INVESTMENT AND FINANCIAL SERVICES ASSOCIATION

Submission to the Parliamentary Joint Committee on Corporations and Financial Services on CLERP (Audit Reform and Corporate Disclosure) Bill

1. EXPANDED FINANCIAL REPORTING COUNCIL (Schedule 1 Part 1 of the Bill)

Proposal:

The Government will expand the responsibilities of the Financial Reporting Council (**FRC**), which currently oversees the accounting standard setting process, to oversee auditor independence requirements in Australia. The FRC will:

- Oversee auditing standard setting arrangements. This will be achieved by reconstituting the existing Auditing and Assurance Standards Board (AUASB) with a Government appointed Chair under the auspices of the FRC, similar to the Australian Accounting Standards Board (AASB). Auditing standards will have the force of law on the same basis as AASB Standards.

- Advise the accounting professional bodies on issues of auditor independence.

- Monitor and report on the nature and adequacy of the systems and processes used by audit firms to deal with issues of auditor independence.

- Monitor and report on the response of companies in complying with audit-related disclosure requirements.

- Advise on continuing steps to enhance auditor independence.

- Promote and advise on the adequacy of the teaching of professional and business ethics by the professional accounting bodies and tertiary institutions.

- Monitor and assess the adequacy of the disciplinary procedures of the accounting bodies.

- Maintain responsibility for oversight of the accounting standard setting process.

IFSA response:

IFSA supports the Governments proposal to expand the role of the FRC to include the responsibilities outlined above. We also support the Government's view that core audit standards should be provided legislative backing. However, the funding arrangements for the FRC are unclear.

IFSA restates its policy position that it is inappropriate, and impractical, for a body that has a fundamental role to play in the Australian corporate regulatory structure to be made responsible for seeking contributions to the costs of overseeing the Australian accounting and auditing standards setting process.

The oversight of the accounting and auditing standards setting process is fundamental to corporate regulation and should be funded by Government. Accounting and auditing standards,

having the force of law, serve a public purpose and IFSA recommends should be funded from ASIC revenue collections.

The regulatory nature of the intended role to be performed by the FRC in connection with accounting and auditing standards is underpinned by the responsibility for standards having the force of law in Australia under the Corporations Act 2001. Those standards are to be legislative instruments that are disallowable for the purposes of the *Acts Interpretation Act* 1901. Additionally, it is noted that a failure to comply with a notice issued by the FRC in the performance of its regulatory duties is an offence (section 225A(7) and (8)).

2. AUDITOR INDEPENDENCE (Schedule 1 Part 3 of the Bill)

IFSA supports a strong auditing regime but is concerned that the impact of the requirements may in fact jeopardise the provision of audit services. The Auditor Independence requirements are extremely broad and do not appear to accommodate the proper management of conflicts of interest that can arise. IFSA also notes the relatively small market for auditing services in Australia and restates its view that the Australian market is too small to justify mandatory rotation of audit firms.

IFSA notes the comprehensive matrix of prohibited relationships set out in the draft Bill. The interaction of the auditor independence requirements of sections 324CC, 324CD, and 324CE with section 324CF gives rise to a number of outcomes that should be reviewed and may be accommodated by further materiality criteria.

IFSA recommends, in particular, that the interest identified in Items 10 and 11 of the relevant relationships table in section 324CF be qualified as being a "material" interest. It appears that where the auditor, or an immediate family member of the auditor, has a legal or beneficial interest in the audited body eg a shareholding in or units in the audited body, then the auditor is not considered independent regardless of the size of the interest. The interest could in fact be very small and immaterial.

IFSA recommends that where a conflict of interest situation does arise in relation to existing clients, the auditor should be required to disclose to the relevant party the conflict or potential conflict, the measures to be put in place to deal with the conflict (including terminating its services). Responsibility for the management of the conflict is on the auditor, the board and the audit committee and will be supported by the proposed chief executive officer and chief financial officer declarations under proposed section 295A.

3. ADDITIONAL AUDITOR REPORTING (Schedule 1 Part 7 of the Bill)

IFSA notes the additional auditor reporting obligations imposed under proposed sections 311, 601HG(4) and 990K(2)(c) of the Act, requiring the auditor to notify ASIC within 7 days of any person who attempts to influence, coerce, manipulate or mislead an auditor in relation to an audit involves a value judgment for the auditor with potential strict liability consequences.

IFSA appreciates the objective of the provisions but considers that the approach is flawed because it is based on a value judgment being made by an auditor and puts in issue the ability of an auditor to provide professional services, the assumption being that the audit will be in some way compromised.

IFSA recommends that a better approach, given the problem that the provision seeks to address, is to give the auditor qualified privilege in relation to reports to ASIC in respect of persons whom the auditor considers are attempting to undermine the probity of the audit by influencing, coercing, manipulating or misleading the auditor in the performance of the audit. The requirement will in this way reflect the obligations and protections for compliance committee members under section 601JE of the Act.

4. FINANCIAL REPORTING (Schedule 2)

Part 2 – CEO and CFO declarations in relation to a listed entity's financial report (Clause 9 – 10)

IFSA notes and supports the additional proposed financial reporting requirements including the declaration of the chief executive officer and the chief financial officer. IFSA notes that proposed section 295A(8) of the Act makes clear that the new requirements do not derogate from the responsibility of directors in relation to financial reports.

Part 4 – Financial Reporting Panel

IFSA notes the establishment of a Financial Reporting Panel under Part 13 of the *ASIC Act 2001* and supports a mechanism for the quick resolution of disputes concerning compliance with accounting standards. The issue remains however whether the establishment of a specialist Tribunal is the best approach or whether the alternative of modifying the current operations of the Urgent Issues Group should be explored.

IFSA considers that if the FRP is established it will need at least to be operationally independent of both ASIC and the Financial Reporting Council. Additionally, like other specialist tribunals, a company should be provided with the option of referring disputes with ASIC involving the company's application of accounting standards in its financial report to the FRP.

5. PROPORTIONATE LIABILITY (Schedule 3 of the Bill)

IFSA acknowledges and supports the proposal to enable the incorporation of audit practices and the introduction of proportionate liability for economic loss or damage to property for misleading or deceptive conduct under the ASIC Act 2001, Corporations Act 2001 and Trade Practices Act 1974.

As acknowledged by the Government, these proposals have been on various Government agenda for a number of years. The cost of insurance for professionals, including auditors, appears to be increasing at a very high rate. This may lead to a reduction in the number of firms

able to provide these services to Australian companies. This is of particular concern given the current concentration of firms in the Australian audit market.

IFSA generally supports the proposals subject to adequate safeguards to protect consumers from circumstances that may be designed to avoid appropriate liability. For example, audit companies should be required to maintain an appropriate level of capital to carry out its functions (analogous to FSRA requirements). We also agree that the proposal for proportionate liability should be considered in the context of the Government's broader review of negligence.

6. REMUNERATION OF DIRECTORS AND EXECUTIVES (Schedule 5 of the Bill)

IFSA supports the strengthening of requirements under the current law to address concerns about the lack of disclosure of payments made to directors and executives. We note in this regard that such additional requirements will be supplemented by the adoption in Australia of international best practice standards. IFSA was a major proponent of the previous amendments to the Corporations Law by the Company Law Review Act 1998 that commenced on 1 July 1998 and resulted in introduction of section 300A. That section requires the directors' report for a listed company to include:

- a discussion of broad policy for determining the nature and amount of payments to directors and senior executives;
- a discussion of the relationship between this policy and the company's performance; and
- in addition to specific financial details of payments made to directors and each of the five highest paid company officers.

The proposed amendments to the Corporations Act in connection with the remuneration of directors and executives will strengthen the existing provisions and are supported by IFSA. IFSA supports the broadening of the provisions to extend the disclosure requirements to the five highest paid executives in a company group.

IFSA supports the introduction of non-binding resolutions in relation to a remuneration report to be included in the directors' report for a financial year. The proposed requirements will permit shareholders to collectively express their opinion on the remuneration paid to directors and senior managers and the board's policy on remuneration.

IFSA has, however, concerns about the proposed provisions applying to retirement payments. . IFSA supports transparency and market disclosure as the most appropriate tools for regulation in this area. Requirements for the remuneration report and non-binding resolutions on the adoption of the remuneration report support this principle. Additionally, IFSA has concerns about the possible retrospective impact of the proposed amendment to section 200F of the Corporations Act in relation to the determination of appropriate retirement payments. The provision has the potential of enabling shareholders to refuse agreed termination benefits to directors and executives. We question the constitutionality of the provision to the extent it applies to existing contractual arrangements. IFSA is currently examining options for an appropriate balance in this area.

Current Debate

IFSA acknowledges that debate over disclosure of executive remuneration has been the subject of a particularly difficult ongoing debate in the last few years. The importance of the issue has been brought to the forefront of community interest given recent high profile cases where poorly designed remuneration schemes have not been fully disclosed to shareholders. In some cases the schemes have resulted in large payments to directors of poorly performing companies.

IFSA considers that the value of share and share option schemes should be fully disclosed to shareholders. IFSA strongly considers that shareholder consideration and approval of employee and executive share schemes is a fundamental shareholder right. The design of executive and employee share and option schemes is an important issue for all shareholders. These schemes involve considerable expense to the company and may dilute the existing shareholder base.

IFSA considers that all aspects of employee and executive share and options schemes should be disclosed to shareholders in a meaningful way. Shareholders may then assess whether boards have designed schemes that meet the particular needs of the company in terms of driving improved company performance. Ensuring that the scheme contains appropriate performance benchmarks is essential to this outcome. It is not in the interest of a company or its shareholders to lose value by providing entitlements to executives and employees for poor company performance. These issues are outlined in IFSA's Guidance Notes No.s 12 and 13 that provide guidelines on the development and approval of executive and employee share and share option schemes.

IFSA does not agree that companies should necessarily suspend executive and employee share and option schemes. What is important is that boards, on the advice of their remuneration committee, develop incentive schemes that are appropriate for the circumstances of the company and which are aimed at driving superior executive performance. Performance hurdles should be clearly disclosed and should be based on specific benchmarks that assess actual company performance, eg peer assessment in terms of long-term growths of the company and resulting shareholder value. Moreover, what is important in director and employee remuneration is that there be a strong alignment between shareholder and board/executive interests.

Shareholder activism critical

The potential benefits to the company and to shareholders of share and option schemes are matters to be considered and assessed by shareholders. IFSA members, as shareholders acting on behalf of their funds management clients, have real responsibilities under the law to act in the best interest of those clients. In this regard IFSA notes the report by KPMG entitled "Shareholder Activism among Fund Managers, Policy and Practice" (July 2003) (Attachment A) which states "shareholder activism is high amongst fund managers. Regular voting and contact with management were shown to be key areas of fund managers' ever increasing activism to raise the bar on corporate governance. Of all shares held on behalf of investors, 98% are routinely voted on all company resolutions."

7. CONTINUOUS DISCLOSURE (Schedule 6 of the Bill)

IFSA is a strong supporter of the continuous disclosure regime and agrees with the Government that the regime is fundamentally sound.

IFSA supports the extension of the civil penalty provisions to individuals who may be responsible for the breach of the continuous disclosure provisions. This is analogous to other current regulatory provisions that permit individuals to be subject to civil penalties for contraventions of other provisions, as properly administered by a court of competent jurisdiction.

IFSA also supports the proposed increase in civil penalty provisions but does not support the proposed introduction of an infringement notice power enabling ASIC to impose administrative penalties for alleged contraventions of the continuous disclosure regime.

The Commentary to the Draft Provisions explain that:

> " The mechanism supplements existing criminal and civil court procedures. It remedies a significant gap in the current enforcement framework by facilitating the imposition of a relatively small financial penalty and requiring information disclosure in relation to relatively minor contraventions of the continuous disclosure provisions of the Corporations Act that would otherwise not be pursued through the Courts. The capacity to issue an infringement notice also allows ASIC to signal its views concerning appropriate disclosure practices to listed entities more effectively than through Court action alone."

In our view, the proposal radically underestimates the impact of adverse publicity that is experienced by a disclosing entity that contravenes the continuous disclosure requirements. The adverse impact that has been experienced in a number of recent high profile cases has involved material impact on the share price as well as dismissal of very senior executives. We consider that no company wishes to be in a similar position to these recent high profile cases. We do not consider that this adverse impact is less or more serious whether or not the company faces financial penalties.

IFSA considers that potential adverse impact of a breach of the continuous disclosure regime serves as a significant deterrent for all companies from breaching the current regulatory requirements. This is reinforced by the proposed increase in civil penalty provisions.

IFSA considers that the proposal to provide ASIC with a fining power is neither appropriate nor justified. It appears that the proposal is to provide ASIC with a fining power for "relatively minor" breaches of the provisions. IFSA's view is that the continuous disclosure provisions should be strictly enforced through the courts and that the creation of a two-tiered system for breaches is inappropriate. If the offence is proven, though relatively minor, the court will impose an appropriate financial penalty to reflect the severity of the contravention.

IFSA notes that as a result of amendments made by the Financial Services Reform Act 2002, ASIC was provided with the ability to pursue financial penalties through civil and criminal proceedings. We understand that although a number of references have been made by the ASX to ASIC in respect of alleged breaches of the continuous disclosure requirements they have not been prosecuted by ASIC. We consider that ASIC should fully test these new powers before requesting a substantive new power to impose fines without the appropriate procedural and evidentiary safeguards provided by a court of competent jurisdiction.

If ASIC takes the view that it is unlikely to successfully pursue the matter in civil court proceedings, it is highly questionable whether companies should be forced to incur the significant adverse media and legal costs in relation to the proposed infringement notice procedures on a matter that ASIC considers it cannot prove on either a civil or criminal standard of proof. Additionally, we do not consider that the proposal provides an appropriate opportunity for ASIC to signal its views regarding appropriate disclosure practices "more effectively than through court action alone." ASIC has many options available to it to make known its approach and requirements for continuous disclosure. Currently, ASIC has available to it enforceable undertakings, and the release of policy statements and guidance notes as effective compliance tools

IFSA is not aware of a problem regarding systematic breach of the continuous disclosure regime that justifies the imposition of a fining power. While aware of a few high profile cases, we consider that the action undertaken by ASIC had significant impact on the companies and senior executives. In our experience, the vast majority of companies take their continuous disclosure requirements (as well as other requirements under the Corporations Act) very seriously. However, we remain of the strong view that the best way ASIC can signal its views regarding continuous disclosure is through appropriate civil proceedings notwithstanding whether a small or large penalty may be imposed by the court.

Additionally, the provisions also effectively introduce an element of double jeopardy whereby a listed entity may have paid a financial penalty prescribed by law under an infringement notice and still be subject to further proceedings in relation to the alleged conduct under sections 1317DAF(6) or 1317DAG(4).

8. DISCLOSURE RULES (Schedule 7 of the Bill)

IFSA supports the requirements of the Bill underpinning the principles for a fully informed market and which promote market efficiency. IFSA considers that the Disclosure Rules in Schedule 7 of the Bill support these principles:

(1) the proposed extension of the product disclosure requirement for 'clear, concise and effective wording and presentation' to Chapter 6D for prospectuses;
(2) relief from disclosure in a PDS for a continuously quoted security of information included in the annual or half yearly financial report lodged with ASIC before the date of the PDS;

(3) the proposed amendments to ensure that the placement market can continue to operate efficiently; and.

(4) The proposed relief from the indirect issue provisions of the Act for the transfer or sale of quoted securities without a product disclosure statement.