.51 The principles underlying these recommendations are applicable to the private sector. The Committee urges all private sector Boards to take note of these recommendations.

- 2.52 In addition, the education and training for board members, the process for appointing board members, remuneration arrangements for directors and executives, the appointment of external auditors and the value placed on the audit function should be dealt with as part of a board's risk management and corporate governance processes. **As such, the Committee recommends that the Australian Stock Exchange's Corporate Governance Council incorporate these views into their work in developing consolidated and up-to-date corporate governance standards for Australian listed companies.**

Management accountability

- 2.53 The relationship between management and boards is crucial to the effective functioning of companies. Senior management has a significant responsibility for ensuring accurate information is provided to the Board as well as ensuring that a company complies with the *Corporations Act 2001*. Division 1 of Part 2D.1 of the *Corporations Act 2001* sets out the duties of other officers, particularly in regard to having a duty to report breaches of the Act or irregularities in the management of the company.⁴⁰
- 2.54 The United States has taken very firm measures in enforcing management accountability. As of August 2002, the US Securities and Exchange Commission requires top executives of large publicly listed companies with annual revenues in excess of US\$1.2 billion to certify in writing, under oath and for publication that their financial reports are 'materially truthful and complete or explain why such a statement would be incorrect'.⁴¹
- 2.55 The Committee also notes that the New York Stock Exchange now requires each listed company CEO to certify annually that he or she is not aware of any violation by the company of the New York Stock Exchange corporate governance standards.⁴²
- 2.56 The Committee received similar recommendations in the course of the inquiry. One submission proposed that the CEO and Chief Financial Officer be required to provide the Board of Directors and the external auditor with a statement of representation which states that the financial statements do present a complete and accurate picture of the companies

40 Australian Consumers' Association, *Submission No.47*, p.S425

41 Securities and Exchange Commission Press Release, www.sec.gov/news/press/2002-96.htm

42 New York Stock Exchange press release, 1 August 2002.

financial position as far as they are reasonably aware, with significant penalties attached for providing misleading information.⁴³

- 2.57 In the course of the public debate regarding the issues surrounding corporate failures there have been calls for increased penalties for directors and senior executives who provide misleading information to the market and the external auditor, as well as increased penalties associated with directors abusing their powers and position. The Committee notes that the *US Public Company Accounting Reform and Investor Protection Act of 2002* significantly increased penalties for a range of crimes related to corporate fraud, including goal terms of up to 20 years and fines ranging from \$US1 million to US\$5 million.
- 2.58 The Australian Consumers' Association (ACA) argued that the present sanctions were too lenient and strongly recommended goal terms for breaches of directors' duties. By way of example, the ACA referred the Committee to a recent decision of the NSW Supreme Court whereby a number of directors who had improperly exercised their powers as directors in making a payment of \$10 million to a company on which one of them served as a director only received a 20 year disqualification. Highlighting the leniency of the sanction the ACA stated that 'the misappropriation of \$10 million in any other context would result in likely imprisonment.'⁴⁴
- 2.59 While the threat of heavy financial penalties and possible lengthy goal terms may provide incentive for managers to ensure the information they provide is true and correct there are significant issues to be addressed. PricewaterhouseCoopers argued that increased penalties might actually restrict the flow of information and inhibit working relationships between auditors and clients. They also identified the danger of lengthy legal actions arguing the legal definition of 'misleading' and whether the actions of executives were 'intentional'.⁴⁵
- 2.60 Given the existence of legal penalties regarding fraud, PricewaterhouseCoopers proposed that a simpler approach would be to require both the Chief Executive Officer and Chief Financial Officer to personally attest that the company's annual report complies with the *Corporations Act 2001*.⁴⁶ This would provide a clear and unarguable indication of management's responsibility for the financial information being provided to the market and the external auditor.

43 Joshua Institute, *Submission No.48*, p.S435

44 Australian Consumers' Association, *Submission No.47*, p.S426

45 PricewaterhouseCoopers, *Submission No.60*, p.S552

46 PricewaterhouseCoopers, *Submission No.60*, P.S552

Conclusion

- 2.61 The Committee takes the issue of director and management responsibility very seriously. The Committee believes that the vast majority of directors and managers are honest and act in good faith. However, although boards carry a great deal of the responsibility for corporate failure, management must also carry a fair share of the responsibility. It is simply not good enough for senior executives of large corporations to claim that they are unaware of the financial situation of the firm for which they are responsible. The large remuneration packages that are paid to senior management also bring clear and significant responsibilities.
- 2.62 A crucial link in the corporate governance chain is the flow of information from management to the board and the market in general. Managers have an obligation to provide not only accurate information that accords with accepted accounting standards, but also truthful and complete information in order for the Board to make decisions that are in the best interests of the shareholders and to allow investors to properly weigh the risks of any investment decisions. In order to strengthen this chain, and establish a clear line of accountability the Committee recommends that the *Corporations Act 2001* be amended to require Chief Executive Officers and Chief Financial Officers to personally attest that the company's annual report complies with the *Corporations Act 2001* and are materially truthful and complete.
- 2.63 By signing such a declaration the Chief Executive Officer and Chief Financial Officer assume personal responsibility for financial reports failing to meet the requirements of the *Corporations Act 2001* and not being materially truthful and complete. To give proper effect to this recommendation appropriate sanctions need to be developed and applied to any breaches of this requirement.

Recommendation 1

- 2.64 **That the *Corporations Act 2001* be amended to require the Chief Executive Officer and Chief Financial Officer of a company to sign a statutory declaration that the company's financial reports comply with the *Corporations Act 2001* and are materially truthful and complete. This declaration must be attached to the company's financial reports whenever they are lodged with ASIC and provided to the company's members and the market operator pursuant to this Act.**

Internal audit

- 2.65 An effective and relatively autonomous internal audit function is a key aspect of good corporate governance. It is a tool that enables managers to obtain valuable information and insights regarding the performance of their company.
- 2.66 Internal auditing is defined by the Institute of Internal Auditors as:
- ...an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.⁴⁷
- 2.67 All companies should evaluate the need for an internal audit function because an effective internal audit function can significantly strengthen their internal control environment. In this regard the Institute of Internal Auditors suggests the following factors should be considered in determining the need for, and size of an internal audit function:
- stakeholders' expectations and the need to sustain their confidence;
 - risk levels; and
 - size and complexity of the organisation, including level of sales or assets, volume of activity and number of operating facilities.
- 2.68 Companies should establish appropriate processes so that the internal auditor is sufficiently independent from management and from any day-to-day operational responsibilities. In addition companies should strive to avoid any restrictions being placed on the scope of internal audit work, in order, as far as possible, not to impair its objectivity and effectiveness. In this regard, better practices for the protection of the independence of the internal auditors include:
- reporting directly to the Board Audit Committee (or equivalent); and
 - existence of a charter, approved by the Board Audit Committee (or equivalent), which amongst other things, defines their authority, rights of access, scope of their work and contains an approved budget.
- 2.69 Australia's auditing standards recognise the importance of a robust internal audit function. *Australian Auditing Standard AUS 604 –*

47 Institute of Internal Auditors, *Submission No.17*, p.S122

Considering the Work of Internal Auditing sets down the following as important criteria when evaluating an internal audit function:

- organisational status, including lines of accountability and responsibility;
- scope of activity, including the nature, timing and extent of work;
- technical competence of the members of the internal audit function; and
- use of due professional care in assignments.

2.70 The following instances are two practical examples, which recognise the importance of the role of internal audit.

2.71 *Prudential Standard APS 310 – Audit & Related Arrangements for Prudential Reporting* indicates that locally incorporated Authorised Deposit-Taking Institutions (ADIs) should have a comprehensive and independent internal audit process to evaluate their internal controls and risk management systems. The standard goes on to say that where the scale of operations does not justify a full time internal audit function, alternative internal review arrangements must be in place.

2.72 The recently announced reforms to the New York Stock Exchange's Corporate Accountability and Listing Standards require every listed company to have an internal audit function.

2.73 An effective and relatively autonomous internal audit function is a key aspect of good corporate governance. The existence of an effective internal audit function would assist Chief Executive Officers and Chief Financial Officers to meet the requirements of the Committee's recommendation (Recommendation 1) that they personally attest that the company's annual report complies with the *Corporations Act 2001* and are materially truthful and complete.

Audit Committees

2.74 Properly constituted audit committees play a central role in good corporate governance, particularly in managing and monitoring the external audit process. The Committee outlined its support for audit committees in the public sector in its report on corporate governance in government business enterprises (Report 372).

2.75 The *Audit Committees: Best Practice Guide 2nd Edition*, published by the Australian Accounting Research Foundation, Institute of Internal Auditors

and Australian Institute of Company Directors, states that an audit committee is a 'vehicle that facilitates the participation of independent directors in the governance process', which:

...can play a key role in assisting the board of directors to fulfil its corporate governance and overseeing responsibilities in relation to an entities financial reporting, internal control system, risk management system and the internal and external audit functions.⁴⁸

- 2.76 There was substantial agreement throughout the evidence received by the Committee that audit committees were a valuable and desirable mechanism for ensuring audit independence and promoting good governance.
- 2.77 The AuASB submitted that 'the existence of an active and effective audit committee provides an excellent market mechanism to strengthen corporate governance and oversee the audit function in a company.'⁴⁹
- 2.78 CPA Australia emphasised the audit committees' role in providing a link between the internal and external audit function and the board. They stated that 'audit committees have a vital role to play in providing comfort to directors on areas of financial significance, as well as providing a link between internal and external audit functions, and the Board.'⁵⁰
- 2.79 Audit committees also support the board in ensuring that the interests of shareholders are recognised and addressed. This was emphasised by Mr Stephen La Greca who stated that audit committees, along with independent directors, ensure a company makes decisions in the best interests of the company and shareholders. He also argued that unless reforms were adopted to bolster audit committee efficacy Australia would continue to lag behind best practice in corporate governance.⁵¹
- 2.80 Publicly listed companies have had the freedom to develop and implement their own corporate governance mechanisms. Although there is a range of models to choose from, such as corporate governance boards and corporate senates, audit committees appear to be the preferred model for managing and overseeing the audit process and fulfilling corporate governance responsibilities. The ASX reports that 93 per cent of the top 200 companies (representing 94 per cent of capitalisation) have established

48 Mr Rob Elliott, *Exhibit* No.8, p.4

49 AuASB, *Submission* No.12, p.S100

50 CPA Australia, *Submission*, No.33, p.S293

51 Mr Stephen LaGreca, *Submission* No. 14, p.S104

audit committees. For companies outside the top 200, forty-five per cent have established audit committees.⁵²

- 2.81 Although audit committees are commonplace in the private sector, a study conducted by Westpac and Monash Sustainability suggested that audit committees are not always structured in a way that would ensure audit independence. One of the findings of the study was that a small but significant number of top 200 companies had audit committees that were structured in a way as to pose a risk to independence, for example by having executives or chief financial officers either on or chairing the audit committee.⁵³
- 2.82 In the course of this inquiry, the two key issues that emerged in relation to audit committees were whether audit committees should be mandated in either the ASX listing rules or the *Corporations Act 2001* and how to enhance the effectiveness of audit committees.

International trends

- 2.83 One of the international trends in corporate governance is towards enhancing the role and function of audit committees.
- 2.84 The US *Public Company Accounting Reform and Investor Protection Act* contains a number of provisions that strengthen audit committees role in ensuring the independence of the external auditor. The provisions of the Act include mandatory auditor reports to audit committees and vesting audit committees with responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services.⁵⁴
- 2.85 Similarly, the NYSE has mandated audit committees for listed companies in its response to recommendations made by its Corporate Accountability and Listing Standards Committee.⁵⁵ The Nasdaq has empowered audit committees with the sole power to hire and fire auditors, sole authority to approve all non-audit related services and the authority to retain legal, accounting and other experts.⁵⁶
- 2.86 The Committee notes that the success of these provisions relies on the Audit Committee being truly independent.

52 Mr Richard Humphry, *Transcript*, pa.39.

53 Macken, J, 'Transparent the Only Way to Go', *The Australian Financial Review*, 20 May 2002.

54 *Corporate Law Bulletin* No 59, July 2002, section 1 (a)

55 New York Stock Exchange press release, 1 August 2002.

56 *Corporate Law Bulletin*, No 59, July 2002, section 1(b)

- 2.87 The UK Coordinating Group on Audit and Accounting Issues in its interim report handed down in July 2002, recommended strengthening the role and responsibilities of audit committees through defining their role in relation to shareholders, enhancing responsibility for approval of purchases of non-audit services and appointment of auditors and possibly underpinning the role and responsibilities of audit committees through company law. In response to the report the UK Government agreed that the role of audit committees must be strengthened and enhanced.⁵⁷
- 2.88 Under Canadian law it is mandatory for listed companies to establish audit committees. The *Canada Business Corporations Act* requires publicly listed corporations to have an audit committee composed of not less than three directors of the corporation, a majority of which are not officers or employees of the company or any of its affiliates. It must also be noted that the regulator may permit a company to dispense with the audit committee if it is satisfied that shareholders will not be prejudiced by such a decision.⁵⁸

Mandating Audit Committees

- 2.89 Requirements for establishing audit committees differ between publicly listed companies and government business enterprises.
- 2.90 A government business enterprise is required to have an audit committee. Sections 32 and 44 of the *Commonwealth Authorities and Companies Act (CAC Act)* require directors of Commonwealth authorities and wholly owned Commonwealth companies to establish an audit committee. The CAC Act requires that audit committees have the following functions:
- helping the authority/company and its directors to comply with obligations under the CAC Act and (for companies) the *Corporations Act*; and
 - providing a forum for communication between directors, the senior managers of the authority/company and the internal and external auditors of the authority/company.⁵⁹

57 *Corporate Law Bulletin*, No 59, July 2002, section 1(c)

58 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.74

59 Joint Committee of Public Accounts and Audit, Report 372, *Corporate Governance and Accountability Arrangements for Commonwealth Government Business Enterprises*, Canberra, Canprint, 1999, p.91.

- 2.91 Similar requirements are not mandated in the relevant legislation or rules for publicly listed companies. Neither the *Corporations Act 2001* nor the ASX Listing rules require a company to have an audit committee.
- 2.92 Although audit committees are not mandated in the ASX Listing Rules, rule 4.10 does require entities to report on corporate governance practices, including whether or not an entity has an audit committee and if not, why (section 4.10.2). In addition, *Guidance Note 9* (GN9), issued by the ASX in July 2000, provides guidance on the disclosure of corporate governance practices as required by Listing Rule 4.10.

Arguments against mandating audit committees

- 2.93 Despite calls for mandated audit committees in the past, the initiative has been resisted for a number of reasons. The Parliamentary Joint Statutory Committee on Corporations and Securities (PJSC) report *Matters Arising from the Company Law Review Act 1998* concluded that audit committees not be mandated due to cost and resource implications for small to medium companies, the belief that there was no single good model of corporate governance and the perceived adequacy of existing ASX rules.⁶⁰
- 2.94 Contrary to the evidence received by the PJSC's inquiry, there was a limited negative response to the idea of mandatory audit committees in evidence to this review.
- 2.95 The potential cost associated with requiring all listed entities to have audit committees was raised with the Committee. The Australian Stock Exchange echoed the findings of the PJSC, arguing that 'the cost burden and the loss of flexibility which results from mandating audit committees and prescribing minimum standards is likely to impact significantly on small to medium size companies'.⁶¹
- 2.96 Organisations representing the business community emphasised the argument that a 'one-size-fits-all' approach was not appropriate given the diversity of the business community. The Australian Institute of Company Directors submitted that the current approach in the Australian Stock Exchange Listing Rules is appropriate and audit committees should not be mandated. While the AICD recognised that audit committees represent good practice, they argued that 'establishing audit committees may not be appropriate or possible for all companies'.⁶² The Australian Chamber of Commerce and Industry stated that while they encouraged

60 Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on Matters Arising from the Company Law Review Act 1998*, Parliament House, Canberra, 1999, pp.99-107

61 Mr Richard Humphry, *Transcript*, pa.40

62 AICD, *Submission* No.26 (including attachments), p.S219

members to establish audit committees they have generally regarded audit committees 'as a matter for the individual enterprise' rather than something that should be mandated.⁶³

- 2.97 A number of submissions downplayed the potential contribution audit committees could make to improved corporate governance. The Australian Stock Exchange told the Committee that 'mandating audit committees will not necessarily ensure auditor independence or audit quality'.⁶⁴ Similarly, Professor Wolnizer said that 'if the community was to look at to audit committees as a profound solution to the problem of corporate governance and to increase the quality of audited financial statements, I fear that we may be disappointed'.⁶⁵
- 2.98 Professor Wolnizer also argued that audit committees are 'constrained by the nature of the information to which they have access' and audit committees 'have no way of finding out whether the information provided to them is reliable and factually based'.⁶⁶ Similarly, in response to the Ramsay proposals for small to medium companies to only be required to have one independent director on the audit committee, the AICD suggests that a single independent director in a small company would be ineffective in the face of management's monopoly of internal information and control systems.⁶⁷
- 2.99 Dr Shann Turnbull argued that an independent audit committee with directors in its membership is essentially an 'oxymoron' because an audit committee will always have links to the company that override independence since directors are principals of the company.⁶⁸

Support for mandating audit committees

- 2.100 Notwithstanding the above, the proposal to mandate audit committees for all publicly listed companies attracted a great deal of support during the inquiry.
- 2.101 In recognition of the important role of audit committees in protecting auditor independence Professor Ramsay recommended that the ASX Listing Rules or *Corporations Act* be amended to require all listed companies to:

63 Mr Brent Davis, *Transcript*, pa.67-8

64 Mr Richard Humphry, *ASX, Transcript*, pa.39

65 Professor Wolnizer, *Transcript*, pa.108

66 Professor Wolnizer, *Transcript*, pa.108

67 AICD, *Submission No 26*, p.S215-222

68 Dr Shann Turnbull, *Exhibit No.4*

- have audit committees;
- specify the composition of the audit committee; and
- require the Board to adopt a written charter to govern the audit committee.

- 2.102 A number of State and Commonwealth Government inquiries, including the Cooney (1989), Bosch (1991) and Lavarch (1991) committees have advocated the mandatory establishment of audit committees for publicly listed companies.⁶⁹
- 2.103 In the evidence received by the Committee, one of the central reasons for mandating audit committees was their perceived role enhancing corporate governance, particularly the independence of the external auditor. The Institute of Chartered Accountants in Australia (ICAA) submitted that a key recommendation arising from the *Expectation Gap Report*, published by them and CPA Australia, was the need for mandatory audit committees. ICAA informed the Committee that it is ‘vital’ that listed companies have mandatory audit committees that have oversight of external audit activity on behalf of the Board (such as appointment, reporting and remuneration). Further, the ICAA proposed that the audit committee ‘should have responsibility to the Board for all corporate governance activity and in the case of any disagreement between the Board and the committee, have responsibility to report direct to shareholders’.⁷⁰
- 2.104 Similarly, the Trustee Corporation Association of Australia strongly supported the Ramsay recommendation that audit committees be mandated for all listed companies, stating that ‘we see a properly structured and functioning audit committee as a fundamental element in ensuring auditor independence, and as an important part of an effective corporate governance framework’.⁷¹
- 2.105 Others saw audit committees as a way of restoring public confidence in the financial reporting of Australian corporations. Deloitte Touche Tohmatsu submitted that, ‘while the Board of directors bears the ultimate responsibility for corporate governance...it should be mandatory for listed companies to have an independent audit committee’. Deloitte argued that mandating audit committees is ‘fundamental to the restoration of confidence in the financial reporting of Australian corporations, and in

69 Wolnizer, P, ‘Are Audit Committees Red Herrings’, *Abacas*, Vol.31 (1), 1995, pp.49-51.

70 ICAA, *Submission* No.29, p.S259

71 Trustee Corporations Association of Australia, *Submission* No.22, p.S181

resolving the perception that the independence of auditors has been compromised'.⁷²

- 2.106 It was also argued that boards had a key role to play in ensuring the effectiveness of audit committees. CPA Australia endorsed the Ramsay recommendations for mandatory audit committees, adding that effective audit committees required support from the Board to ensure adequate resources and independence from management.⁷³
- 2.107 The public sector auditors also supported mandatory audit committees. The Auditor-General of Victoria supported 'proposals for mandatory audit committees with an appropriate charter to enhance the corporate governance structure'.⁷⁴ The NSW Auditor-General submitted that there was little evidence that there are any disadvantages to the establishment and operation of audit committees and that the legislative, mandatory establishment of audit committees for listed companies was supported.⁷⁵
- 2.108 The Australian National Audit Office supported the introduction of legislation to enhance the role and existence of audit committees, with due regard being given to variations in company size and structure. The ANAO informed the Committee that it has observed 'enhanced corporate governance in the public sector arising from the stronger role being adopted by audit committees', including audit committees having independent members that bring external views and experience to committee meetings'.⁷⁶

Responsibilities of the Audit Committee

- 2.109 The *Audit Committees: Best Practice Guide 2nd Edition* outlines a range of responsibilities for audit committees in the areas of external reporting, related party transactions, internal control and risk management, external audit and internal audit.⁷⁷ The Ramsay Report also endowed audit committees with significant responsibilities and functions.⁷⁸
- 2.110 It was also submitted to the Committee that audit committees should play a stronger role in overseeing management activities. The AuASB argued that company management should 'report formally to the audit committee

72 Deloitte Touche Tomatsu, *Submission* No. 23, p.S192

73 CPA Australia, *Submission* No.33, p.S292

74 Victorian Auditor General, *Submission* No.25, p.S210

75 Auditor General of NSW, *Submission* No.28, p.S248

76 ANAO, *Submission* No.27, p.S236

77 Mr Rob Elliott, *Exhibit* No.8, pp.22-5.

78 See Ramsay Report, para 6.78 and Appendix D

annually on the effectiveness of a company's internal control and governance procedures'.⁷⁹ In regard to ensuring the independence of the external auditor, ACCA submits that there should be a mandatory review by the company's audit committee of the independent status of the external auditor and the publication of a statement that it is satisfied with the results.⁸⁰ Stephen LaGreca argues that the audit committee should be responsible for the appointment and fees of the external auditor.⁸¹

- 2.111 A key aspect of an effective audit committee is its independence. The US Blue Ribbon Committee highlighted the importance of independence in their comment that 'several recent studies have produced a correlation between audit committee effectiveness and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud'.⁸²
- 2.112 Clearly prescribing and monitoring the criteria for membership of the audit committee is the central mechanism in ensuring independence. The *Audit Committees Best Practice Guide 2nd Edition* suggests:
- the chairperson of the committee and all committee members need to be either an independent non-executive director or an independent non-director with no operating responsibilities;
 - the managing director should not be a member of the committee; and
 - the committee should always reserve the right to meet with management in attendance.⁸³
- 2.113 Independence also requires access to accurate and verifiable information. Requiring CEOs and CFOs to personally attest to the veracity of financial reports, as recommended in this report, would ensure that audit committees have access to accurate and truthful information. Further, requiring that the internal audit function report directly to the audit committee is another important mechanism to ensure the audit committee is fully informed. Similarly, audit committees should have the resources available so that they can access independent sources of information and advice, for example, the Nasdaq listing rules provide audit committees with the authority to retain legal, accounting and other experts.

79 AuASB, *Submission* No.12, p.S100

80 ACCA, *Submission* No.8, p.S68

81 Mr Stephen LaGreca, *Submission* No.14, p.S103-104

82 Blue Ribbon Committee, cited in Ramsay Report, para 6.62

83 Mr Rob Elliott, *Exhibit* No 8.

Conclusion

- 2.114 The Committee has carefully considered the arguments made in the course of this inquiry in regard to audit committees, with due reference to previous inquiries.⁸⁴ The great weight of submissions received by the Committee support mandating audit committees in legislation and in providing audit committees with significant responsibilities.
- 2.115 The key issue is ensuring a high level of independence for the audit committee. The composition, authority and responsibilities of the audit committee must promote and protect independence. The Board must also take a very active role in ensuring the independence of the audit committee.
- 2.116 The argument that audit committees are an unreasonable cost burden for small to medium companies is increasingly tenuous. Listing on the stock exchange and reaping the potential benefits of selling shares and raising capital brings with it certain costs, obligations and responsibilities. One of these costs should be a properly constituted audit committee. The question that should be asked is whether companies who cannot afford to implement an audit committee, with at least one independent director, be able to publicly list? In recognition of the circumstances of small to medium companies, the Ramsay report makes allowances that would mitigate the cost burden. For example, smaller capitalisation companies would only be required to have one independent director (rather than three as recommended for large companies), which Professor Ramsay rightly described as a 'modest requirement'.⁸⁵
- 2.117 The problem of audit committee reliance on management for information is a vexed one and is a potential problem regardless of how many independent directors are involved. Issues such as this are risk management issues for the whole board to consider and manage. As many submissions have suggested, an effective audit committee requires strong board support to ensure independence and resources. Further, audit committees, and individual directors, should not be passive recipients of information. They should be proactive in verifying information received from management and in seeking out independent sources of information against which internally generated information can be tested. The Committee's recommendation that CEOs and CFOs

84 For example, Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on Matters Arising From the Company Law Review Act 1998*, Parliament House, Canberra, 1999.

85 Ramsay, Ian, *Independence of Australian Company Auditors*, Department of Treasury, Canberra, 2001, p.82.

personally attest to the veracity of the financial reports provided to the board will greatly assist in this respect (Recommendation 1).

- 2.118 In response to the argument that an independent audit committee with directors in its membership is essentially an ‘oxymoron’, the Ramsay report recommends that the chairperson of the Board of Directors not be the chairperson of the audit committee and that directors on the audit committee must meet comprehensive ‘independence’ requirements, which are clearly outlined in Appendix D of the Ramsay report. Adherence to these criteria will provide adequate safeguards to ensure the independence of non-executive directors sitting on audit committees.
- 2.119 Given the passive nature of the ASX role and their lack of statutory powers of inspection and enforcement (as discussed in Chapter 1), the Committee is of the opinion that the *Corporations Act 2001* would be the most appropriate vehicle for mandating the establishment of audit committees. This not only provides firm legislative backing but also allows for ASIC to exercise its inspection and enforcement powers if necessary to ensure compliance.
- 2.120 While recognising the value of audit committees, the Committee recognises that audit committees will not, by themselves, address all the corporate governance and audit independence issues being faced. Nevertheless, a properly constituted audit committee goes a long way towards enabling a company to meet the responsibilities and obligations expected of them by stakeholders. In addition, the Committee agrees with the view that audit committees should always be considered a sub-committee of the Board and should not in any way diminish the overall responsibility of the Board.⁸⁶
- 2.121 In summary, the Committee recommends the following:
- unless exempted upon application to ASIC, all publicly listed companies be required to establish an audit committee comprised of independent members, which is answerable to the full Board of directors;
 - the *Corporations Act 2001* is the best vehicle for requiring publicly listed companies to establish an audit committee, with appropriate provisions to enable small to medium companies to meet the requirement without undue cost burdens; and
 - the *Corporations Act 2001* should clearly set out the basic role, responsibilities and composition of the audit committee so that

compliance can be effectively monitored and policed. Guidance on the role and function of audit committees should be taken from Appendix D of the Ramsay Report.

- 2.122 This recommendation would also assist companies meet the proposed statutory requirement that the auditor be independent (as discussed at Chapter 4).

Recommendation 2

- 2.123 **That the *Corporations Act 2001* be amended to require all publicly listed companies to have an independent audit committee and the Act prescribe the minimum requirements in regard to the role, responsibilities and composition of an audit committee.**

Corporate governance standards

- 2.124 As discussed in the preceding section all companies should have effective corporate governance practices in place. The professional bodies, major audit firms and industry representative bodies have all developed guidelines of one sort or another promoting best practice in corporate governance.
- 2.125 Internationally, the OECD has developed a set of corporate governance principles. While recognising that no single model of good corporate governance exists, the OECD identified ‘some common elements that underlie good corporate governance’.⁸⁷

Current requirements

- 2.126 Where companies do profess to abide by corporate governance principles and practices, such practices are not demonstrable. In other words, they are not tested or independently verified in order to assure shareholders that such principles accord with best practice and are actually being put into practice.
- 2.127 There are no mandated requirements in Australian legislation for companies to have prescribed best practice standards for corporate governance in place. The ASX Listing Rule 4.10.3 only requires a

⁸⁷ *Principles of Corporate Governance*, Organisation for Economic Cooperation and Development, SG / CG(99)5, 1999, p.3

statement of the main corporate governance practices the entity had in place during the reporting period. This is supported by *Guidance Note 9* (GN9), issued by the ASX in July 2000, which provides guidance on the disclosure of corporate governance practices as required by Listing Rule 4.10. In effect, however, a company with no recognised corporate governance mechanisms is not required to report nor are they required to implement any corporate governance practices.

Broadening financial reporting requirements

- 2.128 It is clear from submissions received by the Committee that information beyond the financial statements, such as the quality of corporate governance, is important to shareholders and other stakeholders.⁸⁸

In the current climate, reporting on issues that provide confidence to the Australian public regarding corporate Australia, including corporate governance, internal controls and risk management, the “going-concern” assumption, the health of the business, quality of earnings, management estimates, risks and liquidity, is important.⁸⁹

- 2.129 The issue faced by the Committee was how to model a broader reporting framework that would address the increasingly comprehensive and sophisticated information needs of investors. The term ‘expectation gap’ has been used to describe the ‘difference between expectations of users of financial reports and the perceived quality of financial reporting and auditing services delivered by the accounting profession’.⁹⁰ The public debate in the wake of recent corporate failures reflects the general public’s concern that key non-financial indicators of impending failure were not addressed by the auditor.
- 2.130 At present the only assurance shareholders receive from the audit report is limited to the financial statements and whether they are in accord with the accounting standards and provide a true and fair view. However, one important aspect of the ‘audit expectation gap’ is the extent to which an auditor can or should be reporting on aspects of corporate governance other than the financial reports.⁹¹
- 2.131 In addition to corporate governance standards there was strong support in the evidence to the inquiry for broader and more comprehensive auditing

88 Deloitte Touche Tohmatsu, *Submission* No.23, p.S196

89 PricewaterhouseCoopers, *Submission* No 60, p.S551

90 ICAA, *Exhibit* No.5

91 Victorian Auditor-General, *Submission* No.25, p.S211

as a way of addressing the broader information needs of shareholders. These issues are discussed in more detail in Chapter 4.

A new reporting framework

- 2.132 The central issue in this section of the report is how and in what form this additional information is to be provided, and by what mechanism is it to be tested so that shareholders can have confidence that the information is accurate. According to PricewaterhouseCoopers, although firms have developed criteria for measuring non-financial areas,⁹² there is no framework in place governing additional disclosures:

For financial statements, directors follow accounting standards and auditors report against these. There is no generally accepted framework for other areas, particularly the behavioural areas.⁹³

- 2.133 To give effect to these concerns, a possible initiative considered by the Committee is to embed corporate governance standards in the accounting and auditing framework. This would require the development of a set of testable corporate governance standards and their incorporation into the *Corporations Act 2001*.
- 2.134 The Committee notes the ASX initiative to tighten corporate governance through establishing a Corporate Governance Council. The ASX reported that the Council will develop best practice guidance on issues critical to investor confidence, including audit committees, financial reporting, convergence of reporting standards, independence of directors, and executive options.
- 2.135 The Committee welcomes and supports this very positive initiative. However, this will not provide a framework for enabling broader and more comprehensive reporting as called for in the submissions to this inquiry.

Conclusion

- 2.136 The Committee considers that broader reporting, based on a considered framework of governance principles will provide more useful and broad ranging information to shareholders and other stakeholders. As discussed in relation to audit committees, listing on the stock exchange and reaping

92 The auditing standards also provide guidance for auditors to provide opinions on non-financial issues. For example Auditing Standard AUS 402 defines 'internal control structure' and AUS 810 provides auditors with professional guidance on the conduct of engagements of this nature.

93 PricewaterhouseCoopers, *Submission* No.60, p.S551

the potential benefits of selling shares and raising capital brings with it certain costs, obligations and responsibilities. The following recommendation is aimed at ensuring companies meet these responsibilities and obligations.

- 2.137 The Committee holds the view that embedding corporate governance standards in the *Corporations Act 2001* alongside the present accounting standards would require companies to pay due attention to corporate governance and report fully to shareholders. In a speech to the Monash Governance Research Unit on 16 July 2002, the Chairman of ASIC, Mr David Knott, posed the question ‘Should the regulator have powers to prescribe and enforce governance standards?’ He recognised that this is a ‘radical notion’ and would represent a major shift in the responsibilities of the regulator. While not necessarily advocating this change, he made the point that ‘if you are not in control of governance, you cannot prevent failure.’⁹⁴ In light of repeated failures in corporate governance going back to the 1980s, the Committee considers that it is time to take more control of corporate governance.
- 2.138 In order to give effect to this proposal the Committee recommends that the Financial Reporting Council be directed to develop a set of corporate governance standards. The Committee suggests that guidance should be taken from the findings of the ASX’s Corporate Governance Council in developing these standards.
- 2.139 In addition, the final corporate governance standards should reflect international best practice rather than minimum acceptable standards, and incorporate criteria such as risk management and internal controls. The Committee recognises that this cannot be a static exercise. It must be dynamic and ongoing in order to keep abreast of changes in the broader economy.
- 2.140 Finally, the standards must be given legislative authority. The accounting standards are given legal authority in Section 334 of the *Corporations Act 2001*. The Committee therefore recommends that corporate governance standards be given equivalent legislative authority. The Committee has identified two possible ways of giving legislative effect to this recommendation. The first approach is to recognise corporate governance standards as part of the suite of accounting standards and provide legislative backing to the corporate governance standards pursuant to Section 334 of the *Corporations Act 2001*. The alternative approach would be to create a new section in the *Corporations Act 2001* (ie Section 334 (A)), mirroring Section 334 but giving legislative authority to corporate
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94 Knott, David, *Inaugural Lecture, Monash Governance Research Unit*, 16 July 2002, Melbourne.

governance standards as a discreet set of standards alongside the accounting standards. In this case, the standards would also need to be included in the current compliance requirements in sections 295 and 296 of the Act.

- 2.141 In considering this proposal the Committee has given due recognition to the argument that a ‘one-size-fits all’ approach may not be appropriate. Nor is the Committee wishing to impose unnecessary burdens on business. However, as evidenced by the OECD guidelines, there are basic principles relating to best practice in governance, risk management and internal control to which all companies should adhere. There is also a clear public demand for more extensive reporting of non- financial information, including information on corporate governance and commentary on the health of the organisation. The reporting of this information is addressed in Recommendation 3 and also discussed further in Chapter 3.
- 2.142 In addition to broadening financial reporting, there was strong support in the evidence to the inquiry for broader and more comprehensive audits. The issue of establishing a framework for broadening the scope of audits is discussed in Chapter 4.

Recommendation 3

2.143 **That the Financial Reporting Council:**

- **develop a set of corporate governance standards, including prescriptions for internal audit, taking primary guidance from the findings of the ASX’s Corporate Governance Council; and**
- **take all steps to ensure these standards be given legislative backing in the *Corporations Act 2001*, as either pursuant to or mirroring Section 334.**

Corporate governance in audit firms

- 2.144 The independence of audit firms is important for maintaining public trust in the financial reporting framework. Investors must be able to rely on issuers’ financial statements. Consequently, the effectiveness of the

mechanisms audit firms have in place to manage risks to their independence is a matter of public interest.

- 2.145 Each of the major audit firms conveyed to the Committee the view that the current arrangements in place to address risks to their independence were satisfactory. For example, Ernst & Young advised the Committee that its internal policies dealing with independence were regularly updated to ensure they meet international best practice⁹⁵ and Deloitte Touche Tohmatsu told the Committee:

...to satisfy the quality and the integrity of the services that we deliver, there is a very comprehensive process in place which encompasses internal quality assurance processes, peer reviews and reviews by the Institute of Chartered Accountants.⁹⁶

- 2.146 More generally, PricewaterhouseCoopers stated that the ‘auditing profession in Australia and the standards supporting the profession are sound and reflect world’s best practice’.⁹⁷ Similarly, KPMG stated that ‘Australia has a strong, dedicated audit profession that operates in line with world’s best practice’.⁹⁸
- 2.147 PricewaterhouseCoopers also informed the Committee that processes in place to ensure the independence of audit firms are monitored internally by the firms themselves, by the professional bodies through their ongoing monitoring programs and are implicitly covered by the tri-annual declaration made by registered auditors to ASIC. Many audit firms voluntarily provide independence declarations to their clients’ audit committees on an annual basis.⁹⁹
- 2.148 In terms of public accountability, auditors are required by the *Corporations Act 2001* (sect. 1288) to lodge a triennial statement with ASIC setting out such information as is prescribed.
- 2.149 Australian auditors generally ascribe to very high standards and audit firms have comprehensive quality control and risk management mechanisms in place. However, recent events have raised questions of their independence. Negative perceptions are reinforced by the lack of informed public exposure to the mechanisms audit firms have in place to ensure their independence and the lack of any real public oversight or scrutiny of audit firms. To remedy this negative perception and rebuild

95 Ernst & Young, *Submission* No. 32, p.S278

96 Mr Robert Wylie, *Transcript*, pa.182

97 PricewaterhouseCoopers, *Submission* No.18, p.S129

98 KPMG, *Submission* No.34, p.S311

99 PricewaterhouseCoopers, *Submission* No.60, p.S550

confidence in the audit function the Committee is interested in ensuring that the governance processes and practices used by audit firms are best practice, transparent and accountable. The Committee acknowledges that the major audit firms have recently taken steps to enhance their internal independence and quality control practices.

Ensuring the independence of the auditor

- 2.150 Various initiatives have been adopted or recommended in order to ensure audit firms maintain their independence and to protect the reliability and integrity of financial reporting by publicly listed companies. These initiatives range from highly prescriptive rules-based regimes to self-regulatory frameworks.

U.S Securities and Exchange Commission

- 2.151 At one end of the spectrum is the prescriptive approach taken by the U.S. Securities and Exchange Commission. In November 2000, the Securities and Exchange Commission adopted a set of detailed prescriptive rules regarding audit independence and disclosure applicable to auditors of listed entities. These rules were revised in 2001. The rules are based on four principles for measuring auditor independence. Under these principles, an accountant is not independent when the accountant:
- has a mutual or conflicting interest with the audit client;
 - audits his or her own firms work;
 - functions as management or an employee of the audit client; or
 - acts as an advocate for the audit client.
- 2.152 The SEC rules (Rule 2.10.2-01(d)) outline a range of features that should be present in an audit firms quality control system if it is to provide adequate assurance, including:
- written independence policies and procedures;
 - an automated system to identify investments that might impair independence;
 - an on-going firm wide training program about auditor independence;
 - an annual internal inspection and testing program to monitor adherence to independence requirements;
 - notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence policies;

- written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from the audit client's engagement and to review promptly all work the professional performed related to the audit client's engagement; and
- a disciplinary mechanism to ensure compliance with the SEC rules.¹⁰⁰

2.153 Since adopting the audit independence rules the SEC has initiated and settled cases against a number of large audit firms. Recent examples include:

- July 2002: PricewaterhouseCoopers settled a SEC initiated audit independence case against them where the SEC had found that PricewaterhouseCoopers had violated audit independence rules involving 16 separate audits of public companies.¹⁰¹
- June 2002: the SEC brought a case against a foreign accounting firm for engaging in 'improper professional conduct' within the meaning of the SEC's independent auditing rules.¹⁰²
- January 2002: the SEC censured KPMG for violating audit independence rules by engaging in 'improper professional conduct' because it purported to serve as an independent accounting firm for an audit client at the same time that it made substantial financial investments in the client.¹⁰³

Professional Statement F.1: Professional Independence

2.154 At the other end of the spectrum is the self-regulatory approach taken by the auditing and accounting profession in Australia under the *Professional Statement F.1: Professional Independence* developed by the Institute of Chartered Accountants in Australia and CPA Australia. As a self-regulatory mechanism, the *Professional Statement F.1*

...adopts a conceptual framework for assurance engagements that requires the identification and evaluation of threats to independence and the application of safeguards to reduce any threats created to an acceptable level.¹⁰⁴

100 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.70

101 SEC Press Release 2002-105, 17 July 2002.

102 SEC Press Release 2002-95, 27 June 2002.

103 SEC Press Release, 2002-4, 14 January 2002.

104 *Professional Statement F.1: Professional Independence*, p.44

2.155 In terms of monitoring and enforcement of the principles, *Professional Statement F.1* requires that:

...members should be prepared to justify to the Institute of Chartered Accountants in Australia and CPA Australia, if called upon, any apparent transgression from all the provisions and spirit of this Statement.¹⁰⁵

2.156 Both the ICAA and the CPA told the Committee that adherence to *Professional Statement F.1* will be monitored through their respective quality review programs. Non-compliance will be investigated and disciplinary action taken consistent with existing regulations and processes.¹⁰⁶ The ICAA added that it would expect ASIC and the CALDB to enforce the requirements of *Professional Statement F.1* or bring alleged breaches to the attention of the ICAA (and presumably the CPA).¹⁰⁷

2.157 A number of the major audit firms informed the Committee that for the most part their internal independence and quality control policies already comply with the *Professional Statement F.1*.¹⁰⁸

Independence Boards

2.158 Professor Keith Houghton submitted to the Committee the proposal that audit firms should be required to establish Independence Boards. An Independence Board would have the authority to define, review and decide upon all threats and potential threats to independence. It would also have responsibility for the quality control and educational programs in respect of an audit firm's independence decision making.¹⁰⁹

2.159 According to Professor Houghton, research suggests that markets prefer companies where ultimate policy decisions are made by a body separate from the executive, and are transparent and objective. A process within audit firms that parallels this corporate control mechanism would enhance audit quality and independence. Audit firms with transparent and objective quality control processes will be more competitive in attracting business and will force other audit firms to follow suite. Subsequently, a company with verifiably independent and competent audits will have a

105 *Professional Statement F.1: Professional Independence*, p.2

106 CPA Australia, *Submission No. 56*, p.S527 and ICAA, *Submission No. 53*, p.S505

107 ICAA, *Submission No. 53*, p.S505

108 Deloitte Touche Tohmatsu, *Submission No. 52*, p.S485, Ernst & Young, *Submission No. 57*, p.S530 and PricewaterhouseCoopers, *Submission No.60*, p.S550

109 Professor Keith Houghton, *Submission No.1*, pp.S24-25

lower risk and higher value compared to companies with audits perceived to be lacking independence and competence.¹¹⁰

2.160 The key proposals to establish this control mechanism are:

- Legislation requiring audit firms to have observable quality control for independence.
- Audit firms of a certain size be required to establish external Independence Boards to oversee all issues related to audit independence.
- Small to medium audit firms that audit publicly listed companies would have access to an independence board established under the auspices of the professional bodies.
- Public disclosure by audit firms of quality controls in place for mitigating risks to audit independence.¹¹¹

2.161 The Committee understands that two of the four major audit firms have established mechanisms that reflect the proposal put forward by Professor Houghton and a third, Deloitte Touche Tohmatsu, informed the Committee they were currently considering Professor Houghton's proposal.¹¹²

2.162 PricewaterhouseCoopers informed the Committee that they had established an Audit Standards Oversight Board, comprised of three external members, to 'oversee the manner in which the firm gains assurance that audit quality and independence standards are being met'.¹¹³ KPMG recently established an Ethics and Conflicts Committee to review the firm's policies and procedures relating to ethics and independence and to provide advice on specific matters. The four member Committee, chaired by the firm's National Chairman, has one external member.¹¹⁴

2.163 Ernst & Young, the other major firm, has a comprehensive risk management structure, including a Risk Management Committee. The Committee understands that its internal policies endeavour to imbue staff with a strong risk management focus, including dealing with independence issues.¹¹⁵

110 Professor Keith Houghton, *Submission* No.1, p.S07

111 Professor Keith Houghton, *Submission* No.1. pp.S33-34

112 Mr Robert Wylie, *Transcript*, pa 185

113 PricewaterhouseCoopers, *Submission* No.18, p.S130

114 KPMG, Media Release 11 July 2002

115 Ernst & Young, *Exhibit* No. 15

- 2.164 The Committee considers the adoption of independence boards to be a profitable measure to improve the ability of audit firms to deal with independence issues. To be fully effective, these boards must be able to operate transparently and objectively. As suggested by Professor Houghton, they must be able to operate in real time, have no commercial interests in the outcome of their decisions and be supported by mechanisms that ensure they are not captured by the audit firm.¹¹⁶
- 2.165 The establishment of independence boards complements the Committee's call for increased public accountability for the audit firms and its proposal for a broader role for ASIC in this process (Recommendation No. 4). In the Committee's view, the existence of a properly constituted and functioning board would enable audit firms to more readily address independence issues with ASIC.

Auditor Independence Supervisory Board

- 2.166 The Auditor Independence Supervisory Board (AISB) proposed in the Ramsay report (discussed in more detail in Chapter 4) incorporated an audit firm oversight function. It was envisaged that the AISB would 'monitor the nature and adequacy of systems and processes used by Australian audit firms to deal with issues of auditor independence and advise on the adequacy of these systems and practices'.¹¹⁷
- 2.167 Professor Ramsay proposed that the AISB use the SEC rules (described above) as a benchmark for monitoring audit firms. In addition, the accountancy firms should be prepared to enter into an agreement with the AISB to provide reasonable access to people and papers to help the AISB with this monitoring process.¹¹⁸

Independent Audit Commission

- 2.168 Mr Rodney Bennett recommended to the Committee the creation of an Independent Audit Commission, a government body independent of ASIC and answerable to Parliament. Audit firms would be required to report to the Commission on each listed entity they audit, reporting on all issues discussed, issues uncovered, issues discussed with management or at an audit committee meeting.¹¹⁹

116 Professor Keith Houghton, *Transcript*, pa.265 and pa.267

117 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.70

118 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, p.70

119 Mr Rodney Bennett, *Submission No.4*, p.S50

Auditing the auditors

- 2.169 Investors, both small investors saving for retirement and large institutional investors, place a great deal of trust in audit firms and the independence of their assurances. The public expects auditors to ‘discover and disclose instances of poor corporate governance’.¹²⁰
- 2.170 There are clearly some questions regarding the success of self-regulation. The alleged audit failures of recent times have occurred despite regular assurances by members of the accounting and related professions that the present rules and regulatory frameworks concerning audit independence and professional standards are adequate. The failure of auditors to warn of the pending troubles at One-Tel, HIH and Harris Scarfe, regardless of the actual role of the auditor, have created a very negative public perception of the audit function.
- 2.171 A key factor that must not be lost sight of in the debate is that the principal client of an audit is not management, it is the shareholder. Despite protestations from the profession that there is no need for any external oversight mechanism the Committee considers that the way audit firms protect and promote their independence is a matter of great public importance and as such requires some form of oversight.
- 2.172 The Committee recognises that audit firms already have an array of comprehensive quality control mechanisms and processes in place to identify and address risks to independence. The Committee is also encouraged by the way audit firms have responded to the crisis in confidence in the audit function. However, the problem is not necessarily with the quality of these mechanisms and processes but the lack of public scrutiny and public knowledge of how audit firms operate. Opening up audit firms to public view will assist in lifting confidence in the veracity of financial reporting. Given that the major audit firms have great confidence in their quality control processes, they should have nothing to fear from allowing for regular public scrutiny of those processes. In fact, they have everything to gain by encouraging public confidence in their ability to provide independent opinion and advice.
- 2.173 The Committee has carefully considered both the prescriptive and self-regulatory models applying to the oversight of audit firms. The Committee does not support a highly prescriptive regulatory approach such as that in place in the United States. The Committee notes, however, as highlighted by the second case referred to in paragraph 2.153, that the

120 Australian Consumers’ Association, *Submission No.47*, p.S424

rules applying in the United States may have an impact on the operation of audit firms outside of that jurisdiction.

- 2.174 The situation in Australia does not necessitate an overly prescriptive regime. Conversely, the Committee believes that the self-regulatory model has failed to adequately protect investors and the approach of *Professional Statement F.1* does not provide a sufficient level of public assurance or transparency.
- 2.175 In taking a ‘middle ground’ approach between prescription and self-regulation the Committee recognises the public demand for more accountability of audit firms while allowing audit firms to have the flexibility to develop and implement quality assurance processes that fit their particular circumstances. To provide public confidence in the independence and veracity of the audit function there is a need to provide a mechanism for ‘auditing the auditor’ with the objective of providing public assurance that the internal systems and processes of audit firms accord with best practice.
- 2.176 The Committee is not convinced of the need to establish a new regulatory body to oversee audit firms. The Committee envisages that ASIC, as the regulator, should take on a broader and more vigorous role in ensuring audit independence. The Committee does not aim to add an additional layer of regulation, but seeks to revise and build on the existing system.
- 2.177 In light of the preceding discussion, the Committee proposes a mechanism for the public oversight and scrutiny of audit firms. This may be achieved through amending section 1288 of the *Corporations Act 2001*, which currently states that auditors need only provide triennial statements setting out such information as are prescribed.
- 2.178 First, audit firms undertaking audits of publicly listed companies should be required to submit verifiable ‘independence performance reports’ to ASIC on a regular basis detailing how they have managed independence issues and any future independence management issues that are deemed pertinent.
- 2.179 Second, ASIC should have the authority to investigate and address, through recommendations or penalties, matters arising from those reports.
- 2.180 The third point, in keeping with the monitoring role envisaged for the AISB in the Ramsay Report, suggests that ASIC refer to the quality control systems and procedures outlined in the SEC audit independence rules (Rule 2.10.2-01(d)), and other systems and procedures ASIC thinks appropriate, as a benchmark for determining the adequacy of the internal systems and processes of large audit firms.

- 2.181 Finally, to ensure transparency and accountability these benchmarks should be published so that both audit firms and investors are aware of the requirements that must be met.

Recommendation 4

- 2.182 **That Section 1288 of the *Corporations Act 2001* be amended to incorporate the following principles:**

- **require audit firms undertaking assurance audits of publicly listed companies to submit a report to the Australian Securities and Investments Commission (ASIC) on an annual basis detailing how audit firms have managed independence issues in the preceding period and any future independence management issues that are deemed pertinent;**
- **provide ASIC with the authority to investigate and address independence issues arising from these reports or from other sources as ASIC considers appropriate; and**
- **require publication of the ASIC benchmark criteria used for determining the adequacy of the internal systems and processes of large audit firms.**