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The Secretary
Parliamentary Joint Committee on Corporations and Financial services
Room SG.64
Parliament House
Canberra ACT 2600

Dear Dr Dermody

CLERP 9

Inquiry into the Exposure Draft -
CLERP (Audit Reform and Corporate Disclosure) Bill

Ernst & Young wish to thank you for your invitation to make a submission to the Parliamentary Joint Committee on Corporations and Financial Services in regard to the CLERP 9 Bill (**Bill**).

CPA Australia and The Institute of Chartered Accountants in Australia made a detailed submission (**Submission**) to the Treasury on 10 November, on behalf of the profession. We understand that the Submission will also be provided to the Committee. Ernst & Young agrees with the Submission, both generally and as to the specific points. Clearly the impact of the Bill on the accounting profession, if enacted as presently proposed, is significant. This is outlined in the Submission. We share the concerns raised in the Submission that the legislation in certain respects has moved from a principle-based approach to become overly prescriptive, that "one size fits all" cannot operate in practice; that the new rules mean that in Australia we have gone further than other jurisdictions and that all this will serve to do is increase the cost of auditing in Australia and not deliver the outcomes sought being to restore confidence and enhance capital markets.

CLERP 9, as with other overseas reforms, is in many respects a response to a number of high profile corporate collapses. It is, however, too simplistic to say that those collapses were attributable to a lack of independence of the directors and auditors, or that more independent directors and auditors would have prevented those losses. We recognise that some legislative reaction is necessary to meet public perception, but the proposals in the Bill will restrict the business activities of the accounting profession in a manner which we believe will be detrimental to Australian business generally, and to the accounting profession.

Whilst we are therefore supportive of many of the Government's reforms, we do wish to raise concern about some specific proposals which are noted in the body of our response.

The following is a very brief summary of the impact on Australian business of the proposals directly affecting the accounting profession.

Liability limited by the Accountants Scheme, approved under the Professional Standards Act 1994 (NSW).

- there will be a reduced flow of accounting graduates to the auditing profession because of the restrictions on their career path;

- there will be a reduced flow of trained experienced accountants into the commercial workplace;

- there will be a reduction in competition for the provision of auditing services and accounting services to Australian corporates - particularly the major ones that have international operations, or offshore investors, and must have audit sign off from a recognised firm;

- there will be an increase in auditing costs, consequent on the auditing standards becoming law, the costs of compliance with the independence requirements, and the duplication of services which must be provided by audit firms and those firms independent of the audit firm for non-audit work;

- the relationship between auditors and the companies they audit will become adversarial, as a consequence of the auditing standards being law, the obligation of auditors to report any breach of the Corporations Act, and the cost issues already referred to.

We have reviewed closely all the points made in the Submission and endorse all those comments, but wish to highlight the following as of particular importance to Ernst & Young.

Auditor Independence

The Submission contains detailed argument on most of the proposals contained in Schedule 1, Part 3 of the Bill. As presently drafted the provisions in the Bill on independence are not capable of practical implementation. The profession, through CPA Australia and The Institute of Chartered Accountants, has adopted Professional Standard F1 on independence and it would be our preference that the independence provisions of the legislation simply require adherence to that Professional Standard as amended from time to time. We recognise that this may not be acceptable to many in the community, particularly in light of the recommendations of Professor Ramsay and Mr Justice Owen. We note, however, that a number of the provisions go far beyond what either of those gentlemen proposed, as outlined at relevant places in the Submission. We, together with the professional bodies, suggest a compromise which we believe can be implemented. The Submission contains the redraft for ease of reference.

For your assistance we wish to highlight the key points of principle raised:

- The general auditor independence requirement needs to be qualified, such that it will only arise if circumstances exist that:

  (a) <u>significantly impair</u> or <u>are likely to significantly</u> impair the ability of the auditor to exercise objective and impartial judgment; or

  (b) would give a person with full knowledge grounds <u>to conclude</u> that the ability of the auditor to exercise objective and impartial judgment <u>is likely to be significantly</u> impaired.

- The specific independence requirements should not be breached where the circumstances of the breach are not known or all reasonable steps to correct the contravention have not occurred, provided there is in place a suitable quality control system to prevent those events occurring.

- We agree that auditors and their immediately family should accept constraints on their employment, and their investments, but "immediate family" should be confined to those with whom the auditor has some influence, namely his or her spouse and dependants. The current wide definition, which includes parents and siblings, regardless of dependency, is not capable of control or even monitoring. The general independence test referred to above will protect investors should those relatives have some influence over the auditor that would affect his or her judgment.

- The test for independence of former partners and employees is drafted so widely that there can never be independence for the purposes of the legislation. This is particularly so where the requirements are retrospective. The investing public will be protected by the cooling off periods.

- The cooling off period in the legislation is presently drafted as 4 years for every professional member of the audit team (a term which would extend from high school graduate to trainees and university graduates to the partner) and 2 years for every partner. Sarbanes Oxley requires 1 year only, for a professional members of the team, and the European requirement is 2 years, also only for the audit team. We advocate a 2 year cooling off period for all key senior members of the audit team, including the partner, and for all partners in the firm. The cooling off period would begin on the earlier of the firm ceasing to audit the client, or the employee ceasing to be a member of the audit team.

- The restriction on multiple former audit firm partners joining a client should be removed. The cooling off period protection and the other independence requirements should be sufficient. The present draft does not reflect the fact that many skilled members of the audit profession progress from the professional accounting firms into commerce, many at a relatively early stage in their career, and provide a skilled workforce that is essential for Australian business to develop and to meet its governance obligation.

- The context of the s.307C Certificate must be clarified. It should relate to contraventions of the independence provisions, and there should be scope to provide a non-complying certificate so that the audit client is still in a position to deliver audited accounts as required by the Corporations Act, notwithstanding an inadvertent breach of the independence requirements during the audit period. The certificate must also clearly only apply to the audit of the subject company in that year. If this is not remedied, an audit firm may have to withdraw from a public company audit prior to completion of the audit process with the only remedy being to engage a new auditor. This will cause disruption to the audit process and delay the issue of the financial reports to the detriment of the company and the shareholders.

Auditing Standards as law

We have on many occasions submitted that to make auditing standards law will be to introduce prescriptive law, and hamper the process of harmonisation of international auditing standards. Regrettably we accept this is not acceptable to the community.

- Our preference is for the legislation to refer to the auditing standards approved by the professional bodies (The Institute of Chartered Accountants and CPA Australia) from time to time, recognising this will follow the international trends. They should not become disallowable instruments.

- The standards in their present form are not suitable to become law. They should be introduced into law on a case by case basis, after due consideration as to the context and wording. The AuASB will be undertaking this process in the ordinary course. Our objection is that at commencement of the legislation all auditing standards will be brought within the regulations as foreshadowed in the CLERP 9 commentary.

- When an auditing standard does become law, it should commence as law from the next financial review period. It is not appropriate that standards are introduced mid-way through a review period.

Section 311: Duty of Auditor to inform ASIC

The expansion of the obligation of an auditor to inform ASIC under the revised s.311 will significantly alter the relationship between the auditor and client. The change to an investigator/reporting role will inhibit the free exchange of information that is necessary to achieve the best audit. Clients will incline more to secrecy and minimal information provision.

The obligation to inform of any attempt to unduly influence, coerce, manipulate or deceive is not capable of precise application. An audit process is necessarily a discussion between audit professionals and the client. This legislation may be seen to restrict that discussion.

We support the Submission, the key points of which are:

- the auditor is only obliged to report contraventions or conduct which is not adequately dealt with after bringing it to the attention of the directors (ie reinstate current s.311(b));

- the auditor is only obliged to report fraudulent or dishonest attempts to influence, coerce, manipulate or mislead or interfere with the auditor, where that action is for the purpose of rendering the financial statements materially misleading;

- the obligation to report is within a reasonable time and in any case within 28 (not 7) days;

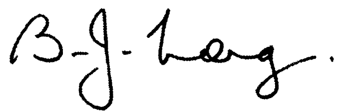
- the obligation should only be on the lead auditor, and not all professional members of an audit team, recognising many of those persons are relatively junior and lack the knowledge or judgment at that point in their careers that warrants their attracting legal obligations of the type imposed by the legislation.

True and Fair View

We support the views expressed in the Submission, however, we are of the opinion that there are unintended consequences with the current draft. For ease of reference, we attach a document which details the technical application of these provisions as currently drafted.

We would be pleased to discuss any aspects of this Submission with the Committee. Please contact Brian Long, Chairman, Ernst & Young, Sydney on 02 9248 4540.

Yours sincerely



Brian Long
Chairman

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ATTACHMENT

CHAPTER 2 FINANCIAL REPORTING

PART 1 TRUE AND FAIR VIEW

Australian accounting standards, like those issued by the IASB, are rigorously principle-based and apply substance over form. Substance over form by its very nature negates a need for a "true and fair" override. Transactions are accounted for in accordance with accounting standards, with the overall requirement that the substance of a transaction, not just its legal form, be considered when assessing the nature of any particular transaction.

We believe that the "substance over form" principle means that the "true and fair" objective should always be achieved. Accordingly if any accounting standard is considered deficient and does not meet the objectives of accounting standards, as detailed in section 224(a) of the Australian Securities and Investments Commission Act, then the onus is on the AASB to change the standard rather than on directors and auditors of individual companies to decide.

We believe that a "true and fair" override implemented as currently proposed could create many issues for auditors and companies.

Practical Example

Two companies, Southcorp and Fosters, both apply AASB 1037 "Self Generating and Regenerating Assets" (SGARAs) as both have bearer-SGARAs, which must be accounted for in accordance with the Standard.

Southcorp applies the measurement, recognition and disclosure requirements of the Standard and believe that application of the Standard provides a "true and fair" view of the company's SGARA position, and as such do not provide any additional discussion in the notes.

Fosters also apply the Standard, however, the directors feel that application of the Standard **does not** provide a "true and fair" view and as such include considerable additional information in the notes to the financial statements. They also include a discussion of the reasons why the additional information was necessary to provide a true and fair view in the directors' report.

Scenario 1

Both companies have the same independent auditor. The auditor is of the opinion that the additional information provided by Foster's in the notes to the financial statements and discussed in thre directors' report is necessary to provide a "true and fair view". As required by the CLERP 9 Bill the auditor addresses this issue in the auditors report and expresses the opinion that the additional information is necessary to provide a true and fair view.

The auditor, having opined that the additional information provided by Foster's is necessary to give a true and fair view must then provide a qualified audit opinion on the financial statements of Southcorp on the basis that the financial report does not give a true and fair view of the company's

financial position as at reporting date and of its performance for the period ended on that date. Southcorp will receive a **qualified audit opinion notwithstanding that the company complied with all accounting standards**.

Southcorp are aware that another auditor would have provided an unqualified opinion, as they do not agree that the additional information was necessary to provide a true and fair view. Southcorp exert pressure on the auditor to reconsider their stance.

Scenario 2

Southcorp and Fosters have different independent auditors. The auditor of each respective company concurs with their clients approach to the SGARA issue and both auditors provide an unqualified opinion on the financial report of each company. Shareholder A, who has shares in each company, must reconcile the fact that both companies deal differently with a major asset, being SGARA's, and yet according to the auditor of each company both present a true and fair financial report. This is notwithstanding the considerable additional information provided in the notes to Fosters financial statements, the discussion in the directors' report as to the reasons why this information is necessary and the statement in the auditor's report that the additional information is necessary.

This example highlights the very real problems that the CLERP 9 Bill approach may create.

Elevating the discussion on additional information to the directors report, and requiring specific comment by the auditor is counter-productive and could undermine the authority and standing of accounting standards and the responsibility of the auditor to form an opinion on the financial report as a whole.

Notwithstanding that application of the accounting standards should implicitly ensure that the financial statements present a true and fair view, we would support amending the Corporations Act to clarify the requirements relating to the inclusion of additional information that companies believe is necessary for a true and fair view. We do not believe that the manner in which the issue is currently addressed in the Bill is the most appropriate course of action

We recommend that information that is provided in the financial statements on the basis that it is required in order to give a true and fair view should be explicit as to its reason for inclusion and the directors should provide a sufficiently detailed explanation as to why such information is necessary and this explanation should be included with the additional information in the notes to the financial statements.

We do not believe that elevating a particular note to the directors' report (which is outside the financial report) and then requiring that the information be specifically addressed in the auditors' report is beneficial, indeed we believe that it could be detrimental and could result in an "argument" being played out in the directors' report and the audit report. We strongly support the notion that the auditors' opinion is formed on the financial report (being the financial statements and the notes) **as a whole.**

Our recommended approach also ensures that additional information provided to give a true and fair view is distinct from additional information that the preparers of the financial report and the

directors believe is beneficial to users. The later, provided it is factually correct and not more prominent than the other disclosures can still be provided.

However, where the directors purport that the information is **necessary as opposed to desirable**, the auditor will necessarily need to concur with that assertion, and if s/he did not then the directors would be required to **remove** the information, or the auditor would qualify the audit report on the basis that the financial report does not give a true and fair view – in which case the matter is rightfully elevated to the audit report. A third option would be for the directors to retain the information **without purporting that it is necessary to give a true and fair view.**