Corporate disclosure

Strengthening the financial reporting framework

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FOREWORD

It is with great pleasure that we present the next chapter of the Government's Corporate Law Economic Reform Program, CLERP 9.

The program, which started under the Howard Government five years ago, has modernised business regulation and played a major role in building a strong and vibrant economy. Central to the whole program have been key principles of market freedom, investor protection and quality disclosure of relevant information to the market.

CLERP 9 builds on these reforms and adopts principles that provide for flexible law that takes account of the changing environment in which business operates, and ensures clear guidance on appropriate corporate behaviour and effective enforcement where breaches occur.

There have been a number of instances of unacceptable corporate behaviour in Australia and overseas and it is important that those who choose to circumvent effective ethical practice and legislative standards are deterred and appropriately dealt with.

However, we should keep in mind that Australian corporate governance regulation and practice are recognised internationally as being of high quality. We have an effective disclosure regime that provides timely and reliable information to the market.

But no country can afford to be complacent. Cases of corporate irresponsibility are not just about accounting standards and corporate governance rules. They potentially involve a range of questions for regulators, companies, auditors, analysts and investors. These issues are covered in this paper.

This Government is determined to ensure that Australia's corporate regulatory framework remains effective and helps define world's best practice. We will continue to work to protect investors and encourage business to innovate and move with the marketplace.

The Hon Peter Costello, MP
Treasurer

Senator the Hon Ian Campbell
Parliamentary Secretary to the Treasurer

September 2002

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REFORM PROPOSALS

Expanded Financial Reporting Council

1. 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 Chairman 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.

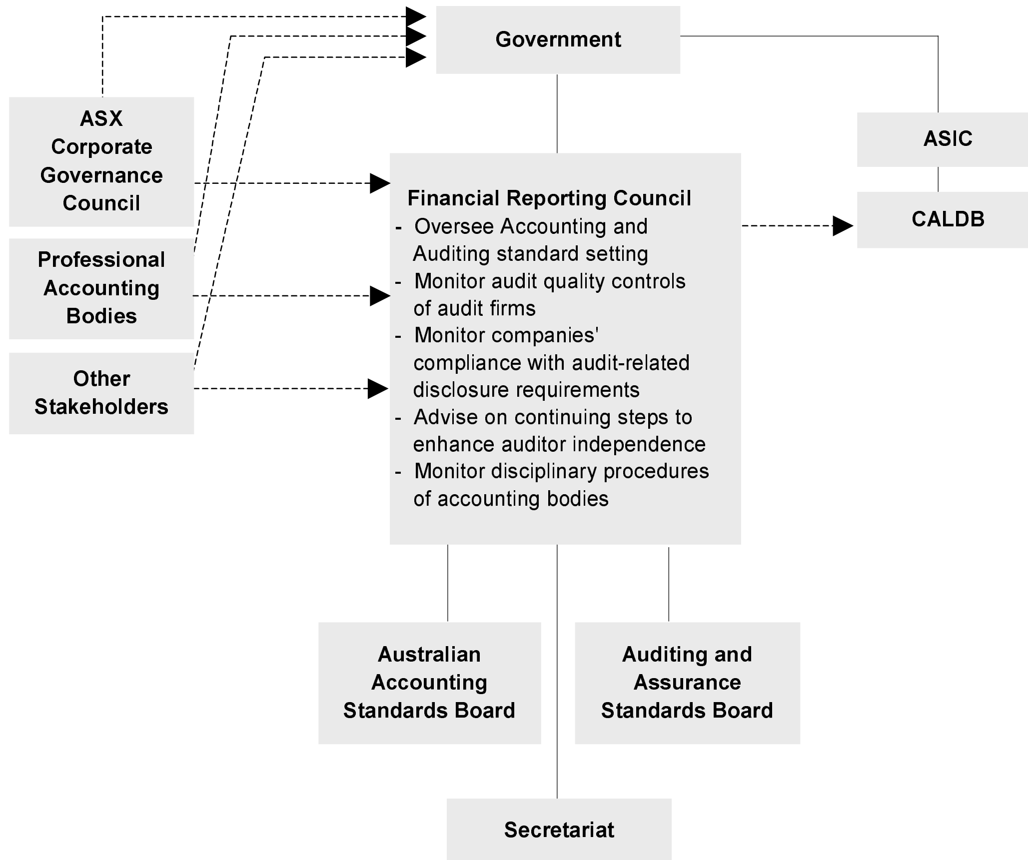
   - Advise on continuing steps to enhance auditor independence.

   - 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.

   These arrangements are outlined in the diagram on the following page.



Quality of audit

Auditor independence

2. The Government will amend the Corporations Act (the law) to include a General Statement of Principle requiring the independence of auditors.

3. The Government will amend the law to require the auditor to make an annual declaration that they have maintained their independence.

4. The Government will amend the law to strengthen restrictions on employment relationships between an auditor and the audit client.

   - This will include a mandatory period of two years following resignation from an audit firm before a former partner who was directly involved in the audit of a client can become a director of the client or take a position with the client involving responsibility for fundamental management decisions.

5. The Government will amend the law to impose new restrictions on financial relationships. This will cover investments in audit clients and loans between an audit client, and the auditor or his immediate family.

Non-audit services

6. The Government supports the immediate application of Professional Statement F1 on Professional Independence, which forms part of the Joint Code of Professional Conduct of the ICAA and CPAA.

   – Statement F1 is based on the independence standard adopted by the International Federation of Accountants. It requires auditors to identify and evaluate threats to independence and apply safeguards to reduce any threats to an acceptable level.

   – Where the provision of non-audit services to an audit client poses a threat that cannot be reduced to an acceptable level, statement F1 prohibits the provision of that service.

7. The Government will implement a series of measures to deal with non-audit services. It will:

   – Amend the law to require mandatory disclosure in the annual report of fees paid for the categories of non-audit services provided.

   – Amend the law to require a statement in the annual report of whether the audit committee is satisfied the provision of non-audit services is compatible with auditor independence. This disclosure would include an explanation as to why the following non-audit services referred to in Professional Statement F1, if contracted, do not compromise auditor independence:

     : preparing accounting records and financial statements of the audit client;

     : valuation services;

     : internal audit services;

     : IT systems services;

     : temporary staff assignments;

     : litigation support services;

: legal services;

: recruitment of senior management for the audit client; and

: corporate finance and similar activities.

Audit committees

8. It will be mandatory for the top 500 listed companies (that is those that compose the All Ordinaries Index) to have audit committees. The ASX has announced it will amend its rules to achieve this.

   – The Government supports the role of the ASX Corporate Governance Council in developing best practice standards for audit committees.

Appointment and removal of auditors

9. The Government will make audit partner rotation compulsory after 5 years.

   – The new requirement will apply to the lead engagement partner and the review partner. To maintain continuity of knowledge, the appointment of these partners could be staggered.

Attendance of auditor at AGM

10. The Government will amend the law to require an auditor to attend the AGM of a listed company at which the audit report is tabled and to answer reasonable questions about the audit.

    – The Government will ensure shareholders are able to submit questions by e-mail to the listed company and that the questions will be posted on the company web site.

Qualifications for registration as a company auditor

11. Accountants seeking registration as company auditors will be required to meet agreed competency standards, to undertake to abide by an accepted code of professional ethics, and to complete a specialist auditing course prior to registration.

Auditor liability

12. The Government will amend the law to allow auditors to incorporate.

13. The Government will seek the agreement of the States to introduce proportionate liability.

    – The Government believes that the market for audit services will be improved if the arbitrary consequences of the present rules relating to joint and several liability in relation to economic loss and property damage are reformed.

Quality of accounting

14. Australia will adopt accounting standards issued by the International Accounting Standards Board (IASB) for reporting entities under the law for accounting periods beginning on or after 1 January 2005, in line with the European timetable.

    – The FRC and the AASB will consult stakeholders on the measures that they regard as necessary between now and 2005 to ensure a smooth transition to IASB standards.

15. The IASB standard requiring expensing of share options will have the force of law on adoption by the AASB, expected to be in the second half of 2003.

16. The legal requirement that financial statements comply with accounting standards and that the financial statements and notes together present a true and fair view of an entity's financial position and performance will be maintained.

    – If any deficiencies in accounting standards have a general, unintended result that compliance with the standard would not result in a true and fair view, the appropriate response would be reform of the standard.

Analyst independence

17. There is a general duty on financial services licensees to ensure that financial services are provided 'efficiently, honestly and fairly'. Licensees should disclose any financial interest that they or a related party have in the subject of their advice or recommendation.

18. The Australian Securities and Investments Commission (ASIC) will be asked to provide guidance by policy statement on the level and manner of disclosure required under this general duty, following consultations with relevant stakeholders.

Continuous disclosure

19. The Government will maintain and enhance the framework of continuous disclosure.

20. Both ASIC and ASX will continue to have the capacity to enforce the continuous disclosure provisions that apply to listed entities.

21. The maximum civil penalty for a contravention of the continuous disclosure provisions by a body corporate will be increased from $200,000 to $1 million. The maximum penalty for bodies corporate in relation to contraventions of other financial services civil penalty provisions (relating to market manipulation and insider trading) will also be increased to $1 million.

22. ASIC will be given the power to impose financial penalties and issue infringement notices in relation to contraventions of the continuous disclosure regime.

23. In addition to its power to seek civil penalties in relation to contraventions of the continuous disclosure regime by disclosing entities, ASIC will be empowered to seek such a penalty against any other person involved in a contravention.

24. The Government will amend the civil recovery provisions relating to contraventions of the continuous disclosure provisions of the law to clarify that a person may seek compensation regardless of whether ASIC has sought a declaration of contravention. It will also allow persons to recover loss or damages from either the relevant entity or any other person involved in a contravention.

25. All investors should have equal access to materially price sensitive information disclosed by listed entities.

26. Market operators will be encouraged to ensure that they provide listed entities with education and guidance to promote compliance with the continuous disclosure provisions of their respective listing rules.

27. Market operators should require listed entities to respond to externally generated speculation in circumstances where the operator determines that this is having a significant impact on the market for their securities.

28. Issuers of managed investment products that are continuously quoted securities will be permitted to issue transaction specific Product Disclosure Statements. The Government will amend the law to ensure that ASIC is empowered to deny access to these arrangements in relation to issuers that have contravened relevant provisions of the law in the past 12 months.

Disclosure requirements for shares and debentures

29. The Government will improve the effectiveness of disclosure in prospectuses through extending the requirement for 'clear, concise and effective wording and presentation' in Chapter 7 for product disclosure statements to Chapter 6D for prospectuses.

30. The Government will more closely align the exemptions from the disclosure regimes that apply to sophisticated investors and wholesale clients.

31. The Government proposes that the disclosure requirements for secondary sales reflect the principle that where a person:

    - already holds pertinent information, or

    - has access to comparable information to what they would have otherwise received in a reasonable, timely and cost-effective manner,

    no further disclosure obligations should apply. This will provide a sounder legislative basis for the operation of placements and will also facilitate ASIC taking relief action where appropriate.

Enforcement

32. ASIC will monitor the adequacy of civil and criminal penalties and make such recommendations as are required to ensure consistency and adequacy of penalties under the law.

33. The Government will amend the law to expand matters which auditors must report to ASIC to include any attempt to influence, coerce, manipulate or mislead the auditor.

34. The institutional arrangements for taking disciplinary action against registered company auditors will be strengthened to:

    – provide a majority of members of the CALDB, with appropriate skills, who are non-accountants;

    – allow the CALDB to sit in more than one Division simultaneously and provide for the appointment of a deputy chairman of the CALDB; and

    – enable the CALDB to provide information obtained in the course of a disciplinary proceeding to the investigation and disciplinary committees of the ICAA, CPAA and NIA to facilitate the disciplinary procedures of those bodies.

35. The Government will amend the law to provide qualified privilege and protection against retaliation in employment for any company employee reporting to ASIC, in good faith on reasonable grounds, a suspected breach of the law.

Shareholder participation and information

36. The Government will establish a Shareholders and Investors Advisory Council, to be chaired by the Parliamentary Secretary to the Treasurer, which it will consult on all disclosure-related reforms to ensure they meet the needs of retail investors.

37. To encourage shorter, more comprehensible notices of meetings:

    – the Government will amend the law to introduce a 'comfort provision' to protect disclosures made in good faith in a short-form notice of meeting; and

- best practice guidelines concerning notices of meetings should be developed by the ASX Corporate Governance Council in consultation with ASIC.

38. The proposed best practice guidelines on notices of meetings will include a section dealing with the explanatory material for 'bundled resolutions'. The guidelines will include material on best practice for:

    - explaining 'bundled resolutions', including the primary purpose, impact and material implications;

    - providing access to fuller information on the component resolutions for those shareholders who seek it (for example, through company websites);

    - describing categories of resolution that should not be bundled but always dealt with as a separate item, with a separate explanation provided (for example, transactions affecting executive remuneration).

39. The Government will facilitate improved shareholder participation by electronic means (including electronic proxy voting, internet broadcasting and related technologies) by:

    - removing unnecessary legislative hurdles to the use of the technologies, subject to the need to maintain the rights of shareholders who are not internet users; and

    - requesting the ASX's Corporate Governance Council, in consultation with ASIC, to prepare guidelines for their use.

40. The Government will amend the law to require the annual directors' report for listed companies to disclose, with respect to each director holding office during the reporting period, details of all other directorship positions held currently and held over the past two reporting periods.

41. The Government will:

    - amend the law to permit members to elect to receive annual reports and notices electronically; and

    - support best practice guidelines concerning electronic distribution of annual reports being developed by the ASX's Corporate Governance Council in consultation with ASIC.

PART 1: INTRODUCTION

1.1 BACKGROUND TO REVIEW

In a joint press statement on 27 June 2002, the Treasurer and the Parliamentary Secretary to the Treasurer announced a process for achieving further improvement in audit regulation and the wider corporate disclosure framework as the next phase in the Government's Corporate Law Economic Reform Program (CLERP).

This policy paper is an important step in that process, aimed at seeking stakeholder comment on specific Government proposals. As announced in the joint press statement, the paper includes a Government response to the Ramsay report on the Independence of Australian Company Auditors. The paper reviews:

- the effectiveness of accounting standards and a proposal that Australia adopt international accounting standards by 2005;
- the regulation of accounting standards and practices;
- the audit function in Australia, including:
  - the market for audit and non-audit services;
  - the institutional framework for setting auditing standards and whether they should be given the force of law;
  - the rules and practices governing the audit engagement including appointment and removal of auditors and related corporate governance arrangements;
  - auditor independence issues canvassed in the Ramsay report;
  - the structures for oversight of the profession, including disciplinary powers, ethical rules, external quality assurance, educational requirements, professional development, competency standards etc; and

  - liability issues, drawing on current work in the context of public liability and medical indemnity insurance, including the question of incorporation of auditors;

- the present continuous disclosure regime;

- conflicts of interest in relation to the provision of financial product advice;

- the current disclosure requirements for shares and debentures; and

- ways to encourage investors to become more active in the companies they invest in.

The final implementation of reforms will need to take account of any relevant recommendations of the HIH Royal Commission, work being undertaken by the Joint Committee of Public Accounts and Audit (JCPAA), and developments overseas. The United States has recently introduced significant legislative reform in the area of corporate disclosure in response to the Enron collapse and the overstatement of earnings by WorldCom and certain other large corporations.

The globalisation of markets means that, in adjusting its regulatory framework, Australia must have regard to developments in major economies. Australian companies will face a cost of capital premium if our framework is perceived to be less rigorous than elsewhere, and they will pay a compliance cost penalty for over-regulation or poorly conceived regulation. In either case, their international competitiveness may be impaired. The objective must be for Australia's regulatory framework to remain in line with or ahead of world's best practice.

The Government believes that Australia starts from a position of strength in terms of the robustness of our institutional framework (including a highly skilled accounting profession) and corporate governance practices.

These practices were substantially strengthened in the 1990s through the Government's CLERP program, changes to the Australian Stock Exchange's Listing Rules, and actions by companies, business peak bodies and regulators to define and adopt industry best practice.

Australia is in line with or ahead of overseas practice in key areas of corporate disclosure. For example:

- as a result of the Government's CLERP 1 reforms, we have an effective accounting standard setting process with broad stakeholder oversight of an

independent and well-funded standard setter, the Australian Accounting Standards Board (AASB);

- our accounting standards emphasise economic substance over form;

- there is an effective continuous disclosure regime requiring provision of timely and relevant information to shareholders;

- arguably, as a matter of 'culture' and practice, the actions of our market participants are less conditioned by short-term earnings results than those of their United States counterparts;

- Australia has an effective and well-resourced corporate regulator, the Australian Securities and Investments Commission, with appropriate enforcement powers; and

- severe penalties are already in place for corporate fraud.

The history of business compliance with disclosure rules is generally good. Most audits are conducted professionally and competently, with full regard to the interests of shareholders, the need for independence, and professional ethical rules.

Had Australia experienced the same speculative 'bubble' seen recently in the United States, it is likely we would have been better able to avoid disclosure problems on an equivalent scale. At the same time, our disclosure framework probably helped avoid the build-up of speculative pressures (for example, by ensuring that the cash positions of high technology start-up companies were disclosed). Nevertheless, Australia cannot afford to be complacent. It is timely to review Australia's corporate disclosure framework in view of developments overseas — in the United States in particular — and in view of lessons learned from recent corporate collapses in Australia.

This is not to say that Australia should match the United States point for point. The recent US legislative response tends to be prescriptive and rules-based. In addressing corporate governance issues, Australia has traditionally relied on a principles-based approach, employing a mix of regulation, co-regulation and encouragement of industry best practice. This approach has worked well in Australia and the Government supports its continuation.

More specifically, the Government has taken the view that legislation is appropriate where it delineates broad parameters for the conduct of business, removes uncertainty in the operation of the law, and clarifies the rights, duties and responsibilities of stakeholders. Beyond this, however, the Government

has been reluctant to legislate without evidence of a clear failure of market-based incentives or sanctions to produce appropriate outcomes.

It is difficult to legislate against fraudulent behaviour by a few market participants. Moreover, it is impossible to legislate against corporate failure, which is inherent in a competitive economy where market participants seek to balance risk and reward. Attempts to do either risk imposing excessive regulatory burdens that could adversely affect innovation and wealth-creation.

Accountability of management, transparency of financial and other information, and the protection of shareholder rights are fundamental to the integrity and efficiency of markets and to investor confidence. The package of proposals in this paper continues the corporate law improvement begun in 1996 under the Government's CLERP initiative. Its aim is to ensure that Australia has an effective disclosure framework that helps define world's best practice and provides the structures and incentives for a fully informed market.

Since 1996, the Internet has become a powerful and widely used communications tool and information source. CLERP 9 recognises that this development has changed the environment for disclosure. It seeks to empower shareholders through Internet based technologies which give them more real time information about their companies and the ability to become more involved in their companies' affairs.

1.2 Key economic principles

The objective of CLERP is to ensure that business regulation is consistent with promoting a strong and vibrant economy and provides a framework that helps business adapt to change.

As with previous reform proposals underpinning CLERP, the policy proposals in this paper are, where possible, assessed against the following key principles:

- cost/benefit analysis of proposed changes;
- the development of a regulatory and legislative framework that is consistent, flexible, adaptable and cost effective;
- the reduction of transaction costs for firms and other market participants;
- an appropriate balance between government regulation and industry regulation;

- the removal of barriers to entry for service providers; and
- improved harmonisation between Australia's regulatory framework with those applying in major world financial markets.

PART 2: OVERSIGHT OF THE AUDITING PROFESSION

2.1 INTRODUCTION

Independent audits are an integral part of the financial reporting framework, and effective oversight arrangements are needed to maximise the value of the audit function.

This Part outlines options for the oversight of the auditing profession. Proposals have been developed in light of the recommendations of the Ramsay report, submissions received on the report's recommendations, and submissions received by the JCPAA's review of Independent Auditing by Registered Company Auditors.

2.2 BACKGROUND

Oversight of the auditing profession may include the following broad functions:

- Monitoring auditor independence — including ensuring an auditor is sufficiently independent of the client, financially, personally, and in their employment.

- Monitoring auditor competence — covering the teaching of auditing and professional ethics, as well as review of the procedures and practices of registered auditors to ensure they are up to standard.

- Investigation and discipline of auditors.

There were several key themes expressed in submissions on the Ramsay recommendations and to the JCPAA. These themes capture what the Government expects to achieve through the oversight of auditor independence.

- The importance of transparency to effective audit. Audits are only of value if they are both in fact, and perceived to be, independent of a company's management.

- The appropriate division of responsibilities between the professional bodies and Government.

- The need for timely advice to be provided to the Government to address the risk of audit failures due to the failure of policies or systems at the audit firm or company level.

2.3 CURRENT STRUCTURE FOR AUDIT OVERSIGHT IN AUSTRALIA

The Australian auditing profession operates under a co-regulatory regime. The three largest professional bodies, The Institute of Chartered Accountants in Australia (ICAA), CPA Australia (CPAA) and the National Institute of Accountants (NIA) have in place rules and professional codes of ethics that govern their members' professional conduct. ASIC is responsible for the registration of auditors. The Companies Auditors and Liquidators Disciplinary Board (CALDB), established under the ASIC Act, is responsible for the discipline of auditors.

2.3.1 The regulator's role in auditor oversight

Registration of auditors

ASIC is responsible for the registration of all company auditors. Any person wishing to practise as an auditor is required to make an application for registration in writing to ASIC. ASIC must then be satisfied that the person meets the requirements for registration as a company auditor, including educational and experience requirements, as well as being capable of performing the duties of an auditor and otherwise being a fit and proper person to be registered as an auditor.

Independence and professional ethics

ASIC plays no formal role in setting professional ethical standards and does not provide detailed guidance on how to conduct an audit.

Investigation and discipline of auditors

ASIC has the power to investigate suspected breaches of the law by auditors. If following its investigation ASIC is of the opinion that malpractice has occurred, it can apply to the CALDB to have the auditor's licence suspended or cancelled. The CALDB must conduct a hearing to examine the evidence and gather more evidence if required before it makes a finding and determines the appropriate punitive action.

The CALDB was established under the ASIC Act and has a chairman who is a legal practitioner appointed by the Minister, and members selected by the Minister from panels put forward by the ICAA and CPAA.

In addition to action by the CALDB, auditors can be litigated against in the courts if a duty of care can be established and a loss resulting from a breach of that duty can be substantiated.

2.3.2 The profession's role in auditor oversight

Registration of auditors

Membership of a professional accounting body is not a legal requirement to become an auditor. However, subparagraph 1280(2)(a)(i) of the Corporations Act provides that members of the ICAA or CPAA are considered to have satisfied the educational qualification requirements to be registered by ASIC as an auditor. In practice most auditors are members of at least one of these bodies.

Independence and professional ethics

The Auditing and Assurance Standards Board (AuASB) develops and publishes auditing standards, which are similar in format to accounting standards issued by the AASB. However, unlike accounting standards, auditing standards do not have the force of law and cannot be relied upon in court proceedings as representing a minimum standard of professional care and skill. The AuASB is funded and staffed by the accounting profession.

The ICAA and CPAA have also developed a *Joint Code of Professional Conduct* as their ethical code. It covers a number of issues including independence, confidentiality, and integrity. The Joint Code has recently been updated to reflect a revised ethical code issued by the International Federation of Accountants (IFAC) in November 2001. As with auditing standards, the Joint

Code does not carry the force of law. Consequently, compliance can only be enforced on the bodies' own membership.

The NIA also has by-laws in its members' handbook governing conduct.

Investigation and discipline of auditors

There are no formal legal arrangements for the monitoring of audit quality. However, the professional bodies encourage members to take specific measures to ensure audit quality. AUS 206 'Quality Control for Audit Work' and the *Joint Code of Professional Conduct* contain guidance on this for members of the ICAA and CPAA.

The professional bodies investigate breaches of the auditing standards and ethical codes among their members, and may impose penalties of suspension or cancellation of membership.

2.4 OVERSEAS STRUCTURES FOR AUDITOR OVERSIGHT

2.4.1 The United States of America

On 30 July 2002 the United States President approved new corporate disclosure legislation, the Sarbanes - Oxley Act.

The Act established a Public Company Accounting Oversight Board (PCAOB). The new board is to be funded through a levy on all listed companies, its primary functions being:

- Registration of public accounting firms that prepare audit reports for issuers.
- Establishment or adoption (or both) by rule, of auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for issuers.
- Conducting inspections of registered public accounting firms.
- Conducting investigations and disciplinary proceedings concerning, and imposing appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms.

- Performing such other duties or functions as the Board (or the Securities and Exchange Commission by rule or order) determines are appropriate to improve the quality of audit services.
- Enforcing compliance with the Sarbanes-Oxley Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons thereof.

2.4.2 United Kingdom

As in Australia, auditors in the United Kingdom must comply with accounting standards and stock exchange rules that carry the force of law.

The Audit Practices Board (APB) is the recognised auditing standard setter in the UK. The APB is funded by the professional bodies through the Consultative Committee of Accounting Bodies (CCAB) with members of the APB appointed by a panel consisting of the Presidents of the CCAB bodies, the Governor of the Bank of England, and the London Stock Exchange (LSE). Membership represents a diverse group of stakeholders. Standards issued by the APB do not carry the force of law. However, the constituent bodies of the CCAB have undertaken to enforce them within their membership.

Under the *Companies Act 1989,(UK)* the major professional bodies have been delegated the responsibility for registration of company auditors. The Act sets out criteria the bodies must address when assessing an application for registration.

The Financial Reporting Review Panel (FRRP) and the Department of Trade and Industry (DTI) share the role of investigating irregularities in financial reports. The DTI focuses on proprietary and small and medium listed companies while the FRRP focuses on larger listed companies. If the investigation finds the audit to be lacking, the auditor may be reported to their professional body.

The professional bodies through their Chartered Accountants Joint Ethics Committee, set ethical standards. A new Ethics Standards Board (ESB) has been established, with a chairman being appointed in February 2001.

The professional bodies are responsible for disciplining their own members, although serious cases can be referred to the Joint Disciplinary Scheme. An Investigation and Disciplinary Board has been established in an attempt to make regulation of auditors more independent of the profession.

The legal system in the UK allows for auditors to be sued through the courts in a similar fashion to the Australian system.

The DTI has published the terms of reference for a review of the way the UK's audit and accounting professions are regulated. The review will consider whether any structural improvements should be made to make the system more effective. Among other things it will examine the need for particular regulatory functions, who should carry them out, how they are funded, and whether current arrangements could be simplified. The review is to be completed by January 2003.

2.5 OPTIONS FOR OVERSIGHT OF AUDITING FUNCTIONS

Currently in Australia there is no independent scrutiny of an audit firm's procedures and processes to produce quality audits. The ICAA and CPAA do require members to participate in peer review programs. However, the results of these reviews and any remedial action are dealt with 'in-house' by the professional body.

The Government has considered a number of models for the oversight of the auditing profession, including:

- a new Auditor Independence Supervisory Board (AISB) as proposed in the Ramsay report;
- an expansion of the role of the existing Financial Reporting Council (FRC) to include the AISB independence oversight function in addition to its existing role of providing broad oversight of accounting standard setting;
- further expansion of the existing FRC to also include oversight of auditing standard setting and oversight of the disciplinary procedures of the accounting bodies;
- the co-regulatory model put forward by CPAA in a recent discussion paper, *'The Financial Reporting Framework - The Way Forward'*; and
- the new United States model, the PCAOB, which would also include a formal role in the registration and disciplining of company auditors (as outlined above).

2.5.1 Auditor Independence Supervisory Board

The Ramsay report recommended that a new body, the AISB, be established to oversee auditor independence. This body would monitor issues such as international developments in auditor independence, the quality control practices of audit firms, the teaching of professional ethics by universities and professional accounting bodies, and the effectiveness of procedures within corporations related to auditor independence.

The AISB would be independent of the accounting profession. It would be established either as a company limited by guarantee or as a statutory body. Funding would be provided either directly by the professional accounting bodies for a fixed period on a 'no strings attached' basis or by an increase in the registration fee for auditors.

The AISB would comprise 12 members nominated by stakeholders from the financial sector as well as one representative each from the ICAA and CPAA, and three members representing the public interest.

The AISB would have no responsibility for the registration of auditors or the investigation and discipline of registered auditors. Responsibility for these functions would remain with ASIC and the CALDB.

Stakeholder comments on the AISB

Stakeholders generally supported the Ramsay proposal for an oversight body for auditor independence.

Some stakeholders considered that the AISB would be under-resourced to adequately perform the functions proposed for it, in particular the monitoring of audit firms and corporations. There was also a view that the AISB was focused too narrowly on issues of auditor independence which is a necessary but not sufficient condition for audit quality.

A number of stakeholders considered that there was no need to establish a new body when the functions of the existing FRC, which has a composition very similar to that envisaged for the AISB, could be expanded to include the oversight of auditor independence.

2.5.2 An expanded role for the Financial Reporting Council

Having considered the merits of the various models, the Government proposes that the existing FRC assume the following functions in addition to its current oversight role for accounting standard setting:

- oversight of auditor independence, as envisaged by Professor Ramsay for the AISB;
- oversight of auditing standard setting; and
- monitor and assess the adequacy of the disciplinary procedures of the accounting bodies.

The FRC was formally established in 2000 under Part 12 of the ASIC Act. It is currently responsible for the broad oversight of the Australian accounting standard setting process for the private, public and not-for-profit sectors.

- Its statutory functions include: advising the Government on the accounting standard setting process and the development of international accounting standards; appointing the members of the AASB (other than the Chair); approving the AASB's priorities, business plan, budget and staffing arrangements; and determining the AASB's broad strategic direction.

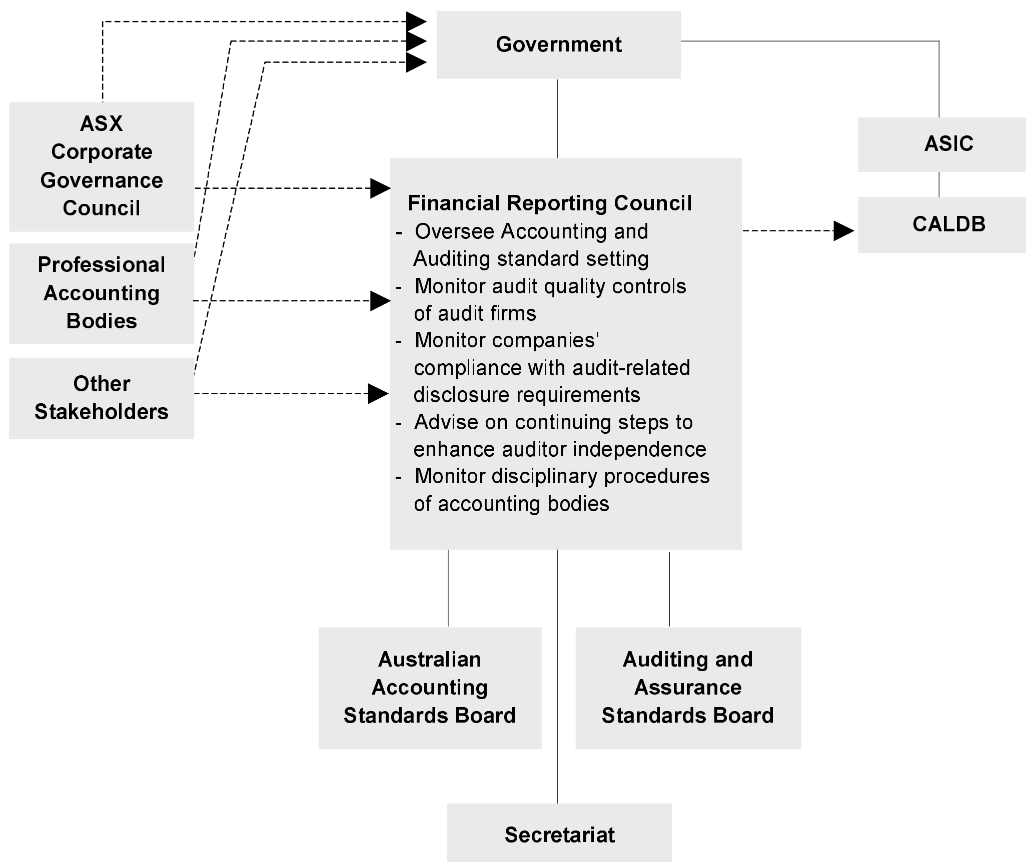
The FRC comprises senior-level stakeholders from the business community, the professional accounting bodies, governments and regulatory agencies.

- The current members of the FRC were appointed by the Treasurer on the nomination of the Business Council of Australia, the Australian Institute of Company Directors, the Securities Institute of Australia, the Investment and Financial Services Association, the ICAA, CPAA, the Australian Shareholders' Association, the Australian Stock Exchange, ASIC, and the Commonwealth, State and Territory governments.

Only minor changes to the FRC's composition would be necessary to accommodate an expanded role.

The proposed new structure is shown in the following chart.

Chart 1: Financial Reporting Oversight Board Structure



Accounting standards

The AASB will continue in its current role of developing and issuing accounting standards and other pronouncements under the broad oversight of the FRC. Accounting standards will continue to carry the force of law under the Corporations Act.

Auditing standards

The AuASB, which is currently funded and staffed by the accounting profession, would be subject to FRC oversight in the same way that the AASB is currently subject to FRC oversight. As the auditing standard setter, the AuASB would be independent, with the FRC unable to involve itself in the development of particular standards. The AuASB would be established under the ASIC Act and, like the AASB, funded jointly by governments, the accounting profession and business.

Auditor independence

As envisaged in the Ramsay report proposal for an AISB, the FRC would:

- monitor international developments in auditor independence;
- advise the professional accounting bodies on appropriate standards dealing with auditor independence and whether it believes these standards have been properly implemented;
- monitor the nature and adequacy of systems and processes used by audit firms to deal with issues of auditor independence and advise on the adequacy of these systems and practices;
- monitor compliance by companies with the new auditor independence regime, including the adequacy of non-audit fee disclosure and the effectiveness of listed company audit committees; and
- monitor the adequacy of the teaching of professional and business ethics by the professional accounting bodies and universities as they relate to issues of auditor independence.

Discipline

As envisaged by the Ramsay report in relation to the AISB, the FRC would monitor and assess the adequacy of existing investigation and disciplinary processes for the audit profession and advise the Government if it considers improvements are required.

This will involve a specific role in providing oversight of the disciplinary procedures of the professional accounting bodies. The FRC would have the power to refer particular matters that came to its attention to the CALDB.

However, it is not proposed that the FRC would have a direct role in disciplining members of the profession. ASIC will continue to have responsibility for the investigation and prosecution of auditor disciplinary matters. The CALDB will remain the sole body with the authority to conduct hearings into auditor misconduct and to take disciplinary action where appropriate (with the exception of the professional bodies in relation to their own membership).

The above structure would bring together, under a single oversight body, policy advising, monitoring and technical oversight functions for the key elements of the financial reporting framework. The use of an existing

stakeholder body, with minor membership changes, will enable a relatively quick start-up and recourse to established funding mechanisms.

Having broad policy direction coming from a single overarching body should ensure coherent and effective oversight while protecting the independence of the two technical Boards within the structure.

As is currently the case, the expanded FRC would have statutory backing and its members would be appointed by the Government. One of its responsibilities would be to advise the Government on the issues for which it is responsible.

The FRC would have a dedicated secretariat staffed from within Treasury (which currently provides the secretariat to the FRC).

Australia's professional accounting bodies will continue to fulfil their present role with the exception that the auditing standard setter under the FRC will provide the authoritative source of auditing standards.

The FRC will liaise with the ASX Corporate Governance Council, which is developing a set of corporate governance standards of best practice for listed companies.

Should auditing standards be given the force of law?

It has been suggested that giving auditing standards statutory backing would make them easier to enforce. Currently, ASIC relies on broader statutory provisions. However, the structure and style of auditing standards are such that there would be practical difficulties in making them easily enforceable without significant redrafting.

Since 1995, the AuASB has been working on harmonising Australia's auditing standards with International Standards on Auditing (ISAs), a program that is now well advanced. With the recent commitments by the European Union and the Australian Financial Reporting Council to adopt international accounting standards by 2005, the momentum for international convergence of auditing standards has increased.

The Government believes that core audit standards should be given legislative backing to facilitate their enforcement by ASIC, consistent with international harmonisation objectives.

Proposal 1 — Expanded Financial Reporting Council

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 Chairman 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.

PART 3: THE MARKET FOR AUDIT SERVICES

3.1 BACKGROUND

The most important features of the audit market for the top 1000 Australian listed companies are that:

- three audit firms combine to audit more than 50 per cent of the market;
- the Big 4 (PricewaterhouseCoopers, KPMG Australia, Ernst & Young, and Deloitte Touche Tohmatsu) audit more than 65 per cent of the market;
- Second tier firms (with at least three listed audit clients) audit more than 24 per cent of the market.

In short, just 10 firms service nearly 80 per cent of the market. The remainder is spread across firms that audit less than three listed clients. This analysis is based on ASIC data covering auditor appointments to April 2002.

With such concentration, companies face a restricted pool of audit firms with experience in auditing listed companies. Where one of the major audit firms is providing non-audit services to a company, the pool of possible providers of audit services may be even more limited. Choice would be further restricted if a company did not wish to contract audit services from a firm that audited a major competitor.

Recent surveys of audit firms and their clients indicate that non-audit services usually account for significantly more than half of an audit firm's revenue. This percentage is growing, and audit firm projections show non-audit services are the engine for their business growth. Audit revenues are relatively static.

3.2 MARKET RESPONSES TO ACCOUNTING DEVELOPMENTS

The market has responded quickly and in various ways to the developments of the past year in accounting and financial reporting. Summaries of these responses are shown in Boxes 1 and 2 below.

Box 1: Private sector responses to concerns about auditor independence

US Accounting firms and the American Institute of Certified Public Accountants

- Jointly issued a list of risk factors for financial reporting and 30 recommendations for addressing them (January 2002).

ANZ Banking Corp

- Introduced in April 2002 plain English disclosure, more discussion on critical accounting policies, disclosure of off-balance sheet structures, restrictions on auditor-provided services. The only non-audit services allowed are those not perceived to be materially in conflict with the role of auditor, subject to approval by the Audit Committee. Exceptions need safeguards and Board approval.

Westpac

- In July 2002 released its first Social Impact Report with triple bottom line reporting, including governance and audit information.

Standard & Poor's

- Created a new set of analytic standards for earnings, aimed at improving reliability.
- Increased contact with internal auditors and Audit Committees.
- Using transparency measures and disclosure surveys in ratings.

Moody's

Added accounting, derivatives and governance teams to its ratings assessments. Increased analysis of accounting procedures, disclosure, risk management and governance.

Box 2: Major changes to the accounting and non-audit services framework in Australia

KPMG

- Instituted voluntary internal independence structures: Ethics & Conflicts Committee (majority KPMG management); external academic review of independence, conflict resolution and quality control procedures — available to clients only.
- Spun off its consulting arm as KPMG Consulting in October 2001, containing business and technology consulting, systems design, applications implementation and system integration.
- KPMG retained assurance, tax, legal, corporate recovery, corporate finance, transaction services and forensic accounting.
- KPMG Consulting in arrangement with Andersen to purchase their consulting division.
- Listed in US on NASDAQ.

Deloitte Touche Tohmatsu

- To spin off consulting services as a private company (Braxton) by the end of 2002.
- No longer accepts new engagements to perform internal audit outsourcing for external audit clients.
- To retain security, actuarial, corporate finance, and tax services.

Ernst & Young

- Sold its consulting arm to Cap Gemini in May 2000.
- Retained assurance, corporate finance, tax, legal, and advisory businesses.
- 75 per cent of Arthur Andersen accounting and audit in Australia merged with Ernst & Young .

Continued

Box 2: Major changes to the accounting and non-audit services framework in Australia (continued)

PricewaterhouseCoopers

- Sold IT consulting arm to IBM Global Services (July 2002), and withdrew plans to spin off and list.
- Established Audit Standards Oversight Board in May 2002 to examine quality control and processes for ensuring audit independence.
- Spun off valuation consulting and HR outsourcing businesses in 2001.

Arthur Andersen

- Spun off Accenture in August 2000.
- Subsequently built a business consulting division that has since joined with KPMG Consulting (75 per cent) and William Buck (25 per cent).
- Ceased operation in August 2002.

Many second tier accounting firms experienced business growth through non-audit services and the acquisition of non-audit service providers.

The consequences of these changes are uncertain.

- Internally-sponsored independence and ethics committees in audit firms — these may have some positive effect on systems and processes to protect audit independence and quality within audit firms. However, the effect on investor confidence is uncertain and may be affected by concerns over the effectiveness and independence.
- Spun-off and listed consulting arms — these may have little effect on the reality or perception of auditor independence. The remaining audit-based firms retain other non-audit service businesses, and the relationships between audit and consulting organisations are opaque. These reforms may not always result in the audit partner no longer having a financial or career interest in cross-selling non-audit services. Further, one major accounting firm has previously spun off a consulting arm and then rebuilt a consulting business.

3.3 THE NATURE OF AUDIT CONTRACTING

The economic function of auditing is to build trust between parties involved in the capital markets. It does this in two ways.

- By aiming to provide reasonable assurance on information quality in financial statements, investors are more able to trust what issuers claim about their financial situation. This lessens the need for investors to spend time and money on search, information gathering and due diligence.

- By providing a review of how investors' money is used, investors can be more trusting that their capital will be used for the purposes they agreed to. This lessens the need for oversight and regulatory effort.

In both cases, building trust through auditing 'lubricates' the capital market and means fundraising is cheaper and easier for audited companies.

3.3.1 Discussion

The unique position of audit — where a 'for-profit' business is central to the public interest — may lead to apparent conflicts in incentives for auditors. These conflicts include that:

- the audit function has a significant public interest element, yet auditors are paid by the entity they are overseeing (management);

- there is a personal relationship between auditor and client;

- audit partners, managers and staff may have career and financial incentives to comply with audit client wishes on the presentation of financial reports;

- lower level audit staff may have career and financial incentives to acquiesce in audit partner wishes;

- audit staff may see themselves more as business consultants;

- audit firms rely on non-audit services for their revenue and profit growth; and

- corporate clients may view audit as a dead compliance cost and want to capitalise on the knowledge of audit firm professionals.

The difficulty in this structure is that:

- only company management has direct fee payment, contract and personal contact relationships with the auditor;
- other incentives such as regulatory penalties, professional rules, the protection of auditor reputation, and personal career development may in some cases not be as strong as those relationships; and
- this can lead to market perceptions of auditors acting for profit rather than in the public interest.

Appointment by external body

There have been suggestions that ASIC or some type of Public Oversight Board be responsible for auditor appointment. The rationale is that auditors would then be contracting with someone representative of the public interest, and there would be financial and contractual structures supporting the public interest aspect of auditing. This is not a position the Government sees as feasible or desirable. This is because it would:

- replace audit market competition with competition for regulatory approval;
- be an inflexible tool in a highly dynamic and flexible environment;
- affect the market process and business decision-making;
- push responsibility for audit failure towards the appointing body; and
- be unlikely to be any more effective than the suggested suite of reforms.

Loss-leading audit to sell non-audit services

There has been significant debate about the use of low-cost auditing services to provide an entry point for on-selling more profitable non-audit services. It has been suggested that the practice is commonplace.

An Australian-based study (A Ferguson, *Evidence of Audit Leader Strategic Price Cutting and Fee Recovery in Non-audit Services: Implications for Independence*, Working Paper 55, School of Accounting, University of Technology, Sydney) has found that loss-leading behaviour does occur in some industry sectors, and that the leading auditor in that industry sector is '…effective in gaining greater consulting revenues compared with other Big 5 firms'. However, this study also found there was no conclusive threat to independence, meaning the evidence in this area is incomplete. Nonetheless, the appearance of

compromise and suggestions of loss-leading behaviour are potentially significant problems for investor confidence.

Low balling for client lock-in

Low-balling, or setting very low initial prices in order to 'lock-in' a client to later audit services at higher prices, is another problem that may arise in a for-profit audit environment.

While the evidence for this is weak, it is strong enough for the UK Accountancy Foundation to consider providing rules to address it. The current requirement in Australia to disclose prices charged for audit services helps address any perception that low-balling is occurring.

3.4 CHALLENGES TO THE VALUE OF AUDIT REPORTS

Recent United States surveys of audit clients indicate that many believe that audit is only a compliance cost which offers them no value as a client.

Further United States studies, and current market events demonstrate that many auditors fail to correctly identify accounting irregularities or issue timely 'going concern' warnings on struggling companies.

It has been suggested that, even if audit fails to ensure compliance with standards, the fact that financial reports are audited at all means management will not allow accounting irregularities to become excessively large. However, recent experience in the United States suggests that this is not always the case (for example, events at Enron and World.Com).

3.4.1 Inadequate information in audit reports

Submissions on the Ramsay report and to the JCPAA indicate that formal audit reports are fragmented, difficult to understand and do not provide as much information as statement users would like, or auditors would like to give. Many submissions from audit firms and professional bodies have expressed a willingness to provide more information — provided there is liability reform to protect them from unwarranted litigation. This view suggests that the content and presentation of audit opinions is uninformative and recognises the growing importance of unsophisticated retail investors and the increasing needs for information of a non-financial nature.

The key requirements for audit opinions are set out in Australian Auditing Standard *AUS 702 The Audit Report on a General Purpose Financial Statement*. It sets out the types of opinion, the content of the report, and the circumstances resulting in a modified audit opinion. This standard also includes the minimum requirements for an audit opinion.

The Minimum Content of a Standard Audit Opinion*

In our opinion, the financial report of xxx is in accordance with

(a) the Corporations Act, including:

  (i) giving a true and fair view of the Company's and consolidated entity's financial position as at 31 December 2001 and of their performance for the year ended on that date; and

  (ii) complying with Accounting Standards and the Corporations Regulations; and

(b) other mandatory professional reporting requirements.

*the Audit Report must also include a Scope section setting the context of the audit opinion.

Submissions received on the Ramsay report and to the JCPAA, statements from accounting academics and other interested institutions variously claim that in a changed audit liability environment audit reports could include information on:

- internal audit processes;
- risk management;
- corporate governance processes;
- the quality of forward-looking financial data;
- the validity of measures of management performance;
- critical accounting policies;
- non-financial data such as environmental and social responsibility reports; and

- the effect on the financial statements of changing critical accounting assumptions.

The argument is that this would improve shareholder, regulator and investor understanding of the real financial position of the client company; make better use of the skills and position of auditors; and increase confidence in financial statements.

3.4.2 Usability

A key assumption of any disclosure measures is that they must be usable to be of benefit. To increase the usability of audit reports, submissions have suggested that the language be simplified and made more concrete, and key audit-related matters removed from the notes and displayed clearly.

For example, an auditor may have concern about a transaction that leads to the reporting of an emphasis of matter appearing after the unqualified audit opinion. An emphasis of matter mentions the issue and refers to a note in the financial statements dealing with it. This method of audit reporting puts relevant audit-related information in three different places, two of which are not in the audit opinion itself. This may reduce the usability of audit reports.

3.4.3 The audit expectations gap

CPAA and the ICAA examined the expectations gap in a joint working party study in 1993. In the study's report the expectations gap was defined as the 'difference between the expectations of users of financial reports and the perceived quality of financial reporting and auditing services delivered by the accounting profession.'

The basic issue is that some users of financial reports expect more from audit and accounting than the profession can reasonably be expected to deliver. For example, users may believe that audit offers a 'guarantee' of the accuracy of financial statements or of the absence of fraud, when in fact it does not.

Submissions to Ramsay and the JCPAA examined the audit expectations gap and proposed to reduce the gap through measures which involved:

- improving education programs for users of financial statements, aimed at correcting unreasonable expectations; and
- providing more information in audit reports.

3.5 COMPETITION IN AUDIT SERVICES

The nature of product competition in the market for audit services is restricted because the audit is not fully visible to those it serves. Shareholders and investors cannot observe the audit and check that it is actually being done as required.

However, competition on audit quality also operates through individual auditor and audit firm reputation. An audit firm can experience significant reputational and liability risk associated with the quality of the audits it performs. In the extreme case of Andersen, loss of reputation arising from the Enron audit and the firm's subsequent conviction for document shredding led to a rapid erosion of its client base and liability consequences that brought the firm down.

Whereas competition for audit services previously may have centred on price, in current market circumstances greater emphasis is probably placed on reputation for providing a quality audit service. This shift has also reduced the likelihood audit will be used as a loss leader. Companies are willing to pay a premium for the quality audit services that are demanded by the market.

The increased availability of specific information on audit firm performance could encourage better market judgements about audit quality and independence.

3.5.1 Support for harmonisation with international auditing standards

The Government will continue its support for harmonising both accounting and auditing standards internationally. As well as providing broader benefits, this process will assist second tier auditing firms to compete in the auditing marketplace through mergers and the ability to provide a broader range of cross-border services, including within the region.

3.6 CONCLUSION

The issues raised are matters for the auditing standard setter, the profession, and where appropriate, the competition regulator. The Government is keen to ensure that the market for audit services functions efficiently and that any regulatory changes to the audit market, including those outlined in this policy paper, consider the impact on competition in the audit market. Regulation must not entrench existing market structures or players, and must allow for innovation in organisation and services delivery.

PART 4: AUDITOR INDEPENDENCE

4.1 BACKGROUND

Since 1996, the Government has been actively involved in the reform of the accounting and audit regulatory framework with a view to achieving quality disclosure to shareholders and other stakeholders. In addition to the overhaul of the accounting standard setting arrangements and the introduction of an effective continuous disclosure regime (which is discussed in Part 8), the Government has carefully examined issues relating to the independence of company auditors.

- A Working Party of the Ministerial Council for Corporations (MINCO) produced a report in July 1997 entitled 'Review of Requirements for the Registration and Regulation of Company Auditors'. This report examined the legal framework for the registration, appointment, supervision and disciplining of company auditors in relation to their functions under the Corporations Act.

- Work on the recommendations of the Working Party report proceeded in consultation with the States and the accounting profession. However, with a sharpening of focus on auditor independence issues in the light of the HIH collapse, the Government decided in July 2001 to engage Professor Ian Ramsay to undertake a comprehensive review of Australia's existing legislative and professional requirements on the independence of company auditors.

- This work updated the Working Party report by taking account of new approaches to auditor independence adopted by the United States, the European Commission, and IFAC.

The Government released Professor Ramsay's report on the *Independence of Australian Company Auditors* (the Ramsay report) for public comment in October 2001 and sought public comments on the Ramsay recommendations by the end of March 2002.

The Government has considered the Ramsay report's recommendations in the light of comments provided by stakeholders and developments in Australia and overseas since the report's release. With the enactment in July 2002 of

United States legislation containing specific provisions on auditor independence, it is timely to determine Australia's approach to these issues.

While the proposals in the present paper constitute a Government response to the Ramsay report, final implementation of these proposals will need to take account of any relevant recommendations of the HIH Royal Commission.

4.2 THE IMPORTANCE OF AUDITOR INDEPENDENCE

Auditor independence is fundamental to the credibility and reliability of auditor's reports. The *Australian Statement of Auditors Practice AUP 32 — Audit Independence* (AUP 32) states that independence 'requires a freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure'.

Audited financial statements play a key role in relation to the efficiency of capital markets and the independent auditor constitutes the principal external check on the integrity of financial statements. The Ramsay report recognises the following four functions of an independent audit in relation to capital market efficiency:

- adding value to financial statements by improving their reliability;
- adding value to the capital markets by enhancing the credibility of financial statements;
- enhancing the effectiveness of the capital markets in allocating valuable resources by improving the decisions of users of financial statements; and
- assisting to lower the cost of capital to those using audited financial statements by reducing information risk.

A lack of auditor independence, or even an appearance of lack of auditor independence, can detract substantially from these outcomes.

The independent audit function is also a key element in the broader corporate governance landscape. President Bush's 10-Point Plan to improve corporate responsibility and protect shareholders recognised the importance of auditor independence:

Point 7 from President Bush's 10 Point Plan

'Investors should have complete confidence in the independence and integrity of companies' auditors.

Investors depend on the judgment, integrity and competence of independent auditors. While auditors cannot prevent intentional deceit, they are a critical external check on corporate management.'

4.3 Co-regulatory environment

The current regulatory environment in relation to the independence of auditors is co-regulatory:

- the professional accounting bodies play a major role through their professional requirements and codes of ethics;
- ASIC performs an essential enforcement role in ensuring that registered company auditors remain independent through compliance with the provisions of the Corporations Act which deal with the independence of auditors;
- disciplinary matters concerning auditors, including the independence of auditors, is the responsibility of the CALDB.

One of the key objectives underlying the recommendations in the Ramsay report is to continue the current co-regulatory approach. The Government supports this objective.

4.4 Overseas developments

The globalisation of capital markets has created a policy environment that is conducive to harmonisation and uniformity in the areas of financial reporting and auditing. This includes the ethical requirements of the professional accounting bodies that govern the conduct of the work of the accounting profession, including as they relate to auditor independence.

The Ramsay recommendations on auditor independence have been significantly informed by recent international developments and the Government's response has also taken account of developments subsequently:

- The release of proposals by the accounting profession's peak international body, IFAC to update its ethical requirements on audit independence.
  - In November 2001 (following release of the Ramsay report), IFAC adopted its new standard on audit independence.
  - Australia's two major professional accounting bodies, CPAA and the ICAA agreed in May 2002 to a new standard for audit independence which is fundamentally based on IFAC's new internationally harmonised standard.
- The release by the European Commission of a consultative paper containing proposals designed to achieve greater uniformity in the requirements in force in the Member States of the European Community.
  - the European Commission published a Recommendation on auditor independence in May 2002. The Recommendation introduces a principles-based approach to auditor independence requiring the auditor to consider for each audit engagement independence threats and risks as well as the safeguards for mitigating those risks.
- The United States SEC decision in November 2000 to remake its rules on audit independence to address issues associated with independence violations by auditors in the United States.
  - Since then the United States has enacted the Sarbanes-Oxley Act of 2002 which contains specific auditor independence requirements.

4.5 CORE CIRCUMSTANCES CREATING LACK OF INDEPENDENCE

The Ramsay report identifies three key issues which need to be addressed when considering whether accounting firms are independent of their audit clients:

- employment relationships;
- financial relationships; and
- the provision of non-audit services.

In developing a framework of reform proposals in relation to these key issues, the Ramsay report also recommended that the Corporations Act be amended to include a general statement requiring an auditor to be independent.

4.6 General statement of principle requiring independence

4.6.1 The Ramsay proposal

Background

While the Corporations Act currently contains several provisions dealing with the independence of auditors, it does not contain a general statement requiring an auditor to be independent. This can be contrasted with the position in Canada and New Zealand.

- Section 161 of the Canada Business Corporations Act contains a general statement that a person is disqualified from being an auditor of a corporation if the auditor is not independent of the corporation, any of its affiliates, or the directors or officers of any such corporation or its affiliates.

- Section 204 of the New Zealand Companies Act states that an auditor must ensure, in carrying out the duties of an auditor, that his or her judgment is not impaired by reason of any relationship with or interest in the company or any of its subsidiaries.

The Ramsay report recommendations

The proposal in the Ramsay report contains three related recommendations.

- The Corporations Act be amended to include a general statement of principle requiring an auditor to be independent.

- The general statement would also provide that an auditor is not independent with respect to an audit client if the auditor is not, or a reasonable investor with full knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement. In determining whether an auditor is independent, the Ramsay report states that all relevant circumstances should be

considered, including all relationships between the auditor and the audit client.

- The auditor should be required to make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the Corporations Act and the rules of the professional accounting bodies.

4.6.2 Stakeholder response

There was broad support from key stakeholders for all three of the recommendations.

- The professional accounting bodies considered it essential that the general statement of principle be consistent with the language and spirit of the more extensive ethical rules of the accounting bodies.

- Some stakeholders considered that any general statement should be included in the ethical rules of the accounting bodies because of concern that legislation could be too prescriptive.

4.6.3 Proposal

Proposal 2 — General statement of principle requiring independence

The Government will amend the Corporations Act to include a General Statement of Principle requiring the independence of auditors.

The general statement of principle will also establish a general standard of independence that an auditor is not independent with respect to an audit client if the auditor is not, or a reasonable person with full knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement. In determining whether an auditor is independent all relevant circumstances should be considered, including all relationships between the auditor and the audit client.

- ASIC will be given the power to issue practice notes or guidelines, either generally or in specific circumstances, to assist with any issues of

interpretation that may arise in relation to the application of the general standard to particular circumstances.

The general standard of auditor independence recommended in the Ramsay report is based on SEC Rule 210.2-01. In drafting the general standard, the Ramsay report has adopted a 'reasonable investor' test from the SEC rule. The Government considers that it would be desirable to adopt a 'reasonable person' test because the users of financial statements extend beyond investors. Furthermore, adoption of a 'reasonable person' test would bring the legislation into line with the language used in the new Statement F1 on Professional Independence which has been adopted in Australia by CPAA and ICAA.

Proposal 3 — Annual declaration by auditor

The Government will amend the law to require the auditor to make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the Corporations Act and the rules of the professional accounting bodies.

4.7 EMPLOYMENT RELATIONSHIPS

4.7.1 The Ramsay proposal

Background

Section 324 of the Corporations Act currently deals with employment relationships between auditors and clients.

The rationale for the imposition of restrictions on employment relationships between an accounting firm and an audit client is that such relationships can give the impression that an auditor is not independent of the client, whether or not that is the case. Where such relationships exist, there may a range of circumstances which, collectively or individually, make it difficult for the auditor to adopt an unbiased approach to the audit engagement, with the result that the audit client could receive a more favourable audit report than the facts or circumstances justify. The Ramsay report notes that in the English-speaking world at least, legislators have long been minded to include in corporate legislation provisions which have the objective of prohibiting or

restricting employment relationships. More recently, professional accounting bodies have also addressed this issue in their ethical codes.

In framing reform proposals, the Ramsay report has taken into account the latest developments overseas. The Ramsay report notes that the IFAC independence standard, the European Commission proposals and the SEC rules all seek to safeguard independence by ensuring that:

- partners or professional employees of an accounting firm are not employed by the audit client or serve as a director of the audit client;
- where a former partner or professional employee of an accounting firm is employed in an accounting role or a financial reporting oversight role at an audit client, there are (with limited exceptions) no residual links with the accounting firm;
- where a former officer, director or employee of an audit client becomes a member of an accounting firm, the person is not in a position to audit, or influence the audit, of financial statements concerning a period during which he or she was employed by, or associated with, the audit client; and
- relatives of a member of an audit team are not directors of an audit client or employed by the audit client in a senior management position, in an accounting role, or a financial oversight role.

The Ramsay report recommendations

The Ramsay report recommended that subsections 324(1)(f) and 324(2)(g) and (h) of the Corporations Act should be replaced by new rules relating to employment relationships in the following areas:

- Employment by client of current auditor/employee of auditor.
- Employment by client of immediate family member of audit engagement team.
- Employment by client of former auditor/employee of auditor.
- Mandatory period of two years following resignation from an audit firm before a former partner of an audit firm who is directly involved in the audit of a client can become a director of the client.
- Employment by audit firm of former employee of client.
- Remuneration from audit firm.

The Ramsay report recommended that there should be protection for inadvertent breaches of the independence rules concerning employment relationships provided certain requirements are met.

The Ramsay report also recommended that the proposed rules would not apply if the audit client is a small proprietary company, as defined in section 45A of the Corporations Act.

4.7.2 Stakeholder response

The great majority of stakeholders supported the recommendations on employment relationships. The main concern raised by some stakeholders was that the recommendations should be implemented in the ethical rules of the accounting bodies rather than the Corporations Act.

4.7.3 Proposal

Since the Ramsay report was released, the European Commission has issued a Recommendation including a provision that a period of two years should have elapsed before a key audit partner can take up a key management position with the audit client. In its July 2002 report, the UK Co-ordinating Group on Audit and Accounting also favoured a two year cooling off period before an audit partner can join an audit client as an employee or director.

It would be appropriate for the Ramsay recommendation for a two year cooling off period to be extended to apply to senior management positions with the audit client as well as directorships.

Proposal 4 — Employment relationships

The Government will amend the law to strengthen restrictions on employment relationships between an auditor and the audit client.

- This will include a mandatory period of two years following resignation from an audit firm before a former partner who was directly involved in the audit of a client can become a director of the client or take a position with the client involving responsibility for fundamental management decisions.

An overview of each of the proposed new requirements is set out below.

Employment by client of current auditor/employee of auditor

An auditor is not independent if a current partner or professional employee of the audit firm is:

- an officer of the client;
- a partner, employer or employee of an officer of the client; or
- a partner or employee of an employee of an officer of the client.

Section 324 is currently limited to members of the firm. The proposal also applies to professional employees of the audit firm.

Employment by client of certain relatives of auditor

An auditor is not independent if an immediate family member of a member of the audit engagement team is:

- a director of the client; or
- an officer or employee of the client who is in a position to affect the subject matter of the audit engagement.

This proposal is drawn from the IFAC standard and the SEC rules which prohibit these employment relationships.

Employment by client of former auditor/employee of auditor

An auditor is not independent if a former partner or professional employee of an audit firm is:

- a director of the client; or
- an officer or employee of the client who is in a position to affect the subject matter of the audit engagement;

unless the individual:

- does not influence the audit firm's operations or financial policies and does not participate or appear to participate in the audit firm's business or professional activities; and
- has no capital balances in the audit firm; and has no financial arrangement with the audit firm other than one providing for regular payment of a fixed

pre-determined dollar amount which is not dependent on the revenues, profits or earnings of the audit firm.

The proposal is drawn from the IFAC standard and the SEC rules which prohibit these employment relationships.

Retired audit partner joining audit client

An auditor is not independent if a former partner of an audit firm who was directly involved in the audit of a client becomes a director or senior manager of the client within a period of two years of resigning as partner of the audit firm.

- If a former partner directly involved in the audit of the audit client becomes a director or senior manager of the audit client after the two year cooling off period, the Corporations Regulations will require that the audit client disclose this information in its annual report.

During the course of the Ramsay review, a significant number of stakeholders identified as a particular concern the issue of retired audit partners joining the boards of their audit clients. The proposal, which extends the Ramsay recommendation to include management positions with the audit client, is designed particularly to address threats to auditor independence when a former partner retains some financial arrangement with the audit firm or continues to exercise influence over the audit firm's operations or financial policies.

The proposal is restricted to a former partner of an audit firm directly involved in the audit of a client. In this way the proposal has attempted to achieve an appropriate balance between promoting auditor independence and not unduly impeding audit professionals joining companies and bringing with them valuable financial expertise.

Employment by audit firm of former employee of client

An auditor is not independent if a member of the audit engagement team has, during the period covered by the audit report, been:

- an officer of the client; or
- an employee of the client in a position to influence the subject matter of the audit engagement.

This proposal is drawn from the IFAC standard and the SEC rules which prohibit these employment relationships.

Remuneration from audit firm

An auditor is not independent if an officer of the client, or an employee of the client in a position to influence the subject matter of the audit engagement, receives any remuneration from the audit firm for acting as a consultant to it on accounting or auditing matters.

This proposal repeats the current paragraph 324(2)(h) of the Corporations Act but has been expanded to include employees of the client who are in a position to influence the subject matter of the audit engagement.

The ICAA, with the support of CPAA, has suggested that this restriction be extended to apply to all consultancy arrangements, not just those relating to accounting or auditing matters. The Government considers that there is merit in this proposal.

Inadvertent breaches

There should be protection for inadvertent breaches of the independence rules concerning employment relationships provided certain requirements are met.

The Government considers that there is a strong case in support of including these provisions in the Corporations Act rather than the ethical rules of the accounting bodies.

- The Government agrees with the approach in the Ramsay report that the legislation should set the core requirements, and the ethical rules of the professional bodies would provide additional guidance for considering the threats to audit independence associated with employment relationships and the safeguards available for eliminating or minimising those threats. Exclusive reliance on the ethical rules of the professional accounting bodies would result in matters of public interest being regulated by a private contract between a professional body and its members.

- There are benefits in terms of enforcement in having the core requirements set out in the Corporations Act. The proposed restrictions in relation to retired partners and former employees of the audit firm could not be enforced under the ethical rules if they were no longer members of the relevant professional body.

Small proprietary companies

As recommended in the Ramsay report the new rules will not apply if the audit client is a small proprietary company as defined in section 45A of the Corporations Act

4.8 FINANCIAL RELATIONSHIPS

4.8.1 The Ramsay proposal

Background

The Ramsay review found that Australia's legislative and professional requirements in respect of financial relationships require significant updating to bring them into line with current and proposed overseas requirements. In particular, the Corporations Act contains no requirements in respect of investments in audit clients or about business relationships between auditors and their clients. The professional rules contain minimal requirements in respect of business relationships.

The Ramsay report proposes that a co-regulation model should continue to be used for ensuring financial relationships between an auditor and an audit client do not impair audit independence.

The Ramsay report recommendations

Section 324 of the Corporations Act currently deals with some aspects of financial relationships between auditors and clients. The Ramsay report recommends that paragraphs 324(1)(e) and 324(2)(f) of the Corporations Act should be replaced with the following rules.

As with the proposals on employment relationships, the Ramsay report recommends an exemption regime for inadvertent breaches of the rules if certain requirements are met.

The Ramsay report also emphasises that the financial relationships addressed in the proposed rules are not an exclusive indication of circumstances where an auditor may lack independence. The Ramsay report states that, as is currently the case, it is appropriate that the ethical statements of the professional accounting bodies contain additional guidance for auditors dealing with other circumstances in which an auditor may lack independence.

Investments in audit clients

An auditor is not independent if:

- the audit firm, any member of the audit engagement team, or any of his or her immediate family has:

  - a direct financial investment in the client; or
  - a material indirect financial investment in the client;
- the audit firm has a material financial interest in an entity that has a controlling interest in the client; or
- any other client service personnel, or any of his or her immediate family has a direct financial interest or a material indirect financial interest in the client.
  - the term 'other client service personnel' is defined as 'partners and managerial employees who provide non-audit services to a client, except those whose time involvement is clearly insignificant'.

The recommendation is drawn from the IFAC independence standard which prohibits all these financial relationships. The Ramsay report notes that the SEC rules also prohibit these financial relationships, although the SEC rules are more prescriptive in a number of respects and include additional prohibitions.

Loans to and from audit clients

An auditor is not independent if:

- subject to the exception contained in subsection 324(3) of the Corporations Act [which relates to certain principal place of residence housing loans to a natural person], a partner of the audit firm, or an entity which the partner controls, or a body corporate in which the partner has a substantial holding, owes more than $10,000 (or such other amount as may be prescribed by regulation) to the client; or
- the audit firm, any member of the audit engagement team, or any of his or her immediate family:
  - accepts a loan from a client; or
  - makes a loan to a client; or
  - has a loan guaranteed by a client; or guarantees a client's loan;

unless the loan is made in the ordinary course of the client's business and the loan is made under normal lending procedures, terms and conditions.

The first recommendation repeats what is currently in paragraphs 324(1)(e) and (2)(f) of the Corporations Act. However, two changes have been made.

- First, the amount of $5,000 currently in section 324 has been increased to $10,000, or such other amount as may be prescribed by regulation. This is consistent with a recommendation made in the report of the Audit Review Working Party.

- Secondly, the prohibition currently in section 324 has been extended beyond partners of audit firms and bodies corporate in which partners have a substantial holding, to include entities which partners control. In order to prevent circumvention of the restriction, the Ramsay report did not consider that it would be appropriate to restrict the prohibition to bodies corporate.

The second recommendation is drawn from the IFAC independence standard. The recommendation does not go as far as the SEC rules which are more prescriptive and include additional prohibitions concerning loans. However, the recommendation does extend the IFAC standard by applying to the immediate family of members of the audit engagement team. The term 'immediate family' is defined as 'a spouse (or equivalent) or dependent'.

Business relationships

The Ramsay report recommended that the following rule should be included in the professional ethical rules of the professional accounting bodies. The Ramsay report noted that the Corporations Act currently does not deal with business relationships between auditors and clients.

An auditor is not independent if:

- a member of the audit engagement team has a business relationship with the client or any of its officers which is not clearly insignificant to both the member of the audit engagement team, and also the client or the officer; or

- the audit firm has a business relationship with the client or any of its officers which is not clearly insignificant to both the audit firm and also the client or the officer.

The proposed rule would provide that 'a business relationship' does not include professional services provided by the audit firm or member of the audit engagement team.

The proposed rule has been drawn from the IFAC independence standard.

4.8.2 Stakeholder response

Investments and loans

There was broad agreement among stakeholders that the financial relationships addressed by the Ramsay report should be prohibited.

- Different views were expressed as to whether the restrictions should be included in the Corporations Act or the ethical rules of the professional accounting bodies. Those favouring inclusion in the ethical rules articulated their concerns by reference to the fact that the ethical rules would overlap with and extend beyond the Corporations Act provisions.

- One stakeholder, while supporting the thrust of the proposals, was critical of the fact that the prohibition on investments in audit clients did not contain a similar monetary ceiling to that contained in the prohibition on loans to and from audit clients. However, the IFAC standard draws a distinction between investments and loans and considers that the type of investments covered in the restrictions create such a significant self-interest threat that no safeguard could reduce the threat to acceptable levels.

Business relationships

There was strong stakeholder support for the recommendations. Two qualifying comments are noted:

- two stakeholders considered that the business relationship restrictions should be included in the Corporations Act rather than the ethical rules of the professional bodies; and

- one stakeholder was critical of the fact that the prohibition contained a subjective test as to whether a particular business relationship was 'clearly not insignificant'.

4.8.3 Proposal

The Government agrees with the Ramsay report recommendations on investments and loans, including the continued location of these provisions in the Corporations Act (except that the Government does not favour an increase from $5,000 to $10,000 in the amount an audit partner can owe the audit client). These are core circumstances indicating lack of independence. Placing these provisions in the Corporations Act rather than the ethical rules reflects the public interest in auditor independence. The ethical rules serve their purpose

in providing auditors with additional guidance in relation to the threats to independence that can arise from inappropriate financial relationships. There would also be benefits in terms of enforcement in having these provisions in the Corporations Act.

Proposal 5 — Financial relationships

The Government will amend the law to impose new restrictions on financial relationships. This will cover investments in audit clients and loans between an audit client, and the auditor or his immediate family.

The Government supports the Ramsay report position that the new rules in relation to business relationships should be dealt with in the professional ethical rules of the professional accounting bodies.

This approach will enable threats to independence from business relationships to be dealt with on a conceptual basis under the ethical rules. At the same time, the relationship would still need to be assessed objectively in accordance with the general standard set out in the statement on auditor independence in the Corporations Act.

4.9 PROVISION OF NON-AUDIT SERVICES

4.9.1 The Ramsay proposal

Background

The Ramsay report defined the expression 'non-audit services', for the purposes of the report, to cover all services not coming within the scope of the audit contract that an audit firm provides to an audit client.

The methodology adopted in the Ramsay report was to examine each of the following issues before drawing together a package of proposals to deal with independence concerns arising from the provision of non-audit services to audit clients:

- the Australian and overseas positions in relation to the regulation of the threats to independence arising from the provision of non-audit services to audit clients;
- the issues underlying the debate whether audit firms should be prohibited from providing non-audit services to their audit clients; and
- the options that could be adopted in Australia in order to establish the most appropriate regulatory model.

Australian position

The Corporations Act is silent on the issue of an audit firm providing non-audit services to its audit clients. The Australian accounting standard AASB 1034 *Financial Report Presentation and Disclosures* does, however, require disclosure of amounts paid or payable to the auditor for 'audit services' and to the auditor and any related entity for 'non-audit services.'

Since the release of the Ramsay report, there has been a significant development in relation to the Australian professional requirements about firms providing non-audit services to their audit clients. In May 2002, the ICAA and CPAA adopted a new standard for professional independence which is fundamentally based on the IFAC standard. While the new standard will only become mandatory after 31 December 2003, the two professional bodies have encouraged their members to apply the standard earlier.

The new Australian standard has adopted all the IFAC requirements in relation to the provision of non-audit services. The IFAC standard (which is now also the Australian position) has adopted a conceptual framework which establishes principles that the firm and the assurance team should use to: identify threats to independence; evaluate the significance of those threats; and identify and apply safeguards to eliminate the threats or reduce them to an acceptable level.

Overseas position

International Federation of Accountants

The IFAC standard identifies nine categories of non-audit services as having the potential to pose a threat to an auditor's independence. These are: preparing accounting records and financial statements; valuation services; internal audit services; IT systems services; temporary staff assignments; acting for or assisting an assurance client in the resolution of a dispute or litigation; legal services; recruiting senior management for an assurance client; and corporate finance and similar activities.

As the IFAC independence standard is the basis of the new Australian standard, it is instructive to consider the following table produced in the Ramsay report which sets out the nature of the threats to independence that may be caused by each of these services and the measures that should be adopted to safeguard independence.

Non-audit services identified by IFAC as posing a threat to independence

Non-audit service	Possible threats to independence	Measures to protect independence
Preparing accounting records and financial statements	A self-review threat may be created where a firm assists an audit client in matters such as preparing accounting records or financial statements and the statements are subsequently audited by the firm.	Services should not be provided to listed audit clients except in emergency situations.
Valuation services	A self-review threat may be created when a firm performs a valuation service that directly affects the subject matter of the assurance engagement.	Services should not be provided where they involve the valuation of matters that are material to the subject matter of the assurance engagement.
Internal audit services	A self-review threat may be created when a firm provides internal audit services to an audit client (see note a).	The audit client should be responsible for establishing, maintaining and monitoring the system of internal controls. An employee of the client should be responsible for internal audit activities, with the client approving the scope, risk and frequency of the internal audit work and which recommendations of the firm should be implemented.
IT systems services	A self-review threat may be created when a firm is involved in the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements.	The audit client must be responsible for establishing and monitoring a system of internal controls. The client or one of its employees should have responsibility for all management decisions concerning the design and implementation of the system, for evaluating the adequacy and results of the design and implementation, and for the operation of the system and the data used or generated by it.
Temporary staff assignments	A self-review threat may be created when a firm lends staff to an audit client, especially when the individual is in a position to influence the preparation of the client's accounts or financial statements.	Assistance may be given provided the client is responsible for directing and supervising the activities of the firm's staff and the firm's staff will not be required to make management decisions, approve or sign agreements or similar documents, or exercise discretionary authority to commit the client.

Non-audit services identified by IFAC as posing a threat to independence (continued)		
Non-audit service	**Possible threats to independence**	**Measures to protect independence**
Acting for or assisting an assurance client in the resolution of a dispute or litigation	An advocacy threat may be created when a firm acts for an audit client in the resolution of a dispute or litigation while a self-review threat may be created when the assignment includes the estimation of the possible outcome.	Except where the amounts involved are immaterial or the threat is insignificant, a firm should not provide such services to an audit client.
Legal services	Self-review and advocacy threats may be created by the provision of legal services to an audit client.	Whether the service should be provided will depend on a range of factors, including the nature of the service and whether there would be a material impact on the financial statements.
Recruiting senior management for an assurance client	Self-interest, familiarity and intimidation threats may be created by the recruitment of senior management for an audit client.	While the firm might advertise for and interview prospective staff and produce a list of potential candidates, the decision about who should be hired is one for the client to make.
Corporate finance and similar activities	Advocacy and self review threats may be created by the provision of corporate finance services, advice or assistance to an audit client.	In the case of some corporate finance services (eg promoting, dealing in, or underwriting an audit client's shares), the threat to independence is so great that no adequate safeguards are available. In other cases, adequate safeguards may be available.

(a) Under the IFAC proposals, internal audit services do not include operational internal services unrelated to the internal accounting controls, financial systems or financial statements.

Europe

The Ramsay report noted that the European Commission's existing requirements on audit independence did not specifically refer to the provision of non-audit services. Similarly, the UK Companies Act does not contain provisions dealing expressly with the provision of non-audit services.

The European Commission had, however, published a consultative paper in December 2000, *Consultative Paper on Statutory Auditor's Independence in the EU: A Set of Fundamental Principles,* which proposed that Member States significantly strengthen independence requirements concerning the provision of non-audit services.

After the release of the Ramsay report, the European Commission published a Recommendation on auditor independence in May 2002. The Recommendation adopts a principles based framework in relation to non-audit services, identifying safeguards to either eliminate or reduce threats to independence to acceptable levels.

United States of America

Paragraph c(4) of Part 210.2-01 of the SEC's rules provides that an accountant is not independent if, at any time during the audit and professional engagement period, the accountant provides services in nine specified areas. The SEC rules define the scope of the restrictions for each service and the extent of any permitted exceptions.

The SEC rules define the scope of the restrictions for each service and the extent of any permitted exceptions.

The Sarbanes-Oxley Act now prohibits the following eight specific categories of non-audit services being provided by an auditor to the audit client: internal audit; actuarial services; bookkeeping; financial information system design; valuation services; management functions (including human resources); investment advice; and legal services. The Act also prohibits any other service that the PCAOB determines, by regulation, is impermissible. The PCAOB may grant exemptions, on a case by case basis, from the list of prohibited services 'to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors'. Any exemption granted is subject to review by the SEC.

Common objectives of overseas requirements

The Ramsay report notes that the IFAC standard, the SEC Rules (since overtaken by the provisions of the Sarbanes-Oxley Act) and the European Commission proposals seek to safeguard independence by ensuring that

auditors are independent in fact and appearance. The rules and proposals seek to achieve this by ensuring the auditor does not:

- have a mutual or conflicting interest with the audit client;
- audit his or her own work;
- function as management of the audit client; or
- act as an advocate for the audit client.

The debate whether non-audit services should be prohibited

The Ramsay report discusses the arguments supporting and opposing the provision of non-audit services in the context of the significant growth in these services over the past decade. The report cites statistics which show that for SEC audit clients in the United States, the ratio of accounting and auditing revenues to consulting revenues dropped from approximately 6 to 1 in 1990 to 1.5 to 1 in 1999.

In January 2002, ASIC announced the findings of a survey it had conducted on auditor independence with the Group of 100 Australian companies. The ASIC survey found that:

- The provision of non-audit services by audit firms to their Australian clients is widespread, at least in respect of major corporates. Almost all respondents to the survey confirmed having retained their audit firms to provide other services, particularly taxation advice.
- Audit firms are earning substantial fees for non-audit services. On average the non-audit fees accounted for nearly 50 per cent of total fees paid.
- Processes for dealing with potential conflicts of interest require attention. ASIC concluded that most companies appeared to lack rigour in processes to manage conflicts.

Subsequent submissions have identified concerns about the imposition of blanket prohibitions on non-audit services. These include unintended consequences such as:

- Increased audit costs — as costs cannot be spread across business lines;
- Severe difficulty for major listed clients seeking competitive non-audit services, particularly in Australia with its high level of concentration in audit and non-audit services;

- The possibility of audit staff switching from firm to firm as audit contracts are changed, ensuring the same auditors remain at the same clients;
- The development of separate incorporated entities for non-audit services, with no real separation in substance;
- The inclusion of some non-audit services in audit engagement contracts;
- The dominance of form over substance on independence issues.

The following is a summary of the arguments presented in the Ramsay report opposing and supporting the provision of non-audit services.

Arguments opposing the provision of non-audit services by auditors to their clients

- When an audit firm provides non-audit services to a client it is serving two different sets of clients: management in the case of non-audit services; and the audit committee, the shareholders and all those who rely on the audited financial statements in the case of the audit. In serving these different clients the audit firm is subject to conflicts of interest.
- A rule prohibiting audit firms from providing non-audit services to their clients would be relatively easy to administer and would not preclude an audit firm from providing non-audit services, as long as those services are not provided to audit clients.
- Systems of compensation within audit firms may not give adequate weight to performing the audit function and may in fact adversely impact audit effectiveness. Success in marketing an audit firm's consulting services is often a significant factor in firms' compensation systems. The skills that make one successful in marketing non-audit services to management are not generally consistent with the professional demands on an auditor to be persistently sceptical, cautious and questioning in regard to management's financial representations, thereby creating a tension counter-productive to audit excellence.

Arguments supporting the provision of non-audit services by auditors to their clients

- There is no solid evidence of any specific link between audit failures and the provision of non-audit services, and non-audit services have been provided by audit firms to their clients for many years. A ban should not be imposed in the absence of compelling evidence of a problem.

- Many non-audit services are both in the public interest and beneficial to audit effectiveness. For example, 'a company may seek the assistance of its auditors to correct control weaknesses identified during the audit. The public interest is served by the controls (and the company's financial reporting process) having been strengthened through the auditors' knowledge of the company and its operations, and audit effectiveness is enhanced through the auditors' increased understanding of the company's systems'.

- Companies that most need to improve their controls may decide not to do so because of the potential added costs and efforts of identifying and using firms other than their auditors.

- It is not correct to assert that an audit firm has divided loyalties when it provides non-audit services to a client because it serves different clients (ie, management in the case of non-audit services and shareholders, the audit committee and those who rely on audited financial statements in the case of audits). To make this argument is to assert that the interests of management must necessarily be inimical to good financial reporting.

- Audit firms increasingly need specialists such as information technology specialists to provide critical audit support. Attracting and retaining these specialists, and motivating them to provide direct audit support, may be hampered if they were to be prohibited from providing non-audit services to clients. These specialists generally are not accountants and their primary professional interest is not auditing. Yet they maintain and build their skills by providing non-audit services. Therefore, an unintended consequence of a prohibition on auditors providing non-audit services to their clients could be to reduce audit effectiveness.

Regulatory model options

The Ramsay report considered whether non-audit services should be dealt with exclusively in either the Corporations Act or the ethical rules or whether a co-regulatory model might be appropriate.

The report concluded that the arguments favoured retaining the professional ethical rules, updated to reflect the IFAC standard, as the basic guidance on maintaining audit independence when providing non-audit services to audit clients:

- Exclusive reliance on the Corporations Act was considered inappropriate given the lack of precedent for this in Australia and elsewhere. More fundamentally, the Ramsay report concluded that this would not be necessary given that the review had not uncovered any evidence to suggest

that there are systemic failures within the accounting profession in complying with the ethical rules for providing non-audit services to clients;

- Furthermore, the Ramsay report also concluded that the Corporations Act was an inappropriate vehicle through which to deal with non-audit services because the rapid changes in this area made it impossible to draft a list of all circumstances which could arise to threaten the independence of an auditor; and
- The Ramsay report did not consider that it would be appropriate to adopt the list of nine non-audit services identified in the SEC's rules because a number of the SEC's restrictions arose from intense debate and discussion and therefore represented compromises which, to an external observer, may lack principle. The Ramsay report concluded that it was inappropriate to rely on the types of political compromises it identified, typically reflecting circumstances in the United States, as precedents for Australia.

The Ramsay report recommendations

The Ramsay report recommended that the provision of non-audit services by audit firms to their clients be dealt with by the following package of proposals:

- by revised and updated professional ethical rules which should reflect the IFAC independence standard;
  - the Australian professional accounting bodies adopted the IFAC professional independence standard in May 2002;
  - the categories of non-audit services identified in the IFAC standard as posing a potential threat to an auditor's independence and the measures that should be put in place to safeguard independence are explained above in section 4.9.1;
- by mandatory disclosure of non-audit services and the fees paid for these services;
  - the Ramsay report recommended that the disclosure of non-audit services should be implemented by the following provisions which would form part of the Accounting Standards, or if they are not amended should form part of Chapter 2M (Financial Reports and Audit) of the Corporations Act:
    - the financial report for the year must disclose the dollar amount of all non-audit services provided by the audit firm to the client, divided by category of service, with appropriate discussion of those services;

  - the financial report for the year must disclose whether the audit committee of the board of directors, or if there is no such committee then the board of directors, has considered whether the provision of non-audit services is compatible with maintaining the auditor's independence.

- by strengthening the role of audit committees (this topic is discussed in section 4.10); and

- by establishing an AISB which would have, among its functions, the task of monitoring the adequacy of disclosure of non-audit services.

4.9.2 Stakeholder response

There is strong support from private sector stakeholders in relation to the overall package of measures proposed in the Ramsay report with the exception of the proposal to establish the AISB.

- While there was considerable support for the need to improve the existing institutional arrangements in relation to auditor oversight, reservations were expressed about the desirability of establishing a new body.

The support was drawn from the professional accounting bodies, individual accounting firms, other professional representative bodies and from the corporate sector who are the main clients for non-audit services. The private sector view has been succinctly encapsulated in the comments received from the Group of 100 (of Australian companies):

- 'We are concerned that the provision of non-audit services contributes to a perception that audit independence may be impaired. However, we are unsure that there is reliable evidence to suggest that the provision of non-audit services actually leads to the impairment of independence and a lack of objectivity in the external audit process'.

- 'We believe companies should implement robust processes relating to the acquisition of non-audit and consulting services from their external audit firm. A total exclusion of non-audit services is inappropriate as often the external audit firm has the best experience or knowledge to perform certain tasks eg. audit services for due diligence or acquisition. Certain activities may be excluded from a business practice perspective eg. internal audit and information systems services. In this regard a number of companies have indicated that they will discontinue these types of practices.'

Submissions have also suggested that it is not the presence of non-audit services themselves that is the threat to independence — it is the possibility of local offices being overly dependent on the fees they generate. Suggested solutions have included the disclosure of the percentage of local office revenues gained from a single client.

The Government recognises that publicly stating fee dependence levels may have detrimental effects on small and growing audit firms. This in turn would undermine the Government's policy of encouraging competition in the audit market. For this reason the Government believes fee dependence issues would be best dealt with under the independence oversight powers of the FRC.

4.9.3 Proposals

Proposal 6 — Application of Professional Statement F1

The Government supports the immediate application of Professional Statement F1 on Professional Independence, which forms part of the Joint Code of Professional Conduct of the ICAA and CPAA.

- Statement F1 is based on the independence standard adopted by the International Federation of Accountants. It requires auditors to identify and evaluate threats to independence and apply safeguards to reduce any threats to an acceptable level.
- Where the provision of non-audit services to an audit client poses a threat that cannot be reduced to an acceptable level, statement F1 prohibits the provision of that service.

Proposal 7 — Non-audit services

The Government will implement a series of measures to deal with non-audit services. It will:

- amend the law to require mandatory disclosure in the annual report of fees paid for the categories of non-audit services provided;
- amend the law to require a statement in the annual report of whether the audit committee is satisfied that the provision of non-audit services is compatible with auditor independence. This disclosure would include an explanation as to why the following non-audit services referred to in Professional Statement F1, if contracted, do not compromise audit independence:
  - preparing accounting records and financial statements of the audit client;
  - valuation services;
  - internal audit services;
  - IT systems services;
  - temporary staff assignments;
  - litigation support services;
  - legal services;
  - recruitment of senior management for the audit client; and
  - corporate finance and similar activities.

Rejection of blanket prohibition

The Government does not agree with the view that a blanket prohibition should be imposed on all non-audit services to audit clients. The Government agrees with the force of the argument in the Ramsay report that this would place Australia out of step with the position in every other developed capital market. Even the harder legislative stance that has been adopted in the new corporate governance legislation in the United States does not contemplate the imposition of a blanket prohibition in relation to all non-audit services. The

UK Co-ordinating Group on Audit and Accounting Issues has stated in its Interim Report of July 2002 that it does not favour a blanket ban on the provision of non-audit services.

Principles based professional ethical rules

The Government agrees with the Ramsay report recommendation that the regulation of non-audit services provided by audit firms to their clients should be dealt with by the professional ethical rules of the Australian professional accounting bodies which were updated in May 2002 to reflect the IFAC independence standard.

The Government considers that the conceptual, principles based approach of the IFAC independence standard will achieve the most effective regulatory outcome. It is noted that under the IFAC standard a number of non-audit services are in fact prohibited because the identified threats to independence cannot be reduced by adequate safeguards to acceptable levels.

The European Commission's Recommendation has also concluded that the principles based approach has clear advantages over the prescriptive, rules based approach adopted in the United States:

- 'A principles based approach to statutory auditors' independence is preferable to one based on detailed rules because it creates a robust structure within which statutory auditors have to justify their actions. It also provides the audit profession and its regulators with the flexibility to react promptly and effectively to new developments in business and in the audit environment. At the same time, it avoids the highly legalistic and rigid approach to what is and is not permitted which can arise in a rules based regime. A principles based approach can cater for the almost infinite variations in individual circumstances that arise in practice and in the different legal environments throughout the European Union. Consequently, a principles based approach will better serve the needs of European capital markets, as well as those of SMEs [Small and Medium Enterprises].'

The co-regulatory framework in relation to auditor independence under the CLERP 9 proposals is designed to achieve an effective enforcement regime in relation to non-audit services.

- The professional accounting bodies will be expected to closely monitor compliance with their professional independence standards by their members and to take effective disciplinary action against members who fail to meet the requirements in the ethical rules which will include suspension or cancellation of membership. The FRC will be required to monitor the

effectiveness of the accounting bodies' enforcement of their professional rules.

- Section 1292 of the Companies Act will be amended to ensure that ASIC will be able make an application to the CALDB for the cancellation or suspension of registration of a registered company auditor who fails to comply with the general standard on independence which is to be included in the Corporations Act.

Audit committees

The Government agrees with the Ramsay report that effective audit committees can perform a very important role in ensuring that the auditor is independent of the company. It will be mandatory for the top 500 listed companies (that is, those that compose the All Ordinaries Index), to have audit committees. The Government's detailed proposals in relation to audit committees are addressed below in section 4.10.

Institutional arrangements for oversight of auditor independence

The Government agrees with the Ramsay report that an independent supervisory body is an essential instrument in addressing the challenge of implementing new auditor independence requirements in Australia.

The Government proposes that this role will be carried out by the FRC. The details of the FRC's oversight responsibilities are discussed in Part 2.

The FRC constitutes a key element of the overall regulatory framework that the Government proposes to introduce in order to deal with auditor independence in relation to the provision of non-audit services to audit clients.

Oversight of fee dependence

The Government agrees with stakeholder views that monitoring audit firm fee dependence has merit. The Government proposes that FRC should monitor fee dependence for all audit firms auditing listed companies.

4.10 AUDIT COMMITTEES

4.10.1 The Ramsay proposal

Background

The Ramsay report formed a strong conclusion that a 'well structured and well functioning' audit committee can play a very important role in ensuring that the auditor is independent of the company.

The role of the audit committee extends beyond the area of audit independence. The *Audit Committees: Best Practice Guide* (published by the Australian Accounting Research Foundation, the Australian Institute of Company Directors (AICD) and the Institute of Internal Auditors — Australia) states that 'the audit committee can play a key role in assisting the board of directors to fulfil its corporate governance and overseeing responsibilities in relation to an entity's financial reporting, internal control structure, risk management systems, and the internal and external audit functions'. One of the main objectives of an effective audit committee is to facilitate the maintenance of the independence of the external auditor.

The Ramsay report based its recommendations in relation to audit committees on an analysis it undertook of the requirements in Australia and overseas, as well as drawing on principles developed from international reports, best practice guides and standards. The accounting and corporate scandals which have occurred in the United States subsequent to the release of the Ramsay report, have provided a sharp focus on the key role that audit committees can play in relation to the independence of the external auditor and broader corporate governance issues. The Co-ordinating Group on Audit and Accounting Issues, in its Interim Report dated July 2002 to the UK Secretary of State for Trade and Industry, notes that 'a thread running through many of the commentaries post-Enron' is the strengthening of the membership and role of audit committees.

Australian position

The current Australian position can be summarised as follows:

- The Corporations Act does not require Australian companies to establish audit committees.
- The listing rules of the ASX also lack a mandatory requirement for companies listed on the Exchange to establish an audit committee. Rule

4.10.2 of the ASX's listing rules does, however, require a company to include in its annual report information whether the entity had an audit committee at the date of the directors' report and, if it did not, it must explain why.

- In addition, rule 4.10.3 of the ASX's listing rules provides that the annual report is to contain a statement of the main corporate governance practices that the entity had in place during the reporting period. Among the matters that must be addressed is one requiring an outline of the procedures the entity had in place for the nomination of external auditors, and for reviewing the adequacy of existing external audit arrangements. Where these procedures involve an audit committee, directors are required to set out or summarise the committee's main responsibilities and rights and the names of committee members; and

  – the Ramsay report notes that, for those companies that have established an audit committee, guidance on the operation of the committee is provided in *Audit Committees: Best Practice Guide*.

United Kingdom

The Ramsay report notes the following:

- There are no requirements in the UK Companies Act which require companies to establish an audit committee.

- In relation to companies listed on the London Stock Exchange, the Listing Rules require listed companies incorporated in the UK to include in their annual reports a statement whether they have complied with the Principles of Good Governance and Code of Best Practice (the Combined Code) and to give reasons for any non-compliance. The Combined Code states that the board should establish an audit committee of at least three non-executive directors, the majority of whom should be independent.

On 27 February 2002, the Secretary of State for Trade and Industry established the Co-ordinating Group on Audit and Accounting Issues, (the Co-ordinating Group) following the collapse of Enron and other companies which had raised concerns over financial reporting and the role of auditors. The UK Government perceived a need to be clear that the regulatory regime in the UK, for financial reporting and audit, continues to be effective and provides appropriate underpinning for strong and efficient national and international capital markets.

The Co-ordinating Group provided an Interim Report to the Secretary of State in July 2002. The general tenor of the relevant part of the report is that the role

of audit committees should be strengthened. In that context, the Co-ordinating Group states that 'in particular, the audit committee can act as a proxy for shareholders (who in theory appoint the auditors) and judge the threats to auditor independence and review quality'.

The Co-ordinating Group also considered the case for giving some form of statutory backing for audit committees, at least for some large companies. While the Co-ordinating Group cautioned that introducing the law into this aspect of corporate governance requires very careful thought in the UK, it nevertheless formally proposed in its Interim Report that 'the Government considers underpinning the role and responsibilities of audit committees in company law.'

European Commission

There is no legal requirement at present in any country within the EU for companies to have audit committees. One of the proposed post Enron policy actions of the European Commission is to examine the role of audit committees in European listed companies. The Irish Republic will be introducing legislative reforms that will require Boards of Directors to establish audit committees, each with a charter setting out a clear set of responsibilities.

United States

At the time when the Ramsay review was being undertaken, the principal requirements in relation to audit committees were contained in the listing rules of the New York Stock Exchange (NYSE). The Ramsay report notes that under the NYSE's rules, each company listed on the exchange must have a qualified audit committee. The requirements for a qualified audit committee include:

- having a formal written charter that has been adopted and approved by the board of directors; and
- having at least three independent directors, each of whom is financially literate and at least one of whom has accounting or financial management expertise.

The rules also place a number of restrictions on audit committee membership for the purpose of ensuring each member's independence.

Since the release of the Ramsay report, there have been a number of significant developments affecting the role of the audit committee in the post Enron environment:

- President Bush's 10 Point Plan included measures to strengthen the role of audit committees:
  - SEC to establish guidelines for audit committees to prohibit the external auditor from providing other services to the audit client if audit independence would be compromised.
  - Audit committees would directly report their recommended choice of auditor to shareholders.
  - The SEC is developing proposals that would require all SEC registrants to have independent audit committees with sole responsibility for hiring, firing and retaining external auditors, and sole responsibility for approving non-audit services provided by the auditor.
- The Sarbanes-Oxley Act which President Bush signed into law on 30 July 2002:
  - Vests the audit committee of an issuer of securities registered with the SEC with responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services.
  - Requires audit committee members to be a member of the board of directors of the issuer, and to be otherwise independent.
- The NYSE Corporate Accountability and Listing Standards Committee submitted proposals for reform in June 2002 which, if implemented, would increase the authority and responsibilities of the audit committee, including granting it the sole authority to hire and fire independent auditors and to approve any significant non-audit relationship with the independent auditors.

Canada

The Ramsay report noted that Canada has a mandatory requirement for companies to establish audit committees under the *Canada Business Corporations Act* where securities have been issued to the public.

Effectiveness of audit committees

The Ramsay review undertook extensive analysis and research on the effectiveness of audit committees. The review concluded that having an audit committee *per se* is not enough; it is essential that the audit committee have the

necessary attributes to render it an effective corporate governance mechanism. The Ramsay report drew the following conclusions:

- An effective audit committee must not only exist and be independent, but must also be active.
- There is a relationship between audit committee composition and effectiveness. In this context, it is important that audit committee members are independent in the sense that they have no relationship with the company that may interfere with the exercise of independent judgment.
- Each member of the audit committee should be financially literate, or made financially literate within a reasonable time of appointment — this includes the ability to read and understand fundamental financial statements including a balance sheet, a profit and loss statement and a cash flow statement.

The Ramsay report recommendations

The Ramsay report recommended that qualified audit committees should be mandated for listed companies:

- The ASX Listing Rules be amended to require all listed companies to have an audit committee. The new Listing Rule would be accompanied by an ASX Guidance Note. The Listing Rule and associated Guidance Note should govern the structure of this committee, and should reflect international best practice in audit committees as outlined in Appendix D to the report (the international best practice principles).
- The Listing Rule should:
  - mandate the existence of a qualified audit committee;
  - specify the composition of the audit committee as contained in the international best practice principles; and
  - require the board of directors to adopt a written charter to govern the audit committee.
- The Guidance Note should:
  - specify the general requirements, and duties and responsibilities, of a qualified audit committee as contained in the international best practice principles and

- contain such other matters as are considered appropriate by ASX.

The Ramsay report also recommended that if the ASX does not amend its listing rules, the Corporations Act should be amended to reflect the recommendations regarding audit committees.

4.10.2 Stakeholder response

Overall, there was strong support for the Ramsay recommendations. However, the following two key stakeholder views are noted:

- The ASX has decided to introduce a Listing Rule that will mandate audit committees for at least the top 500 listed companies (that is, those that compose the All Ordinaries Index), in accordance with a strong recommendation of the ASX Corporate Governance Council.
- The AICD supports mandating audit committees for listed companies but considers that the international best practice principles contained in Appendix D to the Ramsay report should be contained in industry codes rather than the listing rules.

4.10.3 Proposal

The Government considers that, following international developments in response to the Enron collapse and general corporate governance concerns about the quality of financial reporting and the independence of the external auditor, strengthening the role of audit committees, particularly in relation to listed companies, is now recognised as a widely accepted principle of world's best practice corporate governance.

Proposal 8 — Audit committees

It will be mandatory for the top 500 listed companies (that is those that compose the All Ordinaries Index), to have audit committees. The ASX has announced it will amend its rules to achieve this.

- The Government supports the role of the ASX Corporate Governance Council in developing best practice standards for audit committees.

The best practice standards to be developed by the ASX Corporate Governance Council should include the following key issues:

- Audit committees should have a formal written charter adopted and approved by the board of directors. The charter should stipulate matters including:
  - the structure of the audit committee;
  - the requirements for membership of the audit committee;
  - the nature and scope of the audit committee's duties; and
  - the processes to be used by the audit committee in discharging its duties.
- The composition of audit committees should be addressed to ensure that the members are independent.
- Members of audit committees should be financially literate and at least one member should have accounting or related financial expertise.
- Audit committees should have a regular schedule of meetings with a system of reporting to the Board of Directors.
- The broad duties and responsibilities of an audit committee should include the following:
  - The audit committee should review and assess the external reporting of the company.
  - The audit committee should review and monitor related party transactions and assess their propriety.
  - The audit committee should review and assess internal processes for determining, monitoring and assessing key risk areas.
  - The audit committee should review and assess key areas relating to the external audit of the company. In particular the audit committee should:
    - make recommendations to the board on the appointment, reappointment or replacement, remuneration, monitoring of the effectiveness , and independence of the external auditor;
    - review and assess non-audit service provision by the external auditor, with particular consideration given to the potential for the provision

of these services to impair or appear to impair the external auditor's judgment or independence in respect of the company.

- The audit committee should review and assess key areas relating to the internal audit of the company.

The Government notes that a significant proportion of companies listed on the ASX already have audit committees. The Government recognises that audit committees do involve higher costs for companies, particularly smaller companies. Where the appointment of an audit committee cannot be justified for a smaller company, as a matter of good governance, the directors of those companies should undertake the key functions of an audit committee.

4.11 APPOINTMENT AND REMOVAL OF AUDITORS

4.11.1 The Ramsay proposal

Background

The Audit Review Working Party's report addressed a range of issues associated with the appointment, tenure, removal and resignation of company auditors. The Ramsay report considered that these issues and the Working Party's conclusions remained relevant.

Appointment

The options identified by the Working Party for appointing auditors include:

- retaining the existing requirements with or without the provision of a period of fixed tenure for the appointment;
- restricting voting at annual general meetings (AGMs) on resolutions to appoint auditors to those shareholders:
  - who are not directors; or
  - who have not exercised a right (whether written or otherwise), based on the size of their share holdings, to have a nominee appointed to the board of directors;

- having the auditor appointed according to existing requirements but on the recommendation of an audit committee or a committee of non-executive directors; and

- having the auditor appointed by a completely independent body such as ASIC, the Court or an independently established tribunal.

The Ramsay report noted that Australia's regulations relating to audit appointment are broadly in line with those of other developed countries.

The Working Party considered that auditors of listed companies should be appointed on a recommendation of the audit committee or, where there is no audit committee, on a recommendation of an appropriate committee of non-executive directors. In the case of unlisted companies, the Working Party recommended that the auditor should be appointed on the recommendation of the audit committee where such a committee exists.

To facilitate the implementation of this proposal, the Working Party considered that either the ASX listing rules or the Corporations legislation should be amended to make it mandatory for listed companies to have an audit committee.

The Working Party was also of the view that changes to the auditors of a disclosing entity should be made a continuous disclosure matter.

Tenure

The Ramsay report noted that there are divergent views on whether company auditors should be appointed until 'death or removal or resignation' as provided for in section 327 of the Corporations Act, or for some fixed period.

Options available in respect of the tenure of auditors include:

- retaining the existing requirements;

- retaining existing requirements but with a fixed minimum term of appointment;

- termination of the audit appointment after a specific period of time, with or without the opportunity to reappoint the existing auditor;

- requiring, where the auditor is a firm, the rotation of the responsible partner after a specified period of time;

- placing, in the case of a sole practitioner or a firm, a restriction on the period for which the sole practitioner or firm may hold office; and
- requiring the appointment of a second or review partner within the auditor's firm or, in the case of a sole practitioner, from another firm.

Following consideration of these options, the Working Party concluded that there should be mandatory rotation of audit partners in accordance with the principles laid down in AUP 32 for all listed companies.

The Ramsay report endorsed the principle that there be mandatory rotation of audit partners. However, Ramsay considered that AUP 32 is not adequate in this respect. AUP 32 only requires 'the periodic rotation of audit staff between audit engagements'. Some firms may interpret this as only requiring rotation after many years. The Ramsay review was advised that under rules in the United States and the United Kingdom, audit partners are required to rotate after a period of 7 years. The Ramsay report considered that this is an appropriate precedent and therefore recommended that there be mandatory rotation of the audit partners responsible for the audit of listed companies and that the rotation is to occur after a maximum of 7 years.

An issue considered by the Audit Review Working Party, and an issue which also arose for consideration as part of the Ramsay review, was whether or not it is appropriate to mandate rotation of the audit firm, as an alternative to rotating the audit partner. The Audit Review Working Party noted in its Report (paragraph 7.26) that only in Spain and Italy is there a requirement to rotate the audit firm after a specified period of time (9 years). The Ramsay review investigated this issue and was advised that Spain has now withdrawn the requirement to rotate audit firms and that the requirement is therefore limited to Italy.

The Ramsay report did not believe it appropriate to mandate rotation of audit firms. The Audit Review Working Party, in also reaching this conclusion, stated that 'the anticipated cost, disruption and loss of experience to companies is considered unacceptably high, as is the unwarranted restriction on the freedom of companies to choose their own auditors' (paragraph 7.27).

Resignation and removal

The Working Party received submissions suggesting that consideration be given to circumstances when it may be appropriate for a change of auditors to take place other than at an AGM or without the requirement to obtain ASIC approval. The Ramsay report noted that the Working Party was concerned at

the potential in these circumstances for the independence of the auditor to be compromised.

The Working Party considered that any proposal to remove the auditor from office should be the subject of a continuous disclosure notice to be filed with ASX, on the basis that it is 'material' information. The notice should also indicate reasons. Similarly any resignation by an auditor should be the subject of a continuous disclosure notice which contains a statement of the auditor's reasons for resigning.

Any appointment of a new auditor of a public company or disclosing entity must, at present, be approved by shareholders at the next AGM. The Working Party concluded that existing requirements established by the ASIC restricting voting on the change of auditor upon resignation largely to the AGM and to dates not near the financial year end should be retained. There should also be a requirement that any proposal for appointment of auditors should contain information on proposed fees.

The Ramsay report recommendations

The Ramsay report recommended that the following Audit Review Working Party recommendations (as amended by the Ramsay review) should be implemented:

- The auditor of a listed company should be appointed and their remuneration determined on the recommendation of the company's audit committee. (Recommendation 7.2)
- The auditor of a company which is not listed should be appointed and their remuneration determined on the recommendation of the company's audit committee where such a committee exists. (Recommendation 7.3)
- There should be mandatory rotation of the audit partners responsible for the audit of listed companies. (Recommendation 7.7) The rotation is to occur after a maximum of 7 years but may occur sooner if considered appropriate by those involved in the audit. There is to be a period of at least 2 years before the partner can again be involved in the audit of the client.
- The Corporations Act or the ASX Listing Rules (or the ASX Guidance Note relating to continuous disclosure) should be amended to provide that a proposed change to the auditor of a disclosing entity is a continuous disclosure matter. (Recommendation 7.14)

- The Corporations Act should provide that any proposal for appointment of auditors of a disclosing entity must contain information on the proposed fees. (Recommendation 7.15)

4.11.2 Stakeholder response

There is broad support among stakeholders for the Ramsay recommendations.

4.11.3 Proposal

The Government notes that MINCO endorsed the recommendations of the Audit Review Working Party and noted that draft provisions to give effect to the broad thrust of the Working Party's recommendations would be prepared.

Proposal 9 — Appointment and removal of auditors

The Government will make audit partner rotation compulsory after five years.

- The new requirement will apply to the lead engagement partner and the review partner. To maintain continuity of knowledge, the appointment of these partners could be staggered.

The Government supports the implementation of the other recommendations of the Audit Review Working Party and the Ramsay report in relation to the appointment and removal of auditors.

4.12 ATTENDANCE OF AUDITOR AT AGM

4.12.1 The Ramsay proposal

Background

Section 249K of the Corporations Act provides that a company must give its auditor:

- notice of a general meeting in the same way that a member of the company is entitled to receive notice; and
- any other communications relating to the general meeting that a member of the company is entitled to receive.

Section 249V further provides that a company's auditor is entitled to attend any general meeting of the company and is entitled to be heard at the meeting on any part of the business of the meeting that concerns the auditor in their capacity as auditor.

Section 250T of the Corporations Act was introduced by the *Company Law Review Act 1998* and deals with questions by members of auditors at the AGM of a public company. It provides that if the company's auditor or their representative is at the AGM, the chair of the AGM must allow a reasonable opportunity for members as a whole at the meeting to ask the auditor or their representative questions relevant to the conduct of the audit and the preparation and content of the auditor's report.

The Audit Review Working Party recommended that there should be a requirement in the law for an auditor to attend the AGM at which the audit report is tabled, either in person or by way of a representative, except in exceptional circumstances (Recommendation 7.16). The Working Party stated that this recommendation would appropriately complement what was then the draft provision to require the chairperson of the AGM to allow a reasonable opportunity for members to ask questions of the auditor. The Working Party further stated that it received submissions suggesting the role of the external auditor at a company's AGM should be strengthened as this is the only forum where the auditor and the persons to whom the auditor is accountable can meet on a face to face basis. The Working Party also noted that subsection 1289(1)(a) of the Corporations Act provides that an auditor has qualified privilege in respect of any statement that he or she makes, orally or in writing, in the course of duties as auditor.

The Ramsay report saw considerable merit in the views of the Working Party concerning attendance of the auditor at the AGM. It considered that the recommendation operates to both strengthen the role of the auditor and also strengthen the accountability of the auditor to shareholders. The Ramsay review noted that section 250T which requires the chair of an AGM to allow a reasonable opportunity for members to ask questions of the auditor applies only to AGMs of public companies.

The Ramsay report recommendation

The Ramsay report recommended that the Corporations Act be amended to require an auditor, or a representative of the auditor, to attend the AGM at which the auditor's report is tabled unless reasonable circumstances preclude the auditor's attendance. The report also recommended that this requirement for auditors to attend AGMs should apply only to AGMs of listed public companies. There are many small public companies (including many public companies limited by guarantee) where attendance by the company's auditor is not usually expected or required.

4.12.2 Stakeholder response

There was general agreement with the recommendation. Some stakeholders queried whether it was necessary to make a legislative change. The AICD considered that the proposal was appropriate but the obligation should not be extended further than the existing requirement in the Corporations Act to answer relevant questions.

4.12.3 Proposal

Proposal 10 — Attendance of auditor at AGM

The Government will amend the law to require an auditor to attend the AGM of a listed company at which the audit report is tabled and to answer reasonable questions about the audit.

- The Government will ensure shareholders are able to submit questions by e-mail to the listed company and that the questions will be posted on the company web site.

4.12.4 Recommendations of the Audit Review Working Party on auditor qualifications for registration

The Audit Review Working Party recommended changes to the educational and professional requirements to qualify for registration as a company auditor.

The Working Party identified three issues concerning qualifications for registration: educational qualifications, professional requirements, and the appropriate level of experience.

In relation to educational qualifications, the Working Party recommended that all applicants be required to have completed a specialist course equivalent to the auditing module currently provided by the ICAA's Professional Year program or CPAA's CPA program.

In relation to professional requirements, it was recommended that accountants who are not members of a professional accounting body be required to give an undertaking that they will abide by the code of ethics or other rules of one of the professional bodies on the same basis as members of that body.

In relation to the level of experience, the Working Party recommended that competency standards be used for determining whether an auditor has the necessary skills to be registered as a company auditor, rather than the current time-based criteria.

It was recommended in the Ramsay report that the recommendations of the Working Party be adopted in relation to auditor competency standards. Submissions received on the Ramsay recommendations have been widely supportive of this recommendation, which the Government supports.

Some concerns were raised that it may be inappropriate for auditors to be held to the standards of professional bodies of which they are not members. As a possible solution, it has been suggested that ASIC issue a policy statement on auditor independence requirements, perhaps based on that issued by IFAC.

Given the strong support evident in submissions, it is proposed that the recommendations of the Working Party concerning qualifications for registration be implemented, as recommended in the Ramsay report.

Proposal 11 — Qualifications for registration as a company auditor

Accountants seeking registration as company auditors will be required to meet agreed competency standards, to undertake to abide by an accepted code of professional ethics, and to complete a specialist auditing course prior to registration.

PART 5: AUDITOR LIABILITY

5.1 BACKGROUND

Auditors are currently exposed to unlimited liability for professional default. The issue of the professional liability of auditors (and other professional groups) has been under consideration by the professions and the Commonwealth, State and Territory governments since the mid-1980s.

Two major professional accounting bodies in Australia, CPAA and the ICAA, confirmed the profession's ongoing concerns about the need for reform in this area in submissions lodged in May 2002 with the Senate Economics Reference Committee in connection with the Senate Committee's inquiry into Public Liability and Professional Indemnity Insurance.

The need to address the present unlimited liability regime has also been raised by a number of the large accounting firms in their submissions to the Ramsay review on auditor independence. This issue was raised in the context of improving the quality of the audit function by enhancing the scope of the audit and the audit report. It has been asserted that a fundamental improvement in corporate disclosure would be to expand the audit report to comment on other relevant issues such as governance, risk management and internal control, together with key indicators of the financial health of the company. However, the accounting firms considered that it would not be feasible for auditors to contemplate such an expansion in the scope of an audit within the context of the current unlimited liability environment.

Auditors, and other professional groups have traditionally dealt with their unlimited liability exposure for professional default through professional indemnity insurance. Insurance plays an important role in the Australian economy. It provides a mechanism for transferring and pooling the risk of financial loss to entities with the expertise to manage the risks involved. Professional indemnity insurance insures against loss arising from professional services offered by the insured professional.

Australia is currently experiencing a 'hard insurance market', that is, a market characterised by tougher risk selection by insurers. While the Australian experience has been exacerbated by the collapse of a major domestic player in HIH (which held around 35 per cent of the professional indemnity market),

globally most classes of insurance have moved into a hard market cycle in the last two years. This has been compounded by the terrorist attacks on 11 September 2001.

Studies undertaken by MINCO have concluded that of those professionals which might be subject to claims under the Corporations Act, only accountants (and in particular, auditors) required attention in light of their potential liability in relation to Corporations Act matters and that there has clearly been a very significant increase in the size of claims, if not the number, against accountants (primarily auditors) over recent years.

The Insurance Industry Market Pricing Review, which the Australian Competition and Consumer Commission (ACCC) released in March 2002, noted that the insurance industry has experienced low returns on equity over the last nine years. The ACCC concluded that the key driver for recent premium increases has been the shift by insurers from establishing targets for business growth as measured by premium volume to setting targets for return on equity. The ACCC noted, in relation to professional indemnity insurance, that low returns had occurred due to a combination of the following factors:

- inadequate premium rates;
- realisation of the extent of past losses as liability provisions are increased to reflect emerging claims experience;
- low investment returns which represent a significant and important component of insurance profit; and
- liquidation of the HIH Group potentially removing a barrier to price increases.

The information provided by accountants demonstrates a worsening position over recent years regarding insurance cover for this profession:

- a lack of availability of insurance, in Australia and elsewhere;
- substantial increases in average premiums per partner for the major accounting firms;
- larger deductibles (that is, first part of claim to be carried by the insured) and some areas of self-insurance as a result of gaps in the cover; and
- the level of insurance cover, while high, was well below that necessary to meet some of the claims that were presently outstanding.

The recent submissions by the two professional accounting bodies indicate that the position in relation to the availability and cost of professional indemnity insurance has deteriorated in the current 'hard insurance market':

- Both CPAA and ICAA have provided anecdotal feedback from their membership about the increase in premium levels. Detailed aggregated information on trends in the professional indemnity insurance market for members of the two bodies is not available because, unlike some mutual or monopoly schemes found in some other professions, members negotiate their own insurance cover, usually through insurance brokers, with a variety of insurers.
  - CPAA states:
    - : while premiums had remained stable prior to 2001 for about six years, premiums increased during 2001 (pre 11 September) by an average of 25 per cent;
    - : between September 2001 and March 2002 premiums have risen by an average of 25-35 per cent;
    - : premiums since March 2002 have on average increased by at least 40 per cent with many cases where increases have been between 100 to 300 per cent.
  - ICAA membership feedback indicates even steeper increases in premiums:
    - : The minimum increase in premiums being experienced by members in the current renewal period (that is, 2002-03) is in the order of 100 to 300 per cent. This is the experience for small firms undertaking no audit, insolvency, financial planning or management work, with no past claims or notifications.
    - : For larger firms, with no past claims experience, who perform little if any audit or other 'higher risk' work, premium increases are in the order of 300 to 400 per cent.
    - : Firms that have had a claim or notification are experiencing insurance premium increases of ten fold and more.
- Both of the accounting bodies report that deductibles are increasing at similar rates to premium increases.

- Both accounting bodies state that there is clear evidence that professional indemnity insurance is being offered on increasingly restrictive terms by insurers.
  - The ICAA reports that it has received feedback from some members that up to 90 per cent of a firm's activity could be uninsured because it falls under one or another exclusion clause contained in the insurance contract.

The backdrop to the CLERP 9 consideration of the issues relating to the professional liability of auditors is the important role that the independent audit function performs in relation to Australia's corporate governance framework and the efficiency of the capital market. Wider policy issues relating to the insurance industry, including the regulation of general insurance companies and the state of the professional indemnity insurance market are beyond the scope of CLERP 9.

The following policy options have been raised by the accounting profession for the purpose of establishing an appropriate framework to address the profession's concerns in relation to the present system of auditor liability:

- The incorporation of auditors.
- The law of joint and several liability in relation to actions for negligence causing property damage or purely economic loss and its replacement by proportionate liability.
- The capping of professional liability within the framework of State and Territory Professional Standards legislation.

5.2 INCORPORATION OF AUDITORS

The Corporations Act does not allow a company to be registered as a company auditor.

If auditors were allowed to incorporate, this would address some of the concerns relating to the professional liability of auditors:

- Because of the law of joint and several liability, one of the consequences of having large accounting firms structured as a partnership is that the actions of one partner, if those actions are subsequently found to have been negligent, may have severe financial implications for all the other partners.

- Incorporation of auditors would also overcome difficulties associated with the management of large accounting partnerships.
  - Over the past half century, there have been a number of significant changes within the accounting profession, especially in those firms that provide auditing and other services to listed and other economically significant corporations. These changes include:
    - a progressive increase in the size of the firms, both through natural growth and through the acquisition of, or mergers with, other firms;
    - the establishment of international accounting partnerships and affiliations and other links with accounting firms in other major capital markets; and
    - a change in the emphasis of the business undertaken by some firms through expansion into the field of business advising and management consultancy.
  - One of the factors influencing the growth in the size of accounting firms has been the need to match the growth of major clients. As a client's business grows and becomes more sophisticated, so there is a need for the accounting firm to grow and to offer the client a greater range of professional services.

MINCO has given approval to proposals to permit the incorporation of auditors which provide for a regime under which the accounting bodies (to be known as 'prescribed accounting bodies') would be responsible for the administration of the scheme. The prescribed accounting bodies would approve the bodies corporate that are authorised to act as auditors (to be known as 'authorised audit companies' (AAC's). In addition, the accounting bodies would be required to provide a framework against which potential participants in the industry could be assessed and against which their conduct could be judged.

A range of safeguards have been built into the proposed regime to protect the clients of auditors who operated through a corporate structure. These safeguards include:

- that the authorisation and regulation of audit companies would be undertaken by accounting bodies that had been approved for that purpose;
- that audit work could only be undertaken by AAC's authorised by an approved accounting body;

- requiring all members and directors of an AAC to be natural persons;
- that effective control of an AAC remains with appropriately qualified natural persons;
- ensuring that the directors responsible for company audit work undertaken by the AAC are registered company auditors who are not subject to any restriction; and
- the maintenance of professional indemnity insurance at an appropriate level and on appropriate terms to meet claims against the AAC arising out of company audit work and/or the maintenance of a specified level of assets or capitalisation.

The ICAA, in its recent submission to the Senate Economics Reference Committee, raised the proposal for auditors to conduct their business through limited liability partnerships, as an alternative option to incorporation (which the ICAA also supported). It is noted that a 1993 MINCO Working Party did not support this option for the following reasons:

> 'Having regard to the features of limited partnerships, in particular the inability of limited partners to participate in their management, as well as the absence of legislation permitting limited partnerships in three jurisdictions, this approach does not seem desirable or feasible. To go the further step of altering the joint and several liability of partners would also seem undesirable as it is the central feature of the partnership structure'.

A new form of limited liability partnership (the LLP) has been introduced in the United Kingdom after an extensive consultation process which commenced in 1997. Under the UK scheme, the LLP has limited liability but the members of the LLP remain personally liable for their own acts. In Australia, partnerships are regulated under State and Territory partnership legislation and by the application of the rules of equity and of the common law. The Commonwealth does not have the constitutional power to enact comprehensive legislation regulating partnerships in Australia.

In the UK, the *Companies Act 1989* allows a company to be appointed as the auditor of a company. Recognised UK supervisory bodies (the major accounting bodies) are responsible for establishing the eligibility of persons and 'firms' (defined to mean bodies corporate and partnerships) to conduct audits of companies.

The legal effect of incorporation on the liability issue

Incorporation on its own will not overcome all the liability problems raised by the professional accounting bodies who view incorporation as one part of a package of reforms to address the problem. The legal effect of incorporation can be summarised as follows:

- leaves the audit company fully liable for the amount of any judgment that exceeds the amount of its professional indemnity insurance (and ultimately exposed to the possibility of being placed in liquidation);
- places auditors in a similar position to other major commercial parties without providing any special benefit or exemption from the standard liability rules;
- leaves the individual auditor member of a company who carried out a negligent audit liable as well as the company itself (this issue is addressed under the capping of liability proposal);
- protects the private assets of 'innocent' auditor members of the company from the consequences of the negligent conduct of one or more other auditor members of the company; and
- unlike proportionate liability, incorporation does not address the issue of the potential liability (which may arise from the law of joint and several liability) of an audit firm for the negligence caused by third parties where the acts of the firm only partly contributed to the damages involved.

Proposal 12 — Incorporation of auditors

The Government will amend the law to allow auditors to incorporate.

5.3 JOINT AND SEVERAL AND PROPORTIONATE LIABILITY

Joint and several liability means that where the acts or omissions of a number of persons have each contributed to a plaintiff's loss, the full amount of that loss can be recovered by the plaintiff from any one of those persons (the defendants). A defendant who has paid an amount in damages to the plaintiff in excess of his or her proportionate contribution to the plaintiff's loss is entitled to recover from any other defendant an amount equal to that other defendant's contribution to the plaintiff's loss.

Proportionate liability divides the plaintiff's loss among the defendants according to their share of responsibility.

Joint and several liability throws the risk of insolvency or untraceability of any one of the defendants onto the other defendants, and permits a plaintiff to recover the whole of his or her loss from those who are solvent. Proportionate liability also allows for the sharing of liability among a number of persons. However, the difference from joint and several liability is that proportionate liability puts the risk of the insolvency or untraceability of a defendant onto the plaintiff.

Under the proportionate liability principle, the liability of each defendant is in all circumstances limited to the extent to which that party is considered to be responsible for the loss. There is no right of contribution between various defendants, since none of them would, as a general rule, be liable to pay to the plaintiff any more than the proper share owing by each defendant.

The effect of insurance and the law of joint and several liability has given rise to auditors (and other professionals) often being singled out as the sole target for legal action in proceedings for property damage and purely financial loss, even when the professional is only one of the parties involved. Accordingly, a minor degree of fault can result in full liability.

This outcome has led to widespread concern over the years at the increasing level of payments which the insurance funds covering professionals are required to meet, and the consequently increasing level of the cost of that insurance. The accounting bodies state that while it is possible for a defendant who bears the full extent of a judgment to seek contribution from other defendants that have contributed to the loss, equitable apportionment in this manner is rarely achieved because of the insolvency or lack of assets on the part of the other defendants, or because they are untraceable or beyond jurisdiction.

The professional accounting bodies have said that, while accountants are willing to shoulder their responsibilities for what their actions may have caused by way of damages, it is inequitable that accountants should have to bear the liability for the failure of other parties on the basis of the law of joint and several liability.

The MINCO Working Party recommended in 1993 that:

> 'the arbitrary and unfair consequences of the present rules regarding joint and several liability of auditors should be addressed in a review of the law which takes into account the implications of changes in these rules beyond their impact on Corporations Law matters.'

An inquiry into the law of joint and several liability was established by the then Commonwealth and New South Wales Attorneys-General in February 1994 and was conducted by Professor Davis of the Australian National University.

- The terms of reference excluded personal injury claims.
- The Standing Committee of Attorneys-General accepted the need for the inquiry to consider the issues in a context wider than that of the corporations legislation.

The report of the Davis inquiry was released in January 1995. The key recommendation was that the present joint and several liability of defendants in actions for negligence causing property damage or purely economic loss be replaced by liability which is proportionate to each defendant's degree of fault.

On 14 July 1996, draft model provisions designed to implement the Davis report's recommendations were released for public comment. The draft model provisions, if adopted, would amend the common law, State and Territory fair trading legislation, the Trade Practices Act and the Corporations Act.

The Davis report was considered by the New South Wales Law Reform Commission in a discussion paper and a subsequent report entitled *Contribution between persons liable for the same damage*. The NSWLRC's discussion paper (released in 1997) and its report (released in 1999), opposed the introduction of proportionate liability, instead proposing a number of reforms to the law relating to contribution between persons liable for the same damage.

Following the release of the NSWLRC's discussion paper, the matter was removed from the agenda of the Standing Committee of Attorneys-General.

The professional accounting bodies have reiterated the critical importance of the reform of the law of joint and several liability in their recent submissions to the Senate Economics Reference Committee and have called upon the Commonwealth and State Governments to implement the Davis inquiry proposals as a matter of urgency.

The legal effect of proportionate liability on the liability issue

The legal effect of the introduction of proportionate liability in relation to actions for negligence causing property damage or purely economic loss can be summarised as follows:

- limits an auditor's liability or an audit firm's liability to the amount of the plaintiff's loss actually caused by the auditor's negligence; and
- consequently, an auditor or audit firm would no longer risk, because of the 'deep pocket' syndrome, being liable for the negligence caused by non-audit parties, such as the directors of the company. This would address the concerns of auditors that they can face a huge damages bill even though they contributed marginally to the plaintiff's loss.

Proposal 13 — Proportionate liability

The Government will seek the agreement of the States to introduce proportionate liability.

- The Government believes that the market for audit services will be improved if the arbitrary consequences of the present rules relating to joint and several liability in relation to economic loss and property damage are reformed.

The Government recognises that the difficulties with the present joint and several rule in actions for negligence causing property damage or purely economic loss arise across the common law and are not confined to cases in relation to the Corporations Act. These issues need to be considered in a wider context than the Corporations Act, especially in view of its central importance in the general common law of negligence. If the joint and several liability rule were to be removed from one area of the law while being left to operate in others, this could lead to inappropriate and inconsistent results.

The Commonwealth envisages that the implementation of the reforms proposed by the Davis Inquiry would need to be considered in the light of:

- the position adopted by the New South Wales Law Reform Commission opposing the recommendations of the Davis Inquiry report for the introduction of a scheme of proportionate liability in actions for negligence causing property damage or purely economic loss;
- the broader tort and legal system reform currently being undertaken by the Commonwealth, State and Territory Governments; and
- relevant developments overseas since the completion of the Davis report in 1995, such as the introduction in Canada in 2001 of a modified proportionate liability regime.

5.4 CAPPING LIABILITY SCHEME

The professional bodies have also supported the introduction of a statutory 'cap' on professional liability.

New South Wales and Western Australia have introduced legislation that permits the capping of the liability of members of occupational associations in certain circumstances. These capping regimes are contained in the Professional Standards Act, which was enacted in New South Wales in 1994 and similar legislation, which was passed in Western Australia in 1997.

- A scheme limiting the liability of members of CPAA and the ICAA is in operation in New South Wales and a similar scheme will soon be submitted for approval under the Western Australian legislation.

Under the Professional Standards legislation in New South Wales and Western Australia, an occupational association can apply to the Professional Standards Council established under the legislation for acceptance of a scheme to limit liability. A scheme must exhibit features designed to:

- minimise the occurrence of events giving rise to claims;
- facilitate the handling of claims which are made; and
- increase the likelihood of claims being satisfied if liability is established.

Each scheme is designed by the applicant association. Under a scheme, the association must:

- ensure that the members of the scheme have insurance (or net business assets) to cover the relevant level of liability. An important public benefit of the scheme is that the level of insurance required to participate in the scheme is generally greater than the minimum level of compulsory professional indemnity insurance and the professional's liability is limited to that greater amount required for insurance under the scheme;
- have a system of handling complaints and discipline of members;
- have a program of risk management in place.

The capping of liability relates to 'civil liability arising (in tort, contract or otherwise) directly or vicariously from anything done or omitted by a member of an occupational association acting in the performance of his or her occupation.' The capping regime does not apply to claims arising out of personal injury matters, fraud, misappropriation or breach of trust.

No other State or Territory has enacted similar Professional Standards legislation. Furthermore, to be fully effective, the Commonwealth would need to cap damages obtained under the Trade Practices Act.

- Section 52 of the Act prohibits a corporation from engaging in conduct that is misleading and deceptive. Damages awarded to a person under a section 52 action would appear not to be affected by State capping legislation.

- Section 74 of the Act implies warranties of due care and skill and fitness for purpose into certain contracts for the provision of services by corporations to consumers. This warranty cannot be excluded or abrogated. Liability can only be limited under the Act where the contract is not for consumer goods and services.

- To the extent that Commonwealth legislative powers permit, the Trade Practices Act extends most of these consumer protection provisions to the services of professionals, thereby enabling actions against professionals in cases such as where misleading and deceptive conduct may be alleged. Liability under the Act would not be affected by a State capping regime, because such limitations would be inconsistent with this Commonwealth legislation. To date most actions in respect of professional liability have combined an allegation of a breach of section 52 of the Trade Practices Act and negligence at common law.

Similar considerations would apply in relation to provisions of the Corporations Act which establish a cause of action relating to the personal liability of a professional.

The 1993 MINCO Working Party addressed the capping of liability option in its report. The Working Party's report considered that the capping option would have a number of significant draw-backs, including:

- its overall effect would be to reduce the pool of assets legally available to compensate plaintiffs by an amount equal to the difference between the defendant's resources (including insurance) and the cap applicable to the defendant;

- where a defendant's liability was limited to an amount less than the defendant's contribution to the plaintiff's loss, responsibility for carrying the plaintiff's loss would shift to any co-defendants;

- where the co-defendants' resources were insufficient to meet the balance of the plaintiff's damages, the scheme would shift the loss to the plaintiff:

  - this raises the fundamental question of who should bear the loss caused by a professional (that is, should it be the professional or the person who suffers the loss); and

- a capping regime for professionals would also place professionals in a privileged position compared with other individuals or commercial parties who would remain liable for the full amount of any loss or damage caused. Other persons, whether acting in a private or commercial capacity, would remain exposed to the possibility of bankruptcy or insolvency.

A scheme capping professional liability would also adversely affect the operation of the Corporations Act, which relies heavily on civil liability to provide a system of compensation and deterrence for wrongful conduct, whether for claims based on the Corporations Act directly or on common law principles of negligence.

Legal effect of capping on the liability issue

The legal effect of a capping of liability regime can be summarised as follows:

- limits an auditor's liability or an audit firm's liability in accordance with an approved scheme to limit liability;

- in contrast to incorporation where the individual auditor responsible for a negligent audit would be liable to the full extent of the damage involved, capping would limit that individual's liability as well;

- a capping regime may deprive plaintiffs of what would otherwise have been their legal rights where the claim is in excess of the capped amount; and

- professionals would be placed in a privileged position compared with other defendants.

5.5 CONCLUSION

A capping regime would not be fully effective until all the States and Territories agree to enact uniform Professional Standards legislation. The Commonwealth would also need to extend the capping concept for approved professional groups to the Corporations Act and the Trade Practices Act.

The fact that only two States have so far introduced capping schemes, after more than ten years since the capping of liability concept was first mooted, indicates that the majority of jurisdictions remain to be convinced of the appropriateness of this approach.

The Commonwealth Government remains unconvinced that a capping regime for professionals is an appropriate policy response to the audit liability issue. The arguments against the introduction of a capping regime by the 1993 MINCO Working Party remain persuasive. The Government has two further concerns:

- while the objective of improving professional standards, including the introduction of compulsory professional indemnity insurance and risk management programs is admirable, professional bodies should be implementing such measures as a matter of best practice and should not require the incentive of a capping regime to achieve them; and
- the liability system under the Corporations Act and the Trade Practices Act to which auditors (and other professionals) are subject should not operate differently for them than for any other person or group in society. To introduce special rules to protect or benefit one group would give rise to the likelihood of unfair, inconsistent and arbitrary results for others — whether as co-defendants or plaintiffs. This could undermine the integrity of the Corporations Act and the Trade Practices Act.

The Government considers that an appropriate framework for addressing the issue of audit liability would be:

- to implement the proposals allowing auditors to incorporate; and
- to seek the agreement of the States and Territories to replace the present joint and several liability of defendants in actions for negligence causing property damage or purely economic loss by liability which is proportionate to each defendant's degree of fault.

PART 6: ACCOUNTING STANDARDS

6.1 CLERP 1 REFORMS

The Government issued its CLERP 1 paper in 1997. Following an extensive consultation process, legislation was enacted in 1999 to implement the paper's policy proposals.

The key reforms were:

- an overhaul of the institutional arrangements for accounting standard setting;
- the Australian Accounting Standards Board (AASB) was re-constituted independently of the accounting profession which previously provided its secretariat;
- the Financial Reporting Council (FRC), comprising key stakeholders in the accounting standard setting process, was established to: provide broad oversight of the standard setting process; seek contributions towards the costs of the process; appoint the members of the AASB (other than the Chair who is appointed by the Treasurer); approve and monitor the AASB's priorities, business plan, budget and staffing arrangements; and determine its broad strategic direction; and
- an objective of furthering the development of a single set of high quality accounting standards for world-wide use, including their adoption in Australia.

The new institutional arrangements have been in place formally since 1 January 2000 and are working well. The Government is satisfied that the AASB has access to appropriate resources to meet its heavy workload. In line with the tripartite funding model proposed in the CLERP 1 paper, funding is currently provided by government (at the Commonwealth, State and Territory levels, totalling $2 million a year) and the accounting bodies ($750,000 a year), and is being sought from the business sector.

In July 2002, the FRC approached Australia's top 100 listed companies for voluntary contributions, seeking a total annual funding commitment of $750,000 over three years.

In addition, in June 2002, the Parliamentary Secretary to the Treasurer announced $2 million in additional funding over two years to help Australia meet its goal of adopting international accounting standards. This funding will be sourced from the Financial Industry Development Account maintained by the Australian Stock Exchange.

These initiatives will see substantially more investment going into the building of quality accounting standards than at any time previously.

While these new funding sources will enable Australia to make a significant financial contribution to the International Accounting Standards Board (IASB), the FRC has made it clear to the AASB that it will have first call on the funds to meet its own standard setting priorities, including public sector projects and the significant preparations needed for adoption by Australia of international accounting standards by 2005.

The Government has no plans at present to alter the institutional arrangements as they relate to accounting standard setting. However, as proposed in Part 2, it would like to make use of the expertise of the FRC in the audit area. This is seen as preferable to establishing a new body which would in any event require a similar composition and stakeholder support base.

6.2 ADOPTION BY AUSTRALIA OF INTERNATIONAL ACCOUNTING STANDARDS BY 2005

Australian accounting standards are recognised by accounting standard setters world-wide as being of high quality. However, with Australia comprising less than two per cent of the world capital market, participants in markets overseas have little incentive to understand them.

The Government has long recognised the benefit to Australia of a common global accounting language. In a globalised economy with large and growing cross-border capital movements, high quality internationally accepted accounting standards will facilitate cross-border comparisons by investors and enable Australian companies to access international capital markets at lower cost. Business and other stakeholders have given strong support to the Government's convergence objective.

The 1997 CLERP 1 paper proposed that a key role of the FRC should be to ensure that the AASB is committed to, and works towards, the adoption of IASB standards in Australia. This objective was reflected in amendments in 1999 to the Australian Securities and Investments Commission Act (ASIC Act) which took effect from 1 January 2000 — except that the Act was silent on the source of international best practice accounting standards to apply in Australia, reflecting the debate then current about whether US GAAP or IASB standards were likely to fulfil that role.

It was nevertheless recognised at the time that there were potential disadvantages in Australia adopting US GAAP. These are black letter standards and interpretations which are unfamiliar to most Australian companies, have been developed in the context of the US legal environment and enforcement regime, and over which Australia has no influence.

The United States has yet to commit to the adoption of IASB standards and continues to require that Australian and other foreign companies seeking to raise funds or list on the US market reconcile their financial statements to US GAAP. However, the US is reviewing its standards with a view to making them more principles-based and is working with the IASB to achieve greater convergence of US and IASB standards.

Meanwhile, as part of its move to a single capital market, the European Union has decided that EU listed companies will be required to apply IASB standards in their consolidated financial statements for reporting dates beginning on or after 1 January 2005. EU member states have the option of extending this requirement to the individual financial statements of listed companies and to the financial statements of non-listed entities.

European developments are likely to put pressure on the US at least to accept IASB standards for cross-border raisings and listings.

IASB standards have been adopted, or are in the process of being adopted, by significant Asian economies, including Singapore, Hong Kong and China. The International Organisation of Securities Commissions (IOSCO) has also recommended that its member countries adopt 30 core IASB standards for purposes of cross-border offerings and listings, subject to reconciling items.

Against that background, the FRC, on 3 July 2002, announced its formal support for the adoption by Australia of IASB standards by 2005. In practice, this will mean that single entity and combined financial statements required under the Corporations Act will need to be prepared in accordance with IASB standards for accounting periods beginning on or after 1 January 2005. With the need to present one year comparatives, the changeover will effectively commence for most Australian reporting entities from 1 July 2004.

The FRC's announcement was fully consistent with long-standing Government policy under CLERP 1, as reflected in the 1997 paper and subsequent legislation. Indeed, the 2005 timetable is considerably later than envisaged by the Government in 1997, due to slower than anticipated progress at the international level.

In any event, Australia could not realistically adopt IASB standards earlier than Europe. Equally, adoption by Australia later than the European timetable would result in Australian accounting standards being out of step with both Europe and the United States — an outcome the Government does not believe Australia could contemplate.

Accordingly, the Government fully supports the FRC's position on the timing of adoption of IASB standards in Australia. The Government will continue to support the FRC and AASB in discharging their responsibilities for managing the transition to 2005 and encourages stakeholders to work constructively with these bodies on implementation issues.

6.2.1 Implementation issues

Australia would in virtually all cases accept IASB standards without modification (except to ensure that they are appropriate to the Australian legal and institutional environment). Under the ASIC Act, adoption would occur unless considered not to be in the best interests of the Australian private and public sectors. However, such instances are likely to be extremely rare. Any departures by Australia from IASB standards could rapidly erode the advantages of a common accounting language and in particular the acceptance overseas of Australian companies' financial statements as IASB compliant.

The body of IASB standards would be adopted in Australia for reporting periods beginning on or after 1 January 2005. However, existing AASB standards which do not have international counterparts would generally be retained after that date until IASB standards are developed.

The AASB has had a program of harmonisation of its standards with IASB standards since 1996, except where it considered it had a better solution or to remove choices available under IASB standards. The IASB, under its old structure and since the reconstituted Board began operations in April 2001, has been aggressively improving the quality of its standards, drawing on the best the world (including Australia) has to offer with the aim of producing a body of standards that represents world's best practice and is capable of world-wide adoption. Substantial progress has already been made and the IASB is committed to further improvement of its standards in the period to 2005.

To ensure the consistent application of IASB standards across countries, it will be necessary for Australia to also adopt, from 2005, interpretations of IASB standards issued by the IASB's International Financial Reporting Interpretations Committee (IFRIC) and, in the meantime, for the AASB to continue to harmonise interpretations by its Urgent Issues Group with IFRIC interpretations. Similarly, the Government and ASIC will need to further consider measures to promote international cooperation in enforcing IASB standards, having regard in particular to the harmonised enforcement regime being developed by the EU. Even with a common set of accounting standards, the comparability of financial statements could be impaired if standards are subject to differing interpretations and markedly different enforcement regimes.

The AASB has formed a close partnership with the IASB, aligning its work program to the extent possible and standing ready to allocate resources to lead or support projects on the IASB agenda. Recently, the AASB issued a number of IASB exposure drafts in Australia for comment by Australian constituents. It will be important for the business community and other stakeholders to engage fully in commenting on these and future IASB exposure drafts.

The 2005 date will require a major transition by the AASB, the business community, the accounting profession, and users of financial statements, although the harmonisation program has made this transition more manageable than it would otherwise have been.

Many of the details will be a matter for the AASB as the independent standard setter. For example, judgements will need to be made about whether particular IASB standards could be adopted in Australia prior to 2005, or whether the adoption of some standards should be delayed until 2005 in view of their newness and complexity. The AASB will also need to decide how to handle non-conformities between existing AASB and IASB standards — particularly where an Australian treatment is regarded as preferable to the IASB approach. In such cases, the AASB would need to decide whether to seek changes in the IASB standard prior to 2005.

The FRC and AASB have particular responsibilities for ensuring that a strategy for adoption is developed and communicated to stakeholders at an early stage, and that stakeholders are kept fully informed of progress. The accounting bodies also have a key contribution to make through their programs of professional development and their influence on accounting education.

The FRC has indicated that it will carefully consider any AASB requests for additional resources to ensure it is ready for 2005.

Over the years, Australia has influenced IASB standards more than might be expected on the basis of our relative economic position, reflecting our strong expertise in standard setting and the high profile adopted by our standard setting bodies internationally. This contribution is expected to continue in the period up to and beyond 2005 through the work of the AASB and through the active involvement of Australians in senior positions within the IASB (at the oversight, Board, Standards Advisory Council, Interpretations Committee and staff levels).

Proposal 14 — Adoption by Australia of IASB accounting standards by 2005

Australia will adopt accounting standards issued by the International Accounting Standards Board (IASB) for reporting entities under the law for accounting periods beginning on or after 1 January 2005, in line with the European timetable.

- The FRC and the AASB will consult stakeholders on the measures that they regard as necessary between now and 2005 to ensure a smooth transition to IASB standards.

6.3 Purpose of accounting standards

As part of the CLERP 1 reforms, the objectives of accounting standard setting were spelled out in section 224 of the ASIC Act. These are:

- to facilitate the development of accounting standards that require the provision of financial information that: allows users to make and evaluate decisions about allocating scarce resources; assists directors to discharge their obligations in relation to financial reporting; is relevant to assessing performance, financial position, financing and investment; is relevant and reliable; facilitates comparability; and is readily understandable;

- to facilitate the Australian economy by: reducing the cost of capital; enabling Australian entities to compete effectively overseas; and having accounting standards that are clearly stated and easy to understand; and

- to maintain investor confidence in the Australian economy (including its capital markets).

A provision was also included (section 228) to make it clear that accounting standards should be interpreted by reference to these objectives and to the purpose or object of the standard. This provision reinforces the principles-based nature of Australian accounting standards by comparison with the more prescriptive, 'black letter' approach applied in the United States.

Although US standards start from broad concepts, they are supported by detailed rules of the Securities and Exchange Commission (SEC) and industry interpretation. This detail can have the unintended effect of encouraging aggressive accounting techniques aimed at circumventing the broad intent of standards (an attitude of 'where does it say I can't do this?').

For example, in the case of Enron, special purpose vehicles were used to avoid the ownership tests in US accounting standards governing the consolidation of entities into group accounts. By focusing on the economic substance, the equivalent Australian test is less susceptible to circumvention than the US test. The Australian standard uses a 'capacity to control' test which looks at whether there is a capacity, whether direct or indirect, to control financial and operating policies of the other entity.

Authorities in the United States have recently called for the development of more principles-based standards and the SEC and Financial Accounting Standards Board (FASB) are reviewing US standards with this in mind.

IASB standards, with which Australia has been harmonising for some years and which will be adopted here from 2005, are also principles-based.

The Government is generally satisfied that the accounting standards that currently apply in Australia, and that will apply in the future after convergence with IASB standards, look to the economic substance rather than the form of transactions.

6.4 Particular accounting standards

In cases where financial reporting concerns have been raised, it is important to distinguish between any identified weaknesses in accounting standards — requiring action by the independent standard setter — and instances of non-compliance with accounting standards or audit failure, which are a matter for the corporate regulator and/or regulatory policy.

Australian accounting standards are acknowledged to be of high quality.

Business consolidations

The standard relating to the consolidation of special purpose entities includes a control test that is substantially stronger than the equivalent US test. The question of the appropriate accounting for special purpose vehicles, and the broader question of off balance sheet financing, will be further considered by the AASB as part of the IASB convergence project on business combinations.

Insurance accounting

The question of insurance accounting, including accounting for reinsurance contracts, has arisen in the context of the HIH collapse. The IASB has an active project on accounting for insurance contracts which the AASB is monitoring and participating in through other processes such as field-testing. The AASB has made a submission to the HIH Royal Commission and will carefully examine the outcome of the Royal Commission for issues of relevance to this project.

Financial instruments

The question of the measurement and recognition of derivatives will be considered by the AASB as part of an IASB convergence project relating to Financial Instruments: Measurement and Recognition. The AASB recently sought comments from Australian constituents on an IASB exposure draft of this standard.

Revenue recognition

The IASB will soon be commencing a project on revenue recognition which the AASB will monitor in accordance with its policy on harmonisation and convergence with IASB standards.

Accounting for stock options

This issue has received attention in the United States where the use of stock options as a component of executive remuneration is more extensive than in Australia. US accounting standards generally do not require the expense recognition of stock options, resulting in significantly higher reported earnings than would otherwise be the case.

Proponents of expensing argue that options are compensation with inherent value and represent a cost to the company which is properly recognised as an expense. They argue that expensing would provide better information to the

market and reduce incentives for management to manage earnings to inflate the share price.

Those who oppose expensing have argued that the market already has enough information to be able to value the cost of stock options and factor it into the share price. They also point to measurement difficulties and adverse effects of expensing on small, high-tech companies which rely on options compensation to minimise their start-up costs.

There appears to be strong support among users of financial statements in the US and elsewhere for the expensing of employee stock options.

In Australia, sections 300 and 300A of the Corporations Act include requirements for the disclosure of components of director and executive remuneration, including stock options. The AASB currently has no standard on stock options but is developing a disclosure standard, outlined below.

Section 300 of the Corporations Act requires that 'details' of the options granted as part of the remuneration of directors and the five most highly remunerated officers of a company be disclosed in the annual directors' report. Under section 300A, listed companies are also required to disclose 'details of the nature and amount' of each element of emolument. ASIC has issued a practice note indicating that it expects listed companies to disclose the value of options as emoluments.

The Government has indicated that it will amend the Corporations Act to make it clear that the value of stock options must be disclosed. In addition, the AASB has included in a proposed accounting standard on Director, Executive and Related Party Disclosures a requirement that disclosing entities disclose as remuneration:

- the value of equity-based compensation benefits based on the net fair value of the equity instruments; a valuation methodology is also specified; and

- information on the terms and conditions of grants of equity compensation and other bonuses in the year of grant and in subsequent years until fully vested; this includes the price at which options may be exercised and the performance criteria that must be met in order for them to vest.

The AASB issued an exposure draft of this proposed standard on 31 May 2002 and has sought comments by 30 September 2002 with the aim of finalising a standard by early 2003. The proposed AASB standard is a disclosure standard only and would not require the expensing of stock options.

The IASB does not currently have a standard on options generally. However, it has on its agenda a high priority project, 'Accounting for Share-Based Payment', which would require expensing of equity-based remuneration, including stock options. The IASB's aim is to develop a high quality accounting standard that will provide a basis for international convergence of standards in this area (few countries currently have standards on the topic).

The IASB has agreed in principle that share-based payment transactions should be expensed in the financial statements at the fair value of the shares or options issued, estimated at grant date. A valuation model would not be prescribed but entities would be required to disclose the model used and the inputs to it. The IASB aims to issue an exposure draft of this standard towards the end of 2002.

In line with its policy of harmonisation and convergence of its standards with IASB standards, the AASB intends to mirror this project and to issue the IASB exposure draft in Australia on the same time-frame as the IASB's due process. The IASB could issue its final standard in late 2003. It would then be adopted by the AASB.

In the meantime, the ASX's Corporate Governance Council has urged listed companies to voluntarily and fully disclose the existence and conditions of all share and options schemes currently in operation, together with details of performance hurdles.

A number of major Australian companies have reviewed their stock option schemes in the light of market concerns about whether they are a transparent and effective method of executive remuneration. Some have announced that they will suspend or discontinue their schemes. The Government encourages similar reviews by all companies which provide remuneration in this form.

Proposal 15 — Expensing share options

The IASB standard requiring expensing of share options will have the force of law on adoption by the AASB, expected to be in the second half of 2003.

Disclosure risks

In relation to risks surrounding the amounts disclosed in financial statements, the IASB has proposed in its initial improvements project that financial reports should include the following additional disclosures:

> 'An entity shall disclose, in the summary of significant accounting policies and/or other notes, the judgements made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements.
>
> An entity shall disclose in the notes information regarding key assumptions about the future, and other sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:
>
> - their nature; and
> - their carrying amount as at the balance sheet date.'

The AASB will monitor the responses to the IASB exposure draft and IASB deliberations on this issue. Under the convergence objective, Australia would adopt the final form of this provision in 2005 at the latest.

The Government encourages the AASB to continue to work in close cooperation with the IASB to address any gaps or deficiencies in the body of accounting standards that apply in Australia — in particular, any that potentially give rise to systemic risk or industry vulnerability.

6.5 Requirement for accounts to be true and fair

Under section 297 of the Corporations Act, annual financial statements and notes must give a true and fair view of the financial position and performance of an entity and, where consolidation is required, the consolidated entity.

The Corporations Act also notes that this section does not affect the obligation under section 296 for a financial report to comply with accounting standards. If the financial statements and notes prepared in accordance with accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under subsection 295(3)(c) of the Act. This subsection states that the notes to the financial statements are: disclosures required by the regulations; notes required by the accounting standards; and any other information necessary to give a true and fair view.

Equivalent provisions of the Corporations Act apply to half-year financial reports (subsection 303(3)(c) and sections 304 and 305).

The so-called 'true and fair override' was removed from the Corporations Act in 1991. This provision effectively allowed entities to depart from accounting standards by forming a subjective view that complying with standards would not result in a true and fair view of their financial position.

Such cases may have reflected the unusual circumstances of a particular company which were not adequately dealt with by a standard, or deficiencies in standards that promoted the form of transactions over their substance. However, in other cases, departures from accounting standards involved attempts to conceal relevant information from the market. The subjective nature of these judgements gave rise to inconsistent and non-comparable results as well as difficulties from an enforcement viewpoint.

In response, the provision was amended to require financial reports that include:

- financial statements and notes that comply with accounting standards; and
- additional information in the notes to ensure a true and fair view where compliance with accounting standards would not do so.

This approach preserves the requirement to comply with accounting standards — to ensure consistency and comparability of financial information and for enforcement purposes — while at the same time requiring a true and fair view. In most cases, compliance with accounting standards is likely to lead to a true and fair view.

It is nevertheless important that deficiencies in accounting standards not lead to an unintended requirement that entities report the form over the substance of a transaction — and hence, to a less than true and fair view that would need to be corrected in the notes to the financial statements. If this were to occur, the appropriate response would be an amendment of the accounting standard.

The accounting standards issued by the IASB are rigorous, principles-based, and reflect a broader trend towards the application of fair value accounting. Australia will continue after 2005 to have input to the formulation of these standards. It is important that this input rigorously address any form over substance issue that might otherwise result in a gap between the requirements of accounting standards and the obligation to present a true and fair view.

Proposal 16 — Requirement for accounts to be true and fair

The legal requirement that financial statements comply with accounting standards and that the financial statements and notes together present a true and fair view of an entity's financial position and performance will be maintained.

If any deficiencies in accounting standards have a general, unintended result that compliance with the standard would not result in a true and fair view, the appropriate response would be reform of the standard.

Part 7: Analyst independence and the regulation of general advice

7.1 Introduction

Analysts promote the operation of informed and efficient markets by collecting and analysing information about companies and financial products. The research prepared by analysts helps to filter the wide range of information available to investors about product issuers and investments.

Developments in the global financial services industry have given rise to conglomerate firms, which may achieve cost efficiencies by providing a full range of services and using employees in different capacities across the firm. As a consequence, analysts may participate in, and make a valuable contribution to, the provision of services other than research. However, this may create conflicts of interest that undermine the independence of analysts. Investor confidence may be eroded if they perceive a lack of objective research, and they may be reluctant to participate and invest in markets.

Firms have responded to these pressures by developing policies and procedures for managing potential conflicts of interest, such as by putting in place Chinese walls between research and other areas of the firm. However, the efficacy of existing mechanisms has been questioned, particularly in the United States (US). In April 2002, the US Securities and Exchange Commission (SEC) launched a national inquiry into market practices concerning analysts and the conflicts of interest that can arise between research and investment banking. In May 2002, following a similar investigation, the New York State Attorney-General announced a settlement whereby Merrill Lynch agreed to pay a US$100 million penalty, issue a statement of contrition and adopt a range of internal reforms in exchange for avoiding criminal liability and a forced separation of its research and investment banking areas. The SEC also approved comprehensive changes to the rules of the National Association of Securities Dealers and the New York Stock Exchange (NASD/NYSE rules) in May 2002, which prohibit certain research practices and strengthen disclosure obligations for analysts and firms.

In Australia, there has not been the same level of problem or concern in relation to conflicts of interest and research practices. Nonetheless, it is timely

to consider the Australian regulatory framework with a view to identifying a range of possible options for consultation. Consideration is given to key policy objectives and the options available to the Government, regulators and industry participants to achieve those objectives. The objectives include market integrity, greater transparency to investors about conflicts of interest so that they can be considered in evaluating the objectivity of research, and for firms to manage conflicts of interest effectively so that investors will have confidence in research.

7.2 SOURCES OF CONFLICTS OF INTEREST

The way analysts are compensated for the services they provide can create pressure on their independence and objectivity. A research analyst's salary or bonus might be linked to the profitability of other corporate and trading services, such as investment banking services. This might give the analyst an incentive to provide positive research reports and recommendations, which may foster the client company's continued relationship with the analyst's firm and increase the analyst's compensation. Alternatively, an analyst's compensation might be linked to the profitability of the firm as a whole. A conflict of interest might arise if positive research tends to generate more business for the firm, for example if it results in more trading of the financial products covered in an analyst's report and hence more revenue from brokerage services.

Relationships between product issuers and firms that employ research analysts can potentially affect the integrity of research. For example, a firm that is underwriting a company's initial public offering of securities has a financial interest in its success, which might create pressure for analysts to recommend that investors buy the client company's securities. An analyst's research might also be influenced by the firm's desire to retain existing clients by not issuing unfavourable research, and attract new clients through favourable analyst coverage. Further, a firm might have a significant share holding in a company, which might create pressure for analysts to issue buy ratings for the company's securities. Analysts might also be influenced by an association with the product issuer, such as share ownership in the company and might profit if favourable research causes those shares to rise in value.

7.3 CURRENT REGULATORY FRAMEWORK

The current regulatory framework is contained in Chapter 7 of the Corporations Act, as amended by the *Financial Services Reform Act 2001* (FSR Act). For analysts, the new regime is similar to the previous regime under the Corporations Law, but with added protections for retail investors. There is a single licensing regime for all financial service providers and a harmonised disclosure regime for the provision of financial services and advice. The FSR Act contains obligations to disclose certain conflicts of interest where financial services are provided to retail clients through a Financial Services Guide. In the event of a failure to disclose these matters, the new regime no longer provides that it is a defence if Chinese wall arrangements were in place. More generally, the FSR Act introduces additional disclosure protections where retail investors are provided with personal advice through a Statement of Advice, which includes enhanced disclosure of certain conflicts of interest.

7.4 FORCED SEPARATION

The current regulatory framework does not prohibit research and other financial activities being provided by the same firm. An option for reform that has been suggested in response to concerns in the United States is to require a complete separation of research activities from other areas. This would be intended to remedy the problem of analysts being involved in, or aware of, other financial activities within the same firm, which could create conflicts of interest that diminish the integrity of their research. The potential benefits of this proposal include close to complete analyst independence. A forced separation of analysts from other financial activities within the same firm would ensure almost no conflicts of interest in relation to research. As a result, investors could be confident that research is objective and impartial.

However, a forced separation of analysts would impose large efficiency costs on conglomerate firms. Multi-service firms would be required to incur the costs of restructuring their business to ensure complete separation of research analysts from other financial service areas, and any economies of scale or scope from analysts working with other areas of the firm would be lost.

A forced separation could also raise the cost of research for investors. Research is often cross-subsidised by other financial services, such as brokerage commissions and investment banking services, which allows research to be provided free-of-charge to investors. If firms were prohibited from using analysts in other areas of their business, they may not be able to fully recover the costs of research and may reduce the amount of research available.

Similarly, the quality of research may be diminished if analysts lose access to companies that are clients of their firms.

In view of these factors, the Government does not support complete separation of research from other financial activities. It considers options that will promote objective research through more effective management of potential conflicts of interest are more appropriate. Where potential conflicts of interest do exist there should be transparent disclosure so that investors are in a position to consider and assess their impact before making investment decisions.

7.5 LICENSING

Firms that offer research and other financial services are generally subject to the licensing provisions of Chapter 7, which require persons in the business of providing financial services to hold an Australian Financial Services Licence (AFSL). Financial services include financial product advice, which covers research that contains recommendations or statements of opinion about financial products that are intended to influence persons making decisions in relation to those products.

7.5.1 General obligations

Financial services licensees are responsible for meeting a number of general obligations relevant to the integrity of the financial services that they provide. These include an obligation to do all things necessary to ensure that the financial services covered by their AFSL are provided 'efficiently, honestly and fairly'.

As part of this general duty, financial services licensees would be expected to ensure that conflicts of interest are disclosed adequately and managed effectively. This would include implementing and monitoring robust and efficient policies and procedures for managing potential conflicts of interest, ensuring that analysts provide honest and objective assessments of investment opportunities, and the fair treatment of all investors through full and transparent disclosure of relevant conflicts of interest. Financial services licensees should also disclose any financial interest that they or a related party have in the subject of their advice or recommendation.

Another approach would be for the legislation to prescribe rules for the management and disclosure of relevant conflicts of interest. For example, by

amending Part 7.8 of the Corporations Act or imposing conditions on AFSLs. The potential benefits of prescribing rules in legislation include greater clarity and certainty for licensees about how they should manage and disclose relevant conflicts of interest and a more consistent standard across the industry.

However, legislative rules would be likely to impose higher compliance costs on industry than a general obligation for licensees to ensure financial services are provided 'efficiently, honestly and fairly'. Under a general obligation, licensees would continue to have primary responsibility for determining the processes and procedures necessary to ensure compliance with their obligations. In contrast, prescribing rules in legislation for the conduct of licensees would reduce the flexibility for individual licensees to determine whether their existing policies for managing and disclosing relevant conflicts of interest are sufficient to meet their legal obligations, and to adopt those measures best suited to their business.

7.5.2 Administration and enforcement of general obligations

The Corporations Act is administered and enforced by the Australian Securities and Investments Commission (ASIC). In granting an AFSL, ASIC will consider an applicant's likely compliance with all of the general obligations of a licensee. Similarly, ASIC has power to suspend or cancel an AFSL if it has reason to believe that a licensee has not complied with its obligations. ASIC's role also includes providing guidance, monitoring compliance and, where necessary, taking appropriate enforcement action.

ASIC could provide guidance by policy statement on the level and manner of disclosure required under the general duty to act 'efficiently, honestly and fairly'. This would supplement the general guidance that ASIC has provided already on the obligations of financial services licensees.

Policy guidance developed by ASIC, in consultation with relevant stakeholders, could provide several benefits. This includes greater clarity for licensees about the relationship between the duty to ensure financial services are provided 'efficiently, honestly and fairly' and the effective disclosure of material conflicts of interest. Policy guidance could also provide more certainty about how ASIC considers licensees can meet this obligation, including greater public awareness and an impetus for licensees to review and strengthen existing policies for disclosing relevant conflicts of interest.

ASIC's existing policy statement about the general obligations of licensees does not seek to provide comprehensive guidance on the measures necessary to ensure compliance with those obligations. This recognises that the licensing

regime is designed to work in a flexible way, and that the compliance measures an individual licensee needs to adopt would be likely to depend on the nature, scale and complexity of their business. A similar approach in this area would be likely to minimise the impact of any additional compliance costs on industry.

7.5.3 Industry guidance

There are a wide range of industry guidance options available to industry, such as industry standards or codes of conduct. Industry guidance can range from setting out general statements of principle about how an industry or business will operate, to listing rules against specific business practices. It can contain minimum standards or standards aimed at best practice.

In November 2001, the Securities Institute of Australia (SIA) and the Securities and Derivatives Industry Association (SDIA) released *Best Practice Guidelines for Research Integrity* (SIA/SDIA Guidelines). The Guidelines are an industry-based initiative designed to assist analysts and firms to manage potential conflicts of interest that might affect the integrity of research. However, the Guidelines are not as comprehensive as the NASD/NYSE rules.

Industry guidance may provide a more flexible and adaptable framework for dealing with emerging issues than direct government intervention. It would raise industry awareness of the issue of analyst independence and promote a better understanding by firms of how to manage conflicts of interest effectively. Industry guidance would be based upon industry expertise and support for improved industry practices.

However, the benefits of industry guidance, in terms of enhanced investor protection, depend upon the form and nature of the initiatives adopted by industry:

- whether they are binding and enforceable against industry participants through contractual obligations;
- are reinforced by measures to monitor compliance;
- provide remedies and sanctions for breach; and
- are reviewed regularly to ensure their continued effectiveness.

These factors also have implications for compliance costs associated with industry guidance. As compliance costs would be passed on to consumers through higher prices for financial services, they should be the minimum

necessary to ensure conflicts of interest are managed effectively. Industry guidance should not hinder competition among industry participants, such as by creating entry barriers. The Government encourages effective industry guidance as a means of assisting firms and analysts to manage conflicts of interest effectively.

Proposal 17 — General obligation

There is a general duty on financial services licensees to ensure that financial services are provided 'efficiently, honestly and fairly'. Licensees should disclose any financial interest that they or a related party have in the subject of their advice or recommendation.

Proposal 18 — Further guidance

The Australian Securities and Investments Commission (ASIC) will be asked to provide guidance by policy statement on the level and manner of disclosure required under this general duty, following consultations with relevant stakeholders.

7.5.4 Misconduct and general obligations

The Corporations Act prohibits certain kinds of conduct in relation to financial services, products and markets. The misconduct provisions reinforce the general obligations on licensees by providing civil liability, civil penalties and criminal consequences for conduct that offends the principles of market integrity and investor protection. A wide range of the misconduct provisions are potentially relevant to the provision of research services, such as the prohibitions against conduct that is misleading and deceptive, unconscionable or dishonest. An issue is whether the legislation should prohibit particular practices in relation to the provision of research services, or whether the existing prohibitions are sufficient for this purpose.

For example, the NASD/NYSE rules contain particular restrictions on personal trading by analysts, whereas the Corporations Act contains a general prohibition against insiders disclosing or trading on the basis of price sensitive information not generally available to the market. Similarly, the Corporations Act does not contain general prohibitions with respect to the remuneration arrangements for financial service providers but contains obligations to disclose remuneration, commissions and other benefits to alert

retail investors to conflicts of interest arising from these matters. In contrast, the NASD/NYSE rules contain rules that a firm must not tie an analyst's compensation to specific investment banking transactions. However, subject to appropriate disclosure, it is permissible for firms to compensate analysts based on overall performance, including services provided to the investment banking department.

An option for consultation would be for industry guidance to specify certain research practices that should not be engaged in by firms and analysts. For example, the SIA/SDIA Guidelines provide that, as a matter of best practice, analysts should not trade against their recommendations. Industry guidance in this area might provide a more targeted means of identifying particular research practices than general prohibitions under the Corporations Act.

The potential risks of industry guidance include a lack of enforceability and sanctions for non-compliance. Persons engaging in misconduct that has serious consequences for investors and the market as a whole would be expected to be exposed to criminal and civil sanctions for breaching the Corporations Act. However, the flexible nature of industry guidance suggests that a wide range of enforcement mechanisms are possible depending upon the nature and severity of the misconduct. This could range from adverse publicity to disciplinary measures by industry bodies.

The Government considers that the misconduct provisions of the Corporations Act are sufficient to protect investors against conduct that undermines market integrity. It considers that it is not necessary for the legislation to include additional prohibitions in relation to specific research practices. However, the Government encourages effective industry guidance on research practices that might constitute misconduct. While industry guidance is the responsibility of industry, consultation with regulators, consumers and the Government would help to ensure that public policy goals and community expectations are addressed adequately.

7.6 DISCLOSURE

Market failure can result if investors do not have access to adequate information about conflicts of interest capable of influencing the integrity of research. If investors are not aware of potential conflicts of interest they will not be in a position to assess and compare the objectivity of research available to them. As a result, they will not be in a position to decide how much weight to give research recommendations in making investment decisions. The purpose of disclosure obligations is to correct market failures caused by

incomplete or asymmetric information and ensure that investors receive the information they would reasonably require to make informed investment decisions.

Chapter 7 imposes disclosure obligations on financial services licensees and their authorised representatives ('providing entities') in relation to the provision of financial services and advice to retail clients. The relevant disclosure documents are a Financial Services Guide (FSG) and a Statement of Advice (SoA). The obligation to provide an FSG applies to financial services in general, whereas the obligation to provide an SoA is an additional disclosure obligation that only applies if the financial service is personal advice. Providing entities are obliged to disclose certain types of information about conflicts of interest in both FSGs and SoAs. Conflicts of interest are also relevant to whether a providing entity can call themselves independent. As discussed below, the obligations in relation to conflicts of interest differ in these three situations.

7.6.1 Financial Services Guide (FSG)

Providing entities that provide financial services to retail clients are generally obliged to give those clients an FSG as a 'one off' up front disclosure requirement before the financial services are provided. The purpose of an FSG is to ensure that retail clients receive sufficient information to make an informed decision about whether to acquire financial services from the providing entity. In relation to possible conflicts of interest, this includes information about the receipt of remuneration and other benefits; as well as information about associations and relationships with product issuers that might influence the provision of those services. However, these disclosure obligations do not extend to a wider range of potential conflicts of interest and in some ways are narrower than the disclosure obligations for SoAs.

Further, the provision of research services may not require an FSG because there is an exemption for general advice provided in a public forum. Research is usually general advice because the opinions and recommendations it contains do not involve consideration of the objectives, financial situation and needs of the particular person to whom it is provided. However, this exemption does not affect the obligation for providing entities to disclose conflicts of interest. If this exemption applies, retail clients must still be given information about conflicts of interest that would otherwise be included in an FSG.

7.6.2 Statement of Advice (SoA)

Providing entities that provide personal advice to retail clients are generally obliged to give those clients an SoA, in addition to an FSG. An SoA can be how the personal advice is provided to the retail client or a separate record of that advice. An SoA ensures that retail clients receive sufficient information to make an informed decision about whether to act on the personal advice received from the providing entity. This includes information about certain types of conflicts of interest that might influence the provision of the personal advice.

However, there is no equivalent of an SoA for general advice. Research is usually general advice because it does not involve consideration of the objectives, financial situation or needs of the particular person to whom it is provided. As a result, retail investors do not receive any disclosures in addition to an FSG about potential conflicts of interest in relation to research or other general advice. In particular, they do not receive the benefit of the disclosure obligations for personal advice, which oblige providing entities to disclose a wider range of potential conflicts of interest.

7.6.3 Terminology restrictions

The use of the words 'independent', 'impartial' or 'unbiased' is restricted in relation to the provision of financial services. It is generally an offence for financial service providers to use these words unless:

- the financial service provider and certain other persons do not receive certain commissions, remuneration or other gifts or benefits;
- they operate free from any direct or indirect restrictions relating to the financial products in respect of which they provide financial services, and
- they operate without any conflicts of interest that might arise from their associations or relationships with product issuers and might reasonably be expected to influence them in providing the financial services.

7.6.4 Other possible reforms

Given these different obligations in relation to conflicts of interest, two additional options for reform that could be pursued are:

- bringing the obligations for general advice in line with those for personal advice; and

- extending the range of conflicts of interest that are relevant.

These options are discussed in detail below. The Government seeks views on whether all or any of these options should be pursued further.

Bring general advice obligations in line with personal advice obligations

Information about remuneration, commissions and benefits

An FSG must include information about remuneration, commissions or other benefits that are in respect of, or attributable to, the provision of the financial services. The purpose of this disclosure obligation is to ensure that retail clients are in a position to understand how they will be paying for the financial service offered to them. However, this purpose is less relevant to research services as brokerage firms often allow retail investors to access research free-of-charge. In contrast, an SoA must include information about any remuneration, commissions or other benefits that 'might reasonably be expected to be or have been capable of influencing the providing entity' in providing the personal advice. This recognises that remuneration, commissions and other benefits are a potential source of conflicts of interest and ensures that retail investors are alerted to them. The terminology restrictions also refer to 'other gifts'.

Information about associations and relationships

Providing entities are obliged to disclose in FSGs information about certain associations or relationships that 'might reasonably be expected to be capable of influencing the providing entity in providing any of the authorised services'. The disclosure obligation for SoAs is broader because it extends to associations or relationships expected 'to be or have been' capable of influencing the providing entity. This ensures that retail clients are alerted to potential conflicts of interest arising from this source.

Information about other interests

Providing entities are also obliged to disclose in an SoA information about any other interests of certain persons that 'might reasonably be expected to be or have been capable of influencing the providing entity in providing the advice'. However, there is no obligation to disclose other interests in FSGs. As a result, retail investors do not receive the benefit of the disclosure of this source of potential conflicts of interest for financial services, other than personal advice.

Basis for personal advice and general advice warnings

An SoA must include information and any required warnings about the basis for personal advice. This is linked to the obligation to have a reasonable basis for personal advice, which requires providing entities to make reasonable inquiries to determine the relevant personal circumstances of the retail client, and to consider and investigate the appropriateness of the advice for that client. Providing entities must warn retail clients if the personal advice could be based on incomplete or inaccurate information relating to the client's relevant personal circumstances, and that the client should consider the appropriateness of the advice before acting on it. The legislation could also oblige financial services licensees and their authorised representatives to have a reasonable factual basis for general advice, disclose information about that basis to retail clients, and warn retail clients if general advice could be based on any incomplete or inaccurate information.

Providing entities are also obliged to warn retail clients to consider the appropriateness of the general advice to their situation before acting on it, as it has been prepared without taking account of their objectives, financial situation or needs. It is an offence to fail to comply with this obligation. However, there is no obligation to warn retail clients that they should consider information about potential conflicts of interest before acting on general advice. The legislation could oblige financial services licensees and their authorised representatives to warn retail clients that they should, before acting on general advice, consider information about any potential influences on that advice, and to direct retail clients to the source of that information, for example, the appropriate page number in a research report.

This would foster greater consumer awareness of the need to consider potential conflicts of interest before acting on general advice, such as an analyst's recommendation to buy, sell or hold securities in a particular company. It would also encourage retail investors to consider potential conflicts of interest when they consider the overall appropriateness of general advice to their particular situation and financial circumstances. Retail investors would also benefit from more transparent and prominent disclosure of where to find information about potential influences on general advice.

The extra warning would be largely generic and could accompany the warnings that providing entities already provide, so that compliance costs associated with this option would be relatively low.

Extend the range of conflicts of interest

Information about certain persons

Providing entities are only obliged to disclose information about the remuneration, commissions or other benefits to be received by certain persons, associations or relationships between certain persons and the issuers of any financial products, and other interests of certain persons. Similarly, the restrictions on the use of terminology are linked to certain persons.

These obligations could be extended to capture a wider range of persons in both FSGs and SoAs. For example, some reforms adopted overseas include disclosure of information about associations between product issuers and members of an analyst's household or immediate family.

The legislation or the regulations could also provide more detail about the obligation to disclose these matters. For example, by indicating that remuneration based on the volume of business placed with product issuers should be disclosed, or in relation to the presentation or prominence of this information.

Obligation to disclose 'Conflicts of Interest' in FSGs and SoAs

An issue is whether the disclosure obligations for FSGs and SoAs are wide enough to capture the full range of potential conflicts of interest. At present, providing entities are only obliged to disclose information about certain types of conflicts of interest; however, the sources of potential influence on financial services are not limited to these matters.

Providing entities could be obliged to disclose information about 'conflicts of interest' in FSGs and SoAs. The same test could apply to FSGs and SoAs. For example, providing entities could be obliged to disclose conflicts of interest that 'might reasonably be expected to be or have been capable of influencing the providing entity'. This would ensure a consistent obligation for financial services licensees and their authorised representatives to disclose conflicts of interest that might influence them, to enable retail investors to consider and assess potential influences on financial services and advice before making investment decisions.

There would be compliance costs associated with providing entities meeting a wider obligation to disclose 'conflicts of interest'. However, providing entities would only need to disclose conflicts of interest that might reasonably be expected to influence them, and the information that retail clients would

reasonably require to make informed investment decisions. This would help to minimise the compliance costs for providing entities.

A related concern is that a general obligation to disclose 'conflicts of interest' could create uncertainty for providing entities. This could be largely resolved by defining 'conflicts of interest' to include the types of conflicts of interest that providing entities are already obliged to disclose, such as conflicts of interest arising from remuneration, commissions, benefits, gifts, associations and relationships with product issuers, and other interests. This would provide guidance to providing entities about the types of conflicts of interest that should be disclosed, while emphasising that the sources of potential influence are not limited to these matters.

The NASD/NYSE rules prescribe a wide range of specific conflicts of interest that should be disclosed, such as if a firm has a shareholding in a recommended company or if the company is a past, present or possible future client of the firm. In contrast, a general obligation to disclose conflicts of interest would avoid the need to anticipate and prescribe those matters that might constitute a potential influence on financial services or advice. This would ensure that the disclosure regime is sufficiently flexible to accommodate future possible conflicts of interest.

PART 8: CONTINUOUS DISCLOSURE

8.1 INTRODUCTION

Disclosure is fundamental to market integrity and investor protection. Continuous disclosure is an important component of the current Australian disclosure framework. It aims to ensure that investors have timely and equal access to materially price sensitive information in relation to securities traded on secondary markets.

Australia's current continuous disclosure regime is fundamentally sound. This review seeks to propose measures to further enhance its effectiveness.

8.2 RATIONALE FOR CONTINUOUS DISCLOSURE

The primary rationale for continuous disclosure is to enhance confident and informed participation by investors in secondary securities markets. This can be expected to enhance the depth, liquidity and efficiency of these markets.

Continuous disclosure of materially price sensitive information should ensure that the price of securities reflects their underlying economic value. It should also reduce the volatility of securities prices, since investors will have access to more information about a disclosing entity's performance and prospects and this information can be more rapidly factored into the price of the entity's securities.

An effective continuous disclosure regime should also minimise the potential for insider trading and other forms of market abuse that may arise as a result of entities withholding or selectively disclosing materially price sensitive information.

The existence of a mandatory continuous disclosure regime recognises that entities will not always have incentives to voluntarily disclose price sensitive information to investors. This is most relevant in relation to information that may have adverse implications for the price of an entity's securities.

8.3 PRINCIPLES OF CONTINUOUS DISCLOSURE

An effective continuous disclosure regime has seven characteristics.

8.3.1 A properly informed market

Entities should release sufficient information to enable investors to make accurate judgements about the price of their securities (although investors may arrive at different judgements on the basis of this information).

Entities should not release information that is false or misleading. They should also respond to externally generated rumours and speculation when required to do so by the relevant market operator in circumstances where it is apparent to the market operator that these are significantly influencing the market for an entity's securities. However, entities should not be subject to a general requirement to release information to investors in response to external rumours.

8.3.2 Timely release of information

Entities should generally disclose materially price sensitive information to the market as soon as it becomes known to them (except where disclosure can be legitimately withheld). Entities should also promptly disclose information when it becomes apparent that disclosure can no longer legitimately be withheld (for example because it is no longer confidential). Finally, entities should promptly respond to external rumours when required to do so by the relevant market operator.

8.3.3 Equal access to information

Price sensitive information should be made available to all investors on an equal basis so that certain investors are not disadvantaged in comparison with others. The absence of selective disclosure is fundamental to market integrity. Selective disclosure also creates the potential for insider trading, where investors trade on the basis of materially price sensitive information that is not generally available. Selective disclosure and insider trading have the potential to reduce confident participation in financial markets, with adverse implications for their depth and liquidity (and hence the efficient operation of the price mechanism).

8.3.4 Premature release

The continuous disclosure regime should strike an appropriate balance between encouraging the timely disclosure to investors of materially price sensitive information and preventing the premature disclosure of such information where this is likely to result in the emergence of a false market. Entities should be allowed to withhold materially price sensitive information where disclosure would be likely to create a false market for their securities. An entity should not create an environment of speculation and price volatility through frequent conflicting announcements about incomplete or indefinite matters.

8.3.5 Commercial interests

The continuous disclosure regime should also strike an appropriate balance between requiring the timely disclosure of materially price sensitive information and safeguarding the commercial interests of disclosing entities. The regime should not unduly prejudice an entity's commercial operations by requiring the release of trade secrets or the disclosure of sensitive negotiations. It should permit materially price sensitive information to be withheld from investors where this is clearly necessary to safeguard an entity's commercial interests. However, this should only apply where confidentiality has been maintained in relation to these matters.

8.3.6 Confidentiality of information withheld from disclosure

Materially price sensitive information that is withheld from investors must be kept confidential. While an entity may disseminate information to its advisers and commercial partners, these persons should not trade in the securities of the entity while in possession of information that is not generally available to investors. Where information becomes widely available as a result of a breach of confidence, it should be disclosed to investors on a timely and equal basis.

An entity should be required to disclose materially price sensitive information that could otherwise be legitimately withheld from investors if this information is the subject of externally generated rumours that are sufficiently specific that the information can no longer be regarded as confidential in relation to the market. This could apply even where the information relates to a matter that is indefinite or uncertain. In these circumstances, some form of disclosure is likely to reduce rather than increase the potential for a false market in an entity's securities.

8.3.7 Enforcement and remedies

The continuous disclosure regime should be supported by effective enforcement provisions and remedies. Entities should receive clear and consistent guidance in relation to their obligation to disclose materially price sensitive information. The regime should include a range of penalties that can be tailored to different circumstances. Penalty provisions should also strike an appropriate balance between the need for a credible deterrent against contraventions of the regime and the need to maintain appropriate procedural safeguards. There should be effective mechanisms for remedying inadequate disclosure. Finally, there should be adequate mechanisms through which persons who have suffered loss or damage as a result of inadequate disclosure can seek to recover the amount of these losses or damages.

8.4 THE CURRENT REGULATORY FRAMEWORK

The current regulatory framework is contained in the listing rules of the three prescribed financial markets (ASX, BSX and NSX) and the Corporations Act.

The ASX is the most significant of the three prescribed financial markets, with responsibility for well over 99 per cent of listed disclosing entities. There are around 1,400 entities whose securities are listed on ASX (although a number of these are foreign exempt entities). By contrast four issuers have securities listed on NSX while BSX currently has one listing.

ASX Listing Rule 3.1 requires listed entities to immediately disclose materially price sensitive information to ASX so that it can be disseminated to investors. It also contains a 'carve-out' that allows information to be withheld from immediate disclosure if it satisfies one or more of the following five criteria.

- It would be a breach of the law to disclose the information.
- The information concerns an incomplete proposal or negotiation.
- The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
- The information is generated for internal management purposes of the entity.
- The information is a trade secret.

Information may only be withheld if it remains confidential and a reasonable person would not expect it to be disclosed.

In addition to complying with Listing Rule 3.1, ASX listed entities are also required to make ongoing disclosures in relation to a list of events set out in the remainder of Chapter 3 of the ASX Listing Rules.

The BSX and NSX listing rules contain continuous disclosure provisions that are based on the current ASX Listing Rule 3.1.

On 19 July 2002, ASX released draft amendments to Listing Rule 3.1 (which include moving the 'carve-out' into a new Listing Rule 3.1A). The proposed amendments are intended to enable ASX to determine that materially price sensitive information being withheld from disclosure by a listed entity is no longer confidential and must immediately be disclosed to ASX (as it no longer falls within the 'carve-out'). They would also narrow the scope of the 'carve-out' by requiring listed entities to release sufficient information to remedy a false market for their securities when required to do so by ASX. Under ASX's proposal, materially price sensitive information would only be able to be withheld from disclosure if this did not cause a listed entity to breach its duty to avoid a false market for its securities (in addition to the need to satisfy the three other limbs of the 'carve-out').

The Corporations Act provides statutory backing to the continuous disclosure requirements of the listing rules of the three prescribed financial markets. A contravention of the relevant listing rule is also a contravention of subsection 674(2) of the Corporations Act (provided the contravention relates to information that is not generally available and, if it were generally available, a reasonable person would expect the information to have a material effect on the price or value of an entity's securities). A contravention of subsection 674(2) of the Corporations Act may give rise to criminal liability if the mental elements attributed to the subsection by the Criminal Code (intent and, in some cases, recklessness) are proved. subsection 674(2) is also a financial services civil penalty provision. This means that a breach may give rise to a declaration of contravention and, if it causes loss or is serious, a financial penalty of up to $200,000. The Corporations Act also enables the courts to grant a wide range of other orders in relation to contraventions of subsection 674(2), including injunctive orders and orders for compensation.

These provisions were introduced by the *Corporate Law Reform Act 1994* (the Corporate Law Reform Act). They were based on the conclusions of a 1991 report by CASAC, which recommended the establishment of an enhanced statutory disclosure system. Prior to the commencement of these legislative amendments, Australia's continuous disclosure regime was contained exclusively in the ASX Listing Rules. These operate as a contract between a

listed entity and the ASX, but may be enforced by the courts under the Corporations Act.

In addition to providing statutory backing to the continuous disclosure requirements of the ASX Listing Rules (and subsequently those of BSX and NSX), the Corporate Law Reform Act also imposed continuous disclosure requirements on unlisted disclosing entities.

Subsection 675(2) of the Corporations Act requires unlisted disclosing entities to disclose materially price sensitive information to ASIC as soon as reasonably practicable (unless this information would be required to be incorporated into a supplementary or replacement disclosure document). The statutory framework of enforcement provisions and remedies that applies in relation to contraventions of subsection 674(2) of the Corporations Act also applies in relation to contraventions of subsection 675(2).

Finally, the Corporate Law Reform Act imposed more frequent periodic disclosure obligations on both listed and unlisted disclosing entities in the form of a requirement to prepare and lodge audited financial reports and directors' reports on a six-monthly basis rather than a yearly basis.

The legislative framework that was introduced in 1994 underwent significant amendments with the commencement of the FSR Act on 11 March 2002.

- The provisions were re-drafted and relocated from Part 7.11 to a new Chapter 6CA of the Corporations Act.
- A 'carve-out' based on ASX Listing Rule 3.1 was introduced into the continuous disclosure requirements governing unlisted disclosing entities. This is contained in Regulation 6CA.1.01.
- Contraventions of subsections 674(2) and 675(2) were made civil penalty provisions.

A number of the amendments introduced by the FSR Act were based on the recommendations of CASAC's 1996 report on continuous disclosure, which examined the first 18 months of operation of the enhanced statutory disclosure provisions introduced by the Corporate Law Reform Act.

8.5 ISSUES AND PROPOSALS

8.5.1 Relationship between periodic and continuous disclosure

Disclosing entities are currently subject to both periodic and continuous disclosure requirements. Under the Corporations Act (section 302), disclosing entities must lodge annual and half-yearly audited financial reports with ASIC. The US has a system of quarterly financial reporting, leading to suggestions that Australia should also consider mandating (unaudited) quarterly reports.

In the US, public issuers are generally subject to more onerous periodic reporting requirements. They are required to lodge quarterly rather than six-monthly financial reports. This raises the issue of whether Australian disclosing entities should be subjected to more frequent periodic reporting. In particular, it has been suggested that the Australian framework should allow disclosing entities to choose to lodge quarterly rather than six-monthly financial reports. Under this proposal, entities that elected to lodge quarterly financial reports would not be required to continuously disclose materially price sensitive information.

Some have pointed to quarterly reporting in the US as encouraging a short-term focus by companies and the market on meeting quarterly earnings forecasts, rather than on longer-term business fundamentals. Others would see quarterly reporting as facilitating analysis of business turning points and seasonal patterns, providing more up to date accounts than currently available and information about trends and prospects that may not be picked up under continuous disclosure.

Mandatory quarterly reporting in Australia would add somewhat to compliance costs for companies. However, this would be mitigated by the fact that quarterly accounts would not be audited and would be drawn largely from existing internal monthly reporting.

Half-yearly reporting in Australia, combined with an effective continuous disclosure regime, appears to provide appropriate disclosure to the market while minimising compliance burdens for business. While companies can and do choose to report quarterly, it is not clear that a statutory requirement for them to do so would add significantly to meaningful information available to the market.

In this regard, it is important to recognise that US issuers that are subject to quarterly periodic reporting obligations are also required to make ongoing

disclosure in relation to a number of specific matters mandated by the US SEC. These requirements for ongoing disclosure in relation to specified matters are more onerous than those contained in Chapter 3 of the ASX Listing Rules, and the SEC has recently enlarged the list of matters in relation to which ongoing disclosures must be made. Finally, the listing rules of major US financial markets such as NYSE require listed entities to continuously disclose price sensitive information to investors (although, in contrast to Australia, these rules do not have statutory backing).

The introduction of more frequent periodic reporting at the expense of continuous disclosure would therefore be inconsistent with the trend of recent reform in the US, which is to increase the ongoing disclosure obligations of public issuers.

It is not clear that the benefits of mandatory quarterly reporting would warrant the additional compliance costs involved, nor that there is significant demand from users of financial statements for this change.

It is therefore proposed to retain the present half-yearly reporting requirement and to keep the question of mandatory quarterly reporting under review in light of the further operation of the continuous disclosure regime and the effectiveness of other measures proposed in this paper to enhance the corporate disclosure framework.

While it is not currently proposed to mandate more frequent periodic financial reporting in the Corporations Act, it is recognised that it may be appropriate for market operators to impose more frequent financial reporting requirements in relation to particular classes of listed disclosing entities.

Continuous disclosure is a vital component of Australia's corporate disclosure framework. Any future increase in the frequency of periodic reporting by disclosing entities should not be at the expense of the current requirement to continuously disclose materially price sensitive information to investors.

8.5.2 Allocation of responsibility between ASIC and market operators in relation to listed entities

Under the current regulatory framework, the continuous disclosure rules that apply to listed entities are contained in the listing rules of their respective listing markets. Market operators have front line responsibility for monitoring and enforcing compliance with these rules. They are responsible for the receipt and dissemination of materially price sensitive information to investors. As part of their responsibility for enforcing compliance with their listing rules, market operators are also responsible for providing guidance to listed entities

on the interpretation of the continuous disclosure requirements as well as for dealing with inadequate disclosure by listed entities and remedying false markets that may have emerged as a consequence of externally generated rumours or speculation.

Monitoring and enforcing compliance by listed entities with the continuous disclosure requirements of their respective listing rules is fundamental to the obligation of each market licensee to maintain a fair orderly and transparent market.

ASIC has two major roles under the current regulatory framework. The first is to ensure that market operators comply with their obligation under the Corporations Act to maintain fair, orderly and transparent markets and to monitor and enforce compliance with their respective listing rules. The second is to deal with selected contraventions of the continuous disclosure provisions that are referred to it by market operators (the operation of the current framework of enforcement and remedies is discussed in greater detail below).

There has recently been discussion over whether ASIC should assume responsibility from market operators for the administration of their listing rules. This discussion has been motivated in part by the demutualisation of ASX and its transformation from a mutual body into a commercial entity (in common with BSX and NSX). This has raised the issue of the potential for conflicts of interest between the commercial and regulatory responsibilities of market operators. The issue is whether market operators will effectively monitor and supervise entities from which they directly derive a significant portion of their revenue in the form of listing fees (and which also contribute to trading revenue). Market operators are also potentially subject to greater competition for listings from overseas exchanges, with a significant proportion of ASX's largest listed entities having secondary listings on overseas markets.

In the UK, the Financial Services Authority (in its capacity as the UK Listing Authority) has been given responsibility for administering a single set of listing rules that apply to all UK listed entities. This model was adopted in part because of concerns about the potential for conflicts between the commercial interests and regulatory responsibilities of the LSE. However these concerns focused primarily on the implications of the LSE's demutualisation on its capacity to continue to act as the listing authority for all UK financial markets rather than for its capacity to adequately supervise its own market.

In considering these issues, it is necessary to recognise that the potential for conflicts between the commercial and supervisory responsibilities of market operators existed prior to the recent wave of financial market demutualisation. While mutuals could not return profits to members, listing revenue could be used to effectively subsidise the trading activities of member brokers. It is also

necessary to recognise that demutualised market operators have commercial incentives to maintain appropriate levels of supervision in relation to their respective markets.

The current market licensing framework in Part 7.2 of the Corporations Act requires market licensees to have adequate arrangements for handling conflicts between their commercial interests and their obligation to maintain fair, orderly and transparent markets. ASIC is required to conduct regular assessments of how each licensee is complying with this obligation.

At present, there does not appear to be any evidence that ASX, BSX or NSX have been unsuccessful in managing potential conflicts of interest between their commercial and supervisory objectives. This conclusion was supported by the Senate Economics References Committee in the February 2002 report of its Inquiry into the Framework for Market Supervision of Australia's Stock Exchanges.

8.5.3 Information that must be continuously disclosed

The continuous disclosure provisions should strike an appropriate balance between encouraging the timely disclosure to investors of materially price sensitive information; preventing the emergence of a false market as a result of the premature disclosure of information in relation to uncertain matters; and safeguarding the commercial interests of disclosing entities.

The Government supports the current requirement for disclosing entities to disclose all materially price sensitive information. This requirement should not be relaxed so that information need only be disclosed when it has the potential to 'substantially' alter the price or value of an entity's securities (the approach contained in the UK Listing Rules).

It is necessary for there to be certain limited exceptions from the requirement for listed disclosing entities to immediately disclose materially price sensitive information to the market operator (or, in the case of unlisted disclosing entities, to lodge information with ASIC as soon as practicable). Disclosing entities should be permitted to withhold materially price sensitive information in the following circumstances.

- Where disclosure would amount to a breach of the law.
- Where the information relates to a matter that is sufficiently incomplete or uncertain that disclosure could not be made without misleading investors or creating a misinformed market for an entity's securities.

- Where disclosure of information would unduly prejudice the commercial interests of the disclosing entity as the information concerns either a trade secret or commercial negotiations that could be jeopardised if they were disclosed.

A disclosing entity should only be able to withhold materially price sensitive information where it is kept confidential from the market (so that investors are equally uninformed). While it may be necessary for this information to be disclosed to an entity's advisers or potential commercial partners, it should be clearly identified as information that is being withheld under an exception to the continuous disclosure provisions. The exceptions should cease to apply where the information is 'leaked' or where it becomes the subject of externally generated rumours that are sufficiently specific that the information can no longer be regarded as confidential. In these circumstances, the need to maintain a fair, orderly and transparent market would require the information to be disclosed to investors (even where it relates to an indefinite matter or a commercial negotiation).

Under the current regulatory framework, listed disclosing entities are also required under the listing rules of their respective listing markets to make ongoing disclosures in relation to certain specified matters. These ongoing disclosure requirements presently relate primarily to matters such as takeover bids, buy-backs and capital reconstructions (although they also include requirements relating to directors' share trading and ownership limits).

This approach differs from that adopted in the US, in which public issuers are subject to more onerous ongoing disclosure requirements in relation to their commercial activities. The recent enlargement of the list of matters in relation to which US issuers are required to make ongoing disclosures raises the issue of whether the Australian regulatory framework should specifically mandate ongoing disclosure of additional matters as a means of enhancing disclosure to investors. In particular, it raises the issue of whether the current continuous disclosure regime should be supplemented by additional mandatory requirements to make ongoing disclosures in relation to major developments with the potential to impact on an entity's commercial performance.

The Government has concluded that there is not currently any need to place greater reliance on the ongoing disclosure of specific matters to ensure an informed market for the securities of disclosing entities. However, it may be necessary in the future to consider whether more extensive use of specific ongoing disclosure requirements would assist in remedying any particular shortcomings that might emerge in the disclosure practices of listed entities.

Disclosing entities should continue to be required to disclose materially price sensitive information on a timely basis. While the emphasis should be on

maximising the amount of price sensitive information that is disclosed to investors, the framework should allow entities to withhold information from immediate disclosure in certain limited circumstances. However, where confidentiality is breached in relation to this information, it must be promptly disclosed to investors.

8.5.4 Dissemination of price sensitive information

A key characteristic of an effective continuous disclosure regime is that all investors should have access to materially price sensitive information on an equal basis, so that particular market participants are not disadvantaged in relation to others. This is important to ensure that the operation of a financial market is fair and transparent.

Under the current regulatory framework, listed disclosing entities disclose information to the operator of their respective listing market. The market operator has primary responsibility for disseminating information to investors (although section 792C of the Corporations Act requires market licensees to provide this information to ASIC).

In the case of ASX, the listing rules require listed entities to maintain the confidentiality of information until the market operator acknowledges that it has been released through the CAP. When an announcement is released by ASX, a header is displayed on trading terminals alerting ASX participants to the existence of an announcement. A full image of the text of an announcement is made available to commercial information vendors as well as to subscribers of ASX's Image Dissemination Server. Summaries of market sensitive announcements are 'voicelined' to ASX participating organisations. ASX Market Data summarises and edits the text of announcements, which is made available to information vendors and subscribers through Signal G, the ASX's company information dissemination system.

ASX aims to make Signal G information available free of charge to the general public on a twenty minute delayed basis through its website. However, it has acknowledged that there has sometimes been a substantial delay between the release of materially price sensitive information to ASX Participating Organisations and commercial information vendors and its subsequent release to the general public through the ASX website. As a result, these persons may have a substantial market advantage over investors who do not have immediate access to up-to-date information as it is disclosed to the market (and may not receive the information until after a trading halt imposed to enable market participants to become aware of announcements has been lifted).

In order for ASX to fulfil its responsibilities as the front line market supervisor, it is necessary that listed entities are required to disclose materially price sensitive information to ASX and to maintain confidentiality in relation to this information until it has been disseminated to market participants. In the absence of this requirement ASX would be unable to maintain an informed market for the securities of listed entities. As market operator, ASX must decide whether or not it is necessary to institute a trading halt in relation to a particular disclosure. This would not be possible if it did not have access to information prior to its release to the market.

It is less apparent that market operators such as ASX should be solely responsible for the dissemination of information once it has been released to market participants. The current procedures for the dissemination of price sensitive information released by listed entities would seem to disadvantage small investors in comparison with market participants (who often engage in significant trading activity as principals) and institutional investors.

This disparity could be addressed if market operators were prepared to make price sensitive information immediately available to all investors (without a 20 minute delay). As an alternative, listed entities could be required to establish websites and post materially price sensitive information at the same time that this information is first released by the relevant market operator (and, in the case of ASX listed entities, they receive notification that the information is no longer confidential). It would also be highly desirable for listed entities to provide facilities for investors to be electronically alerted through real time electronic messaging systems (such as e-mail or SMS) to the existence of new postings (along the lines of the notification that is currently provided to ASX participants through the SEATS system). This proposal would also ensure that all investors have equal and timely access to price sensitive information released by listed disclosing entities. It is consistent with the best practice disclosure guidelines that have been published by the Australasian Investor Relations Association.

8.5.5 Enforcement and remedies

An effective framework of enforcement and remedies consists of four components: education and guidance to ensure that entities understand their continuous disclosure obligations; penalties that provide a credible deterrent against non-compliance; mechanisms for remedying inadequate disclosure and for requiring disclosing entities to institute remedial measures to reduce the likelihood of future contraventions; and mechanisms that enable persons who have suffered loss or damage as a consequence of contraventions to recover the amount of their loss or damage.

Education and guidance

The provision of education and guidance in relation to the interpretation of the continuous disclosure requirements plays a vital role in fostering a culture of compliance. The importance of this function derives from the subjective nature of these rules (especially in relation to the question of whether materially price sensitive information is required to be disclosed to the market or whether it may be legitimately withheld from investors). It is difficult to create a culture of compliance if disclosing entities do not have a clear understanding of their obligations. It is therefore important for market operators to provide listed disclosing entities with clear and consistent guidance in relation to the operation of the continuous disclosure provisions of their respective listing rules.

In this regard, the Government welcomes a recent proposal by ASX to devote additional resources to educating company directors and advisers in relation to the practical application of the continuous disclosure regime and promoting best practice in relation to continuous disclosure.

Penalties

The provision of education and guidance alone is not sufficient to ensure compliance by disclosing entities with the continuous disclosure regime. It must be supported by a framework of penalties that operates as a credible deterrent against contraventions of the regime.

There are four key issues in relation to penalties: the types of penalties that may be imposed in relation to contraventions of the continuous disclosure regime; the flexibility with which different types of penalties may be tailored to the circumstances of particular contraventions; the extent to which penalties may only be imposed against disclosing entities or are also able to be imposed against individuals involved in a contravention; and the processes through which penalties are imposed (including the extent to which different types of penalties should be able to be imposed through judicial or administrative processes).

Types of penalties

There are currently four types of penalties that may be imposed in relation to contraventions of the continuous disclosure regime: removal of an entity from the official list of its listing market by the relevant market operator; financial penalties; adverse publicity; and imprisonment (in relation to individuals convicted as accessories to a criminal contravention by a disclosing entity of the continuous disclosure provisions of the Corporations Act).

These four types of penalties may be imposed concurrently with one another. In particular, the imposition of a financial penalty on a disclosing entity is likely to be accompanied by adverse publicity and the potential for damage to both the entity's reputation and its future cost of equity capital (as investors may demand a higher risk premium before investing in the securities of an entity with a reputation for poor disclosure). While adverse publicity can be expected to accompany the imposition of a financial penalty, it may also be appropriate as a penalty in its own right, particularly in relation to less serious contraventions of the regime.

Flexibility of penalties

It is important that penalties should be able to be tailored to reflect the different circumstances of particular contraventions. The appropriate penalty in relation to an intentional contravention by a major corporate entity is likely to be substantially different from that which might be appropriately imposed in relation to a minor or inadvertent breach by a much smaller entity.

Of the four types of penalties under the current framework, de-listing and imprisonment are least able to be tailored to individual circumstances. As a consequence, they would only be appropriate in relation to the most serious contraventions of the regime. As a consequence of their inflexibility, these two types of penalties do not constitute credible and effective deterrents in relation to all but the most serious contraventions of the regime.

Financial penalties and adverse publicity are characterised by a higher degree of flexibility and may therefore be tailored to fit the circumstances of a much wider range of contraventions. They are therefore more likely to operate as a credible deterrent against a wide range of contraventions of the regime.

Under the current regime, financial penalties of up to $200,000 may be imposed on a disclosing entity (the maximum civil penalty that may currently be imposed by a court in relation to a contravention of subsection 674(2) or 675(2)). The amount of adverse publicity that may be experienced by a disclosing entity that contravenes the continuous disclosure regime can also vary significantly under the current regime. Most adverse publicity is likely to be associated with a criminal conviction due to its connotations of immorality (despite the lower maximum financial penalty of $110,000 that a court may impose on a body corporate in relation to a criminal convention). By contrast, a public censure in the absence of a criminal conviction or a civil penalty is likely to be associated with less adverse publicity.

A key issue in relation to the current regulatory framework is the capacity of financial penalties to operate as a credible deterrent in relation to more serious contraventions of the continuous disclosure regime by large bodies corporate.

While a maximum financial penalty of $200,000 may represent a substantial impost in relation to a smaller entity, it is unlikely to be regarded as such by a large body corporate (even taking into account the level of adverse publicity that is likely to accompany its imposition).

For this reason, it is considered that the maximum financial penalty that may be imposed in relation to a contravention of the continuous disclosure provisions by a body corporate should be increased from $200,000 to $1 million.

This could be achieved by inserting into the Corporations Act a provision similar to section 1312 to provide that the maximum civil penalty that may be imposed on a body corporate in relation to contravention of a financial services penalty provision is five times the maximum penalty that applies to an individual (which would remain at $200,000). This would bring financial services penalty provisions into line with the offence provisions of the Corporations Act, in which the maximum financial penalty that may be imposed in relation to a body corporate is five times the maximum financial penalty listed for the offence in Schedule 3 (which sets out the maximum financial penalty in relation to a criminal contravention by an individual).

An increase in the maximum financial penalty that may be imposed on bodies corporate in relation to contraventions of the financial services penalty provisions would reflect that fundamental importance of these provisions to market integrity and investor protection. It would also increase the level of adverse publicity that would be likely to accompany the imposition of such a financial penalty. However, this proposed increase in the maximum financial penalty that may be imposed on a body corporate does not mean that substantially smaller financial penalties would not still be appropriate in many circumstances.

Persons against whom penalties may be imposed

Under the current regulatory framework, penalties are generally imposed on disclosing entities rather than individuals. However an individual who is convicted as an accessory to a criminal contravention of the continuous disclosure provisions can be fined or imprisoned. A person involved in a contravention can also be subject to an adverse publicity order under section 1324B of the Corporations Act as well as an order for compensation under section 1325. However it is not currently possible for ASIC to seek a civil penalty order against an individual who was involved in a contravention of the continuous disclosure provisions. Such a penalty may only be sought against the relevant entity.

While it is appropriate to impose financial penalties on entities in relation to contraventions of the continuous disclosure provisions, this practice may shield from responsibility individuals who should arguably themselves be held accountable for contravening conduct by the relevant disclosing entity. It can also be argued that the burden of financial penalties imposed on an entity is likely to fall disproportionately on persons such as shareholders (who may have already suffered loss or damage as a result of a contravention) rather than on the individuals whose conduct lead to the contravention.

This raises the issue of whether the current regime should be amended to allow civil penalty orders to be sought against persons involved in a contravention by a disclosing entity as well as against the entity itself. The prospect of financial penalties being imposed on individuals may operate as a more credible and effective deterrent than the prospect of financial penalties being imposed on a body corporate.

This proposal may not represent a substantial departure from the principles established under the current regulatory framework to the extent that individuals are already exposed to the potential for financial penalties and imprisonment (in relation to accessorial liability for criminal contraventions by an entity) and a person involved in a contravention may also be subject to an adverse publicity order under section 1324B of the Corporations Act, as well as actions for compensation under section 1325.

Processes through which penalties may be imposed

Under the current regulatory framework, there are a number of processes through which penalties may be imposed on entities and individuals. A key distinction in this regard is between formal court proceedings and administrative processes.

In relation to court proceedings, it is possible to distinguish between criminal and civil proceedings. While these are similar in some respects, there are significant differences between them. Firstly in a civil proceeding, it is only necessary for ASIC to prove the physical element of a contravention. This is different from a criminal proceeding, in which the DPP must prove both the physical and mental elements of an offence. In addition, civil proceedings may be characterised by reduced evidential standards (balance of probabilities rather than beyond reasonable doubt) and the absence of certain safeguards that would apply in criminal proceedings. However, the degree of satisfaction called for by the civil standard of proof may vary according to the severity of the relevant penalty. There is also some potential for the courts to modify civil procedures to reflect the gravity of penalty to which a respondent may be liable. These factors may narrow the distinction between criminal and civil proceedings.

Under the current framework, imprisonment and financial penalties may only be imposed through court proceedings. Imprisonment is an exclusively criminal penalty. However, as a result of the commencement of amendments contained in the FSR Act, financial penalties may now be imposed through either criminal or civil proceedings.

The maximum fine that may be imposed as a result of a criminal proceeding is currently $22,000 in relation to an individual and $110,000 in relation to a body corporate. The maximum financial penalty that may be imposed following a civil penalty proceeding is currently $200,000. It is proposed that this should be increased to $1 million in relation to bodies corporate (but remain at $200,000 in relation to individuals), and that other persons involved in a contravention of the continuous disclosure provisions should be potentially liable to financial penalties as a result of both civil and criminal proceedings.

Adverse publicity is likely to result from the imposition of financial penalties by a court (especially in relation to a criminal conviction, where the imposition of a smaller financial penalty is offset by greater adverse publicity as well as other consequences for an entity that may flow from a criminal conviction). The courts may also impose an adverse publicity order under section 1324B of the Corporations Act in the absence of a financial penalty. Adverse publicity orders are a type of civil penalty as they may be imposed as a result of civil rather than criminal proceedings.

Under the current regulatory framework, only a limited range of penalties may be imposed through administrative processes by market operators or ASIC.

A market operator may de-list an entity for failing to comply with its continuous disclosure obligations (arguably the most severe penalty that may be imposed against a listed entity). However, market operators have not given themselves the capacity under their respective listing rules to impose other types of penalties on listed entities. This situation can be contrasted with the range of penalties that is potentially available to market operators in relation to contraventions of their respective business rules by market participants. For example, the ASX's National Adjudicatory Tribunal may impose a wide range of penalties on participating organisations in relation to contraventions of ASX's Business Rules, including censure, suspension, completion of education and compliance programs, disgorgement of profits and financial penalties of up to $250,000.

An order made under section 713(6) of the Corporations Act to deny an entity access to transaction specific prospectuses is the major administrative remedy currently available to ASIC in relation to breaches of the continuous disclosure provisions. ASIC may also accept enforceable undertakings from disclosing entities (a process discussed in greater detail below in the section of the

Chapter dealing with remedial mechanisms). ASIC may publicise these administrative actions. ASIC has also recently publicised instances where it believes that an entity has contravened the continuous disclosure provisions but where it considers that it would be unable to successfully pursue the matter in the courts.

The key issue in relation to the procedures through which penalties may be imposed in relation to contraventions of the continuous disclosure provisions is the extent to which they strike an appropriate balance between the need to provide an effective and credible deterrent to contraventions and the need to maintain appropriate procedural safeguards that reflect the seriousness of the penalty involved.

Criminal proceedings are appropriate where there is the prospect of individual imprisonment. However the pre-FSR Act requirement to pursue financial penalties solely through criminal proceedings was a significant shortcoming in the enforcement framework. It meant that financial penalties could only be imposed in relation to the most serious and blatant contraventions of the continuous disclosure regime. This substantially reduced the deterrent effect of financial penalties. Indeed, in part as a consequence of the evidential burdens associated with criminal proceedings, no prosecutions have been launched in relation to contraventions of the continuous disclosure provisions of the Corporations Act. While ASIC is yet to utilise its capacity to seek financial penalties using civil as well as criminal proceedings, this can be expected to enhance the deterrent effect of financial penalties, particularly in relation to negligent contraventions of the regime, which cannot be dealt with through criminal processes.

By contrast, it is relatively straightforward for ASIC to impose a penalty of adverse publicity in the form of a public censure contained in a media release. However, an entity may consider that such a penalty is characterised by an absence of appropriate procedural safeguards.

Administrative penalties in relation to continuous disclosure

As noted, under the current regulatory framework, only the courts may impose financial penalties in relation to contraventions of the continuous disclosure regime.

It is proposed that ASIC should be able to impose financial penalties through a third process that could potentially involve both administrative and judicial proceedings (including an infringement notice mechanism that would enable an entity to bring the process to an end after its administrative phase by paying ASIC a financial penalty fixed by statute).

This process would operate in the following way:

- ASIC would hold a hearing to determine whether it should form an opinion that an entity had contravened the continuous disclosure provisions of the Corporations Act.
  - An entity would be informed of the nature of the case against it and would be permitted to make submissions to ASIC's hearing.
- If ASIC formed an opinion that a contravention had occurred, it would issue an infringement notice notifying the entity of its opinion and indicating that the breach may be addressed through payment of a fixed financial penalty set out by statute.
  - The notice would specify a fixed amount as a penalty. This penalty would be substantially less than the financial services penalties proposed in this paper. The notice would also set out the period in which proceedings may be commenced if the penalty is not paid.
- This mechanism is not intended to amount to the imposition of a penalty by ASIC. Instead it is intended to provide a mechanism through which an entity that in ASIC's opinion has contravened the continuous disclosure provisions of the Corporations Act may forestall an application to the courts by ASIC for the imposition of a financial penalty in relation to the contravention.
- Payment of a financial penalty in response to an infringement notice would not be taken as an admission by the entity of liability or a contravention of the Corporations Act for any other purpose.
  - The entity would not be subject to further civil or criminal proceedings instituted by ASIC in relation to the contravention.
- If the financial penalty is not paid within the period of time specified in the infringement notice, ASIC may commence court proceedings.
- ASIC's application to the court would be supported by:
  - evidence that it had formed an opinion that the continuous disclosure provisions had been contravened and that the fixed penalty set out in the infringement notice had not been paid; and
  - a statement of the facts and matters that ASIC relied upon in forming its opinion in relation to the existence of a contravention.

- In these civil proceedings, the court would be able to consider all matters afresh and form its own view about whether a contravention had occurred.

- If a court determines that a contravention had occurred, it would be permitted to impose a financial penalty not less than the penalty set out in the ASIC infringement notice. However it would not be able to make a pecuniary penalty order against the entity. If ASIC is unable to satisfy the burden of proof in these proceedings, the court would quash the financial penalty set out in the infringement notice.

- A financial penalty imposed by the court would become a debt payable to ASIC and would be able to be enforced as such in the courts.

This process would supplement existing criminal and civil court procedures. It would remedy a significant gap in the current enforcement framework by facilitating the imposition of a financial penalty in relation to relatively minor contraventions of the regime that would not otherwise be pursued through the courts and in relation to which ASIC considers a relatively small financial penalty would be justified. The capacity to issue an infringement notice would also allow ASIC to signal its views concerning appropriate disclosure practices to listed entities more effectively than through court action alone.

The fundamental issue in relation to the proposed new process is whether it strikes an appropriate balance between enhancing ASIC's capacity to deal with relatively minor contraventions of the continuous disclosure provisions and ensuring that there are adequate procedural safeguards.

In particular, there may be concerns about a process under which ASIC would perform a dual role of investigating alleged contraventions and then holding a hearing to determine whether it should form an opinion that a contravention had occurred (and that an infringement notice should be issued).

In this regard, it is relevant to note that ASIC currently performs a similar dual role in relation to persons holding licenses granted under the Corporations Act and directors involved in multiple insolvent companies. ASIC decisions to suspend or cancel a licence (which may have far more adverse implications for an entity than the imposition of a financial penalty) are made as a result of an administrative process. Market operators also use administrative processes in determining whether to penalise participants in relation to contraventions of their business rules. As previously noted, ASX may impose financial penalties of up to $250,000 in relation to contraventions of its Business Rules.

The imposition of financial penalties through administrative procedures is also common in overseas jurisdictions. For example, the UK Listing Authority is

able to impose unlimited financial penalties on listed entities (as well as their directors) in relation to contraventions of the UK listing rules.

In addition, a decision by ASIC to issue an infringement notice in relation to a contravention of the continuous disclosure provisions would be subject to judicial scrutiny. An entity that receives an infringement notice following an ASIC hearing would be able to decide for itself whether to pay the specified penalty and bring the matter to an end or whether it will require ASIC to prove it's case before the courts.

Finally, it is envisaged that the financial penalty that may be imposed using an infringement notice would be substantially lower than the maximum financial penalty that could be sought through criminal or civil court proceedings. If ASIC elected to pursue a contravention using this process, it would not be able to take any other court action in relation to the matter (aside from enforcing any penalty that was eventually imposed by the court). Furthermore, payment of a financial penalty at any stage of the process would not be taken as a contravention of the law by an entity for any other purpose.

The proposed limitation on the magnitude of the financial penalty that would be able to be imposed through this process and restrictions preventing ASIC from taking other action in relation to a matter dealt with using this process are intended to ensure that it does not come to be utilised for dealing with more serious contraventions as an alternative to existing court processes.

The process would therefore be subject to appropriate judicial oversight and the financial penalties that could be imposed would be commensurate with the types of contraventions that are intended to be dealt with in this way.

Proposals for peer review in relation to continuous disclosure

There have recently been suggestions that some form of peer review panel might play a role alongside market operators and ASIC in the administration of the continuous disclosure regime. In particular, it has been suggested that the Takeovers Panel might establish a separate disclosure division to perform this role.

Under the current framework, market operators and ASIC share responsibility for enforcing the continuous disclosure regime in relation to listed entities. The addition of a peer review panel may detract from the responsibility of market operators for maintaining an informed market. It may also limit their capacity to refer suspected contraventions of the continuous disclosure regime to ASIC as well as ASIC's capacity to respond to such contraventions. Fragmentation of responsibility for enforcement of the continuous disclosure regime may also create the potential for inconsistency in the guidance provided to listed entities

(particularly in relation to when materially price sensitive information may be withheld from disclosure and when it must be disclosed to the market) since the views of a peer review panel may differ from those of the relevant market operator and ASIC.

There are also significant differences between the current role of the Takeovers Panel and the role that might be performed by a peer review body in relation to continuous disclosure. Most importantly, the current role of the Takeovers Panel is overwhelmingly remedial rather than punitive. It is concerned with remedying unacceptable circumstances rather than imposing sanctions in relation to contraventions of the takeover provisions of the Corporations Act. In relation to continuous disclosure, it is considered that function should remain the primary responsibility of market operators (as market operators are best placed to take timely action to remedy inadequate disclosure by listed entities). It is unclear that a peer review panel would be able to react on a sufficiently timely basis to deal with these issues. This is not such a significant issue in relation to takeover bids, as a bid may last for several months and can be placed on hold for a short time pending a Panel decision.

For these reasons, the Government does not currently consider that there would be any benefit in utilising an external peer review panel to deal with contraventions of the continuous disclosure provisions.

Remedial mechanisms

Under the Australian regulatory framework, market operators have primary responsibility for instituting remedial action in relation to non-disclosure by listed disclosing entities. This function is important where leaks of price sensitive information result in selective disclosure to investors. It is also important where externally generated rumours in relation to an entity are sufficiently specific that information to which the rumours relate can no longer be characterised as confidential and must therefore be disclosed to the relevant market operator. Remedial mechanisms are also relevant in relation to situations where incorrect externally generated rumours concerning a listed entity result in the emergence of a false market in relation to the securities of that entity.

Market operators are best placed to perform this function because of their responsibility for monitoring securities trading. It is also closely related to their role providing guidance to disclosing entities in relation to the interpretation of the listing rules, including when materially price sensitive information must be disclosed and when it can be legitimately withheld from disclosure. This is one of the main ways in which market operators currently fulfil their responsibility

for monitoring the conduct of listed entities and ensuring compliance with the listing rules.

Market operators may seek to remedy uninformed or false markets by seeking to exert informal pressure on listed entities or by issuing a formal price query. A market operator may suspend trading in a security where it considers there to be an inadequately informed market. Alternatively, a listed entity may request trade in its securities to be halted pending the release of materially price sensitive information.

In the light of the significance of this function, it is necessary to consider whether market operators have provided themselves with adequate remedial mechanisms to remedy uninformed or false markets.

As previously noted, ASX has recently proposed a number of amendments to its Listing Rules relating to continuous disclosure. The first is intended to enable ASX to determine that information is no longer confidential (either because it was leaked or is the subject of an externally generated rumour that is sufficiently accurate that the it can no longer be regarded as confidential) and must therefore be disclosed to the market operator. A failure of a listed entity to release information in these circumstances would amount to a contravention of ASX Listing Rule 3.1 and potentially subsection 674(2) of the Corporations Act. A mechanism that would enable ASX to determine that information is no longer confidential and must therefore be disclosed to the market should enhance its capacity to remedy instances of selective disclosure and to deal with certain types of externally generated rumours. However, it would not appear to enhance the capacity of ASX to remedy false markets that may emerge as a result of incorrect externally generated rumours.

A second amendment that has been proposed by ASX is to add a fourth limb to the current 'carve-out' that allows listed entities to withhold materially price sensitive information from disclosure in certain circumstances. This would provide that entities could only withhold this information if the ASX has not asked the entity to provide it with information to prevent a false market in its securities. This second amendment would supplement the first (in relation to information that is no longer confidential). However it is not clear that it would enhance the capacity of ASX to require disclosure to address false markets that may emerge as a consequence of incorrect externally generated rumours. This is because a listed entity is unlikely to be withholding information to which an incorrect rumour relates (and so is unlikely to be relying on the 'carve-out' in the current Listing Rule 3.1 in the first place). In addition, while the intent of ASX's proposal is to require listed entities to deny false rumours in certain circumstances, it does not appear to be intended to require such an entity to release additional information that may otherwise remain within the scope of the 'carve-out' in the current Listing Rule 3.1.

While the current proposal has the potential advantage that a failure to disclose information at the request of ASX could amount to a contravention of subsection 674(2) of the Corporations Act, a requirement for a listed entity to respond promptly where ASX considers that a false market exists for its securities may be better suited to addressing the third source of a false market.

Market operators should ensure that they have adequate powers under their respective listing rules to require listed entities to disclose information that ceases to be confidential because it is selectively disclosed or is the subject of a sufficiently specific externally generated rumour. Market operators should also ensure that they have explicit powers to require a listed entity to disclose sufficient information to remedy a false market that emerges as a consequence of an incorrect externally generated rumour. However these powers should only be used in limited circumstances. Listed entities should not be subject to a general requirement to respond to non-specific rumours that are not having a significant impact on the market for their securities.

Remedial mechanisms are not just used for dealing with inadequate disclosure or remedying false markets. Entities that have contravened the continuous disclosure provisions may also be required to institute remedial measures to reduce the likelihood of future contraventions.

ASIC has played a leading role in requiring disclosing entities that may have contravened the continuous disclosure provisions of the Corporations Act to institute specific internal compliance measures in an effort to minimise the likelihood of inadequate disclosure in the future.

There are two mechanisms by which ASIC may require an entity to take remedial action. If an entity has been found by a court to have contravened the continuous disclosure provisions of the Corporations Act, ASIC may seek remedial orders under section 1325. Alternatively, ASIC may seek to accept an enforceable undertaking under section 93A or 93AA of the ASIC Act.

This mechanism is generally used as an alternative to formal court action (but where there exists the prospect of successful court action, so that action may be taken if the undertaking is breached). In this regard, the introduction of civil penalties in relation to contraventions of the continuous disclosure provisions should enhance the scope for ASIC to requiring entities to institute remedial measures through the use of enforceable undertakings where this is deemed appropriate.

Compensation mechanisms

The purpose of these mechanisms is to enable a person that has suffered loss or damage as a consequence of a contravention of the continuous disclosure provisions of the Corporations Act to recover the amount of the loss or damage.

The current regulatory framework (section 1317HA) allows a person to apply to the courts for a compensation order against a disclosing entity in relation to loss or damage that the person may have suffered as a result of a contravention of subsections 674(2) or 675(2). In addition, a person may be able apply to the Court for compensation under section 1325. In contrast to section 1317HA, section 1325 allows damages to be pursued against both the relevant entity and any other person involved in the contravention.

ASIC is empowered to launch representative action under section 50 of the ASIC Act to recover damages in relation to contraventions of the continuous disclosure provisions where it considers that it would be in the public interest to do so.

There currently appears to be some uncertainty about whether a person can apply to recover loss or damages as a result of a contravention of the continuous disclosure regime if ASIC has not sought a declaration of contravention under section 1317J. It is proposed to amend these provisions to clarify that a person may seek compensation regardless of whether ASIC has sought a declaration of contravention.

In addition, while the former section 1005 of the Corporations Act enabled a person to seek to recover loss or damages in relation to a contraventions from either the relevant entity or any other person involved in the contravention, the current provisions of section 1317HA only enable loss or damages to be recovered from the relevant entity. It is proposed to allow persons to recover loss or damages from either the relevant entity or any other person involved in a contravention.

8.5.6 Fundraising

Continuous disclosure is only one component of Australia's disclosure framework. The other two elements are corporate governance disclosure and fundraising disclosure. There are significant differences between continuous disclosure and fundraising disclosure.

Fundraising disclosure applies where a financial product is first issued to an investor. It only applies for anti-avoidance purposes in relation to a limited

range of secondary sale situations. In addition, these requirements generally apply only in relation to the issue of financial products to certain categories of investors (known as non-sophisticated, non-professional or retail investors). The relevant provisions are found in Chapter 6D and Part 7.9 of the Corporations Act.

By contrast, the primary purpose of continuous disclosure is to ensure the existence of an informed secondary market for financial products. Disclosing entities are required to disclose materially price sensitive information on a continuous basis to all categories of investors.

Despite the different purposes of these two disclosure frameworks, there is significant overlap between them. Most importantly, the current framework of fundraising disclosure governing securities and debentures provides concessionary arrangements in relation to further issues of continuously quoted securities by listed disclosing entities. section 713 of the Corporations Act provides that these securities can be issued to retail investors through a transaction specific prospectus (rather than a full prospectus of the type that would ordinarily be required under section 710 of the Act). It allows this prospectus to refer to other information that has been disclosed by the entity under the continuous disclosure provisions. It also contains a provision that allows ASIC to deny a disclosing entity access to these arrangements if the entity has contravened the continuous disclosure provisions (or other relevant disclosure provisions) in the previous 12 month period. This is one of the few administrative powers available to ASIC under the current regulatory framework in relation to contraventions of the continuous disclosure provisions.

As a consequence of the commencement of the FSR Act, the provisions governing fundraising disclosure in relation to managed investment products have been transferred from Chapter 6D to Part 7.9 of the Corporations Act. The new provisions (section 1013F) simply provide that in determining what information needs to be contained in a PDS, an issuer's status as a disclosing entity is one of the factors that a responsible person may take into account. They do not provide any further guidance and there is no mechanism by which ASIC is able to exclude a disclosing entity that may have contravened relevant disclosure provisions in the previous 12 months from taking advantage of any concessions that might potentially be available under these provisions.

It is proposed to clarify that issuers of managed investment products that are continuously quoted products may issue shorter or transaction specific Product Disclosure Statements. It is also proposed that ASIC should be able to deny access to these arrangements to entities that have contravened relevant

provisions of the Corporations Act along the lines of the current arrangements in subsection 713(6).

Proposal 19 — Maintain and enhance continuous disclosure

The Government will maintain and enhance the framework of continuous disclosure.

Proposal 20 — Enforcement responsibility

Both ASIC and ASX will continue to have the capacity to enforce the continuous disclosure provisions that apply to listed entities.

Proposal 21 — Higher maximum civil penalties

The maximum civil penalty for a contravention of the continuous disclosure provisions by a body corporate will be increased from $200,000 to $1 million. The maximum penalty for bodies corporate in relation to contraventions of the other financial services civil penalty provisions (which relate to market manipulation and insider trading) will also be increased to $1 million.

Proposal 22 — Administrative penalties

ASIC will be given the power to impose financial penalties and issue infringement notices in relation to contraventions of the continuous disclosure regime.

Proposal 23 — Civil penalties in relation to other persons involved in a contravention

In addition to its power to seek civil penalties in relation to contraventions of the continuous disclosure regime by disclosing entities, ASIC will be empowered to seek such a penalty against any other person involved in a contravention.

Proposal 24 — Compensation mechanisms

The Government will amend the civil recovery provisions relating to contraventions of the continuous disclosure provisions of the law to clarify that a person may seek compensation regardless of whether ASIC has sought a declaration of contravention. It will also allow persons to recover loss or damages from either the relevant entity or any other person involved in a contravention.

Proposal 25 — Dissemination of information

All investors should have equal access to materially price sensitive information disclosed by listed entities.

Proposal 26 — Guidance to listed entities

Market operators will be encouraged to ensure that they provide listed entities with education and guidance to promote compliance with the continuous disclosure provisions of their respective listing rules.

Proposal 27 — Externally generated speculation

Market operators should require listed entities to respond to externally generated speculation in circumstances where the operator determines that this is having a significant impact on the market for their securities.

Proposal 28 — Relationship with fundraising disclosure

Issuers of managed investment products that are continuously quoted securities will be permitted to issue transaction specific Product Disclosure Statements. The Government will amend the law to ensure that ASIC is empowered to deny access to these arrangements in relation to issuers that have contravened relevant provisions of the law in the past 12 months.

PART 9: DISCLOSURE REQUIREMENTS FOR SHARES AND DEBENTURES

9.1 INTRODUCTION

With the introduction of the *Financial Services Reform Act 2001* (FSR Act) in March 2002, the *Corporations Act 2001* (the Corporations Act) contains two separate disclosure regimes for financial products:

- Chapter 6D for securities and debentures; and
- Part 7.9 for financial products other than securities (such as managed investment products and superannuation).

These regimes were designed to effectively promote disclosure across all financial products, while taking into account the inherent differences between securities and other financial products. These differences are reflected in the different levels of disclosure in each regime - a due diligence and general disclosure test applied to securities in Chapter 6D's prospectus and a directed disclosure regime applied to other financial products in Part 7.9's Product Disclosure Statement.

While the FSR Act harmonised the disclosure arrangements that applied across a range of financial products, they were not extended to shares and debentures. The principle reason was that the *Corporate Law Economic Reform Program Act 1999* (CLERP Act 1999) had only recently amended the requirements in Chapter 6D for securities.

The recent reforms have been subject to extensive consultation and have put in place two effective disclosure regimes for all financial products. Nevertheless, there is the potential to improve the operation of the respective disclosure regimes. Potential harmonisation and other general improvements may lead to more effectively targeted disclosure regimes.

9.2 THE DISCLOSURE REGIMES

9.2.1 Chapter 6D

Chapter 6D was introduced as part of a suite of reforms contained in the CLERP Act 1999 and commenced operation in March 2000. The reforms were designed to minimise the costs of fundraising while improving investor protection.

Chapter 6D utilises a general disclosure test, which places the onus on the preparers of a prospectus to provide the information reasonably required by investors and their advisers in deciding whether to subscribe for securities. There has been very strong support from the business community for the general disclosure test regarding securities, with an acknowledgment that the quality of information available to the marketplace has improved since its introduction.

9.2.2 Part 7.9

Part 7.9 was introduced as part of the FSR Act and came into effect in March 2002. For existing industry participants, there is a two-year transition period until the regime fully comes into force in March 2004.

Part 7.9 takes a directed approach to disclosure, rather than the general disclosure approach in Chapter 6D. The directed disclosure approach is supplemented by a requirement to provide other information known to the issuer that might materially influence an investor's decision to acquire a financial product. The focus is on the needs of retail investors, rather than professional advisers and the aim is to achieve shorter, more comparable disclosure documents.

Public submissions during the development of the FSR Act were supportive of harmonised and consistent disclosure obligations. Many noted the need to develop flexible obligations, which could apply to a range of financial products, and that it would be undesirable to introduce prospectus type requirements to products that do not warrant that level of disclosure.

9.3 BETTER TARGETING THE DISCLOSURE REGIMES

9.3.1 Consistency in presentation

The FSR Act introduced a requirement for Product Disclosure Statements in section 1013C(2) to be worded and presented in a clear, concise and effective manner. This requirement does not exist in Chapter 6D. The application of such standards for prospectuses in Chapter 6D would improve the effectiveness of these documents.

The Government is mindful that this change may impact upon other provisions. A specific example is where a bidder offers securities under a takeover bid. Under section 636, the bidder's statement must include all material that would be required for a prospectus for an offer of the securities. The current takeover disclosure requirements were designed to be consistent with the CLERP Act 1999 fundraising disclosure requirements (see Explanatory Memorandum CLERP Act 1999 paragraph 7.23.)

Proposal 29 — Improve the presentation of prospectuses

The Government will improve the effectiveness of disclosure in prospectuses through extending the requirement for 'clear, concise and effective wording and presentation' in Chapter 7 for product disclosure statements to Chapter 6D for prospectuses.

9.3.2 'Sophisticated investor' and 'wholesale client'

Harmonisation is proposed between Chapter 6D's 'sophisticated investor' and Part 7.9's 'wholesale client'. Even though both Chapter 6D and Part 7.9 do not require disclosure documents to be provided to a class of investors, which broadly represent the same class of persons, the definitions adopted to achieve this result differ somewhat. As each approach has a similar objective and produces a similar result, there is scope for harmonisation of the terms to classify those investors who do not require the protection of the disclosure regimes. This will improve the consistency and effectiveness of disclosure overall.

Chapter 6D — Sophisticated investor

The Corporations Act requires that an offer of securities or debentures needs prospectus disclosure to investors unless excluded in section 708. Along with exclusions for small offerings, subsections 708(8) to 708(20) of the Corporations Act identify certain persons and circumstances as not requiring disclosure, including the following persons:

- a 'sophisticated investor;' which is defined where:
  - the minimum amount payable for securities is at least $500,000; or
  - the collective amount invested in the same class of securities adds up to $500,000; or
  - a qualified accountant certifies the net asset worth of $2.5 million or gross income for each of the last two financial years of at least $250,000 per annum.
- the offer is made to a person through a financial services licensee where the licensee is satisfied that the person has relevant previous experience in investing in securities; and
- a 'professional investor,' as defined in section 9 of the Corporations Act.

The exemption for 'sophisticated investors' recognises that certain investors are able to protect their own investment interests without regulatory protection. In fact, both industry and such investors may discourage regulatory coverage and consider the imposition of any legislative disclosure to be an unwanted cost and burden.

Part 7.9 — Wholesale client

The FSR Act also draws a distinction (for financial products other than securities and debentures) between 'retail' and 'wholesale' clients. Wholesale clients in Part 7.9 do not receive the same level of protection, as these clients are better informed and better able to assess the risks involved.

Wholesale clients are defined in the negative, that is, as persons who are *not* retail clients. With the exception of general insurance products, superannuation and RSA products, a financial product and the related disclosure requirements is provided to what is defined as a retail client unless the provisions of section 761G(7) apply:

- the price or value for the provision of the financial product is at least $500,000; or
- the financial product or service is provided for use in connection with a business that is not a small business; or
- when not provided for use in connection with a business, a qualified accountant certifies the net asset worth of $2.5 million or gross income for each of the last two financial years of at least $250,000 per annum; or
- the person is a 'professional investor,' as defined in section 9 of the Corporations Act.

Current overlap

To some extent elements of the section 761G definition of retail and wholesale clients are essentially a duplication of the exclusions from disclosure under section 708. The two regimes already share several tests in common in identifying those investors that do not require disclosure:

- the product value test and currently prescribed amounts;
- the individual wealth test and currently prescribed amounts; and
- the professional investor test.

Differences between sophisticated investor and wholesale client

There are significant differences between the two regimes, with each containing separate tests that reflect the different nature of shares and other financial products. Specific examples of the differences include:

- Chapter 6D's certification of investment experience was not replicated in Part 7.9. Further, a mechanism canvassed during the development of the FSR Act that would have effectively allowed people to 'opt-out' from the disclosure regime was not well supported and was not adopted.
- Chapter 7's business test is not found in Chapter 6D.
- While the individual wealth test is shared between the two regimes, section 761G's wealth test is subject to 'the relevant service or product is not provided for use in a business,' while section 708 does not contain this limitation.

- The structure of the regimes is also not consistent. Chapter 6D provides for disclosure to all purchasers of securities, except in limited circumstances in section 708. Part 7.9 relies on the retail client or wholesale client distinction, with all retail clients receiving full disclosure and wholesale clients, defined as those who are not retail clients, not receiving this information.

It is desirable to achieve greater harmonisation to provide a more consistent approach for determining which investors will receive disclosure information and which will not. This will promote consistency of regulation where possible across all financial products.

Proposal 30 — Harmonisation of when disclosure is not required

The Government will more closely align the exemptions from the disclosure regimes that apply to sophisticated investors and wholesale clients.

9.3.3 Certification of investment experience

The current operation of the certification ability regarding securities under section 708 has been the subject of concerns related to liability. There is no similar provision in Part 7.9. Industry participants have suggested that they may be held liable in the event that something goes wrong with investments made by a person they have certified as sufficiently experienced in securities investment to not need a disclosure document.

This potential liability might be viewed as an incentive for licensees to ensure that persons do in fact possess the requisite experience to justify such a certification. However, it might also raise doubts about whether this may unduly limit, in practice, the use of the provisions.

The decision as to whether to certify a person's investment experience appears at present to be a commercial decision which must be balanced against the associated liability risk. A form of sanction for misuse is necessary, as these provisions may provide an avenue for parties to subvert the intent of the disclosure requirements. This sanction is currently potential civil liability.

The Government believes that the current arrangements provide an appropriate balance between these factors. The Government will retain the current option for licensees to certify investment experience in Chapter 6D based on the existing potential for liability.

9.3.4 Placements

Secondary sales occur when a security or financial product is issued to an intermediary who then on-sells them to the wider market.

The FSR Act tightened disclosure obligations related to secondary sales of securities and financial products by amending the operation of section 707 of the Corporations Act to remove some unintended potential loopholes in the CLERP Act 1999. It also inserted section 1012C of the Corporations Act, which applies to financial products other than securities.

The Government has been clear in its intent to enhance consumer protection through minimising the avoidance of disclosure requirements.

Industry concerns

Industry has raised concerns about a potentially adverse impact of the need to satisfy more stringent disclosure arrangements. In particular, some have argued that the operation of the amended provisions may cause practical difficulties for the placements market for securities.

Further, concerns have been raised that the amended anti-avoidance provisions will impact upon underwriting arrangements, because an underwriter will generally have intended to on-sell any securities it is required to take up as a result of a shortfall in acceptances of an offer. Where an underwriting arrangement is subject to these disclosure obligations, additional costs may be imposed. Underwriters may choose to recoup these costs though the imposition of higher costs for customers or through seeking a greater discount on the underwritten share price. Ultimately, higher costs may adversely impact upon the efficiency of the secondary sales market.

It has also been suggested that retail clients who were issued financial products, without disclosure under a specific statutory or regulatory exemption from the disclosure provisions, might not be able to on-sell those products within 12 months of their issue.

Following the commencement of the FSR Act, the Australian Securities and Investments Commission (ASIC) has sought to clarify the operation of these provisions by class order relief and the release of consultation papers seeking industry's views on this issue. Currently, interim class order relief addresses a number of concerns related to existing ASIC prospectus relief exemptions or statutory exemptions, and where there is adequate information already available to the market.

The Government proposes to reduce the potential for the anti-avoidance provisions to interfere with legitimate business practices by imposing additional costs, while maintaining investors ability to make informed investment decisions. In some circumstances, imposing additional disclosure obligations (with associated costs) on the provider of the security or financial product may be of little or no benefit in terms of consumer protection or market integrity.

The Government will improve the practical operation of the anti-avoidance provisions on placements to limit the need for disclosure where information is already available.

Proposal 31 — Improve the operation of the placement provisions

The Government proposes that the disclosure requirements for secondary sales reflect the principle that where a person:

- already holds pertinent information, or
- has access to comparable information to what they would have otherwise received in a reasonable, timely and cost-effective manner,

no further disclosure obligations should apply. This will provide a sounder legislative basis for the operation of placements and will also facilitate ASIC taking relief action where appropriate.

Relationship with continuous disclosure

It has been suggested that as a general principle, placements of any listed securities should not require a prospectus where a company is listed on the Australian Stock Exchange (ASX) and has been continuously quoted for 12 months. This is on the basis that the price at which those sales take place should have factored into it all information disclosed by way of periodic reports and the continuous disclosure obligations in the ASX Listing Rules which are legislatively supported by Chapter 6CA of the Corporations Act.

However, information available under the continuous disclosure regime is not necessarily the same as that available under a prospectus, especially noting the operation of the carve-out included under ASX Listing Rule 3.1. Hence, the secondary market may not have access to the information necessary to allow retail investors to make a fully informed decision when entering into a secondary transaction resulting from a placement. This view is evidenced by

instances where professional investors offered securities in a placement may obtain warranties as to any information withheld under the carve-out.

These factors suggest that the current general requirement for a prospectus is appropriate. Consequently, it is not the Government's intention to exclude secondary sales of listed securities from the existing prospectus disclosure obligation solely on the basis of the continuous disclosure requirements.

PART 10: ENFORCEMENT ISSUES

This part discusses a number of enforcement issues, including changes to the Corporations Act penalties regime, an expansion of the duty to report information to ASIC by auditors, protection for company officers who report breaches, and the institutional arrangements and procedures for enforcing discipline against registered company auditors.

Enforcement issues specific to the continuous disclosure regime are covered in Part 8. Enforcement issues specific to the provision of non-audit services and the proposed auditor statement of independence are covered in Part 4.

10.1 PENALTIES FOR BREACHES OF THE CORPORATIONS ACT AUDITING AND ACCOUNTING REQUIREMENTS

10.1.1 Background

The role of ASIC includes enforcing the auditing and accounting disclosure requirements of the Corporations Act.

Under Australia's corporate governance model, it is the responsibility of the board of directors of a company to certify that a company's financial statements comply with accounting standards, and also give a true and fair view. This is consistent with the broader fiduciary responsibilities of directors under the Corporations Act. The role of registered company auditors includes forming an opinion about whether a company's financial statements comply with accounting standards and give a true and fair view.

The United States has recently adopted an approach of requiring chief executive officers to personally vouch for the veracity, timeliness and fairness of their companies' public disclosures, including their financial statements. While the Government does not currently propose any departure from the present corporate governance model, it remains the case that senior company officers can be prosecuted if they engage in any fraudulent activity in relation to the presentation of the company's financial statements.

ASIC enforcement powers

ASIC has substantial enforcement powers relating to financial reporting and audit under the Corporations Act, the ASIC Act, and the various State Crimes Acts.

ASIC's can: make orders to require compliance; institute legal proceedings which can produce outcomes that carry heavy civil and criminal penalties; direct companies to prepare and lodge reports; seek injunctions to restrain contravention of the Corporations Act; and investigate matters where it believes the Corporations Act or other corporate laws have been broken.

ASIC employs a substantial team of accounting qualified staff involved in enforcement matters related to financial reporting. ASIC's enforcement program is resourced from its appropriation, estimated to be $158.4 million in 2002-03. In the 2002-03 Budget, ASIC received new funding totalling $90.8 million over four years. This will equip ASIC to maintain and, where necessary, extend its surveillance and enforcement activities, including in the area of corporate reporting.

ASIC enforcement actions

ASIC has been active in referring matters to the CALDB. Over the past 10 years, ASIC has referred 249 registered company auditors to the CALDB with the result that 146 auditors had their registration cancelled or suspended, 11 auditors received reprimands, and 82 matters were withdrawn — generally after auditors voluntarily surrendered their registrations. Additionally, in 10 cases the CALDB refused to exercise its discretion.

ASIC has also been active in enforcing financial reporting in accordance with accounting standards and the Corporations Act. From 1998-2002, ASIC investigated and resolved financial reporting matters involving accounting irregularities which produced more than $3 billion in restatements in company financial statements.

On 12 July 2002, the ASIC Chairman announced a new accounting surveillance project directed to areas of accounting abuse of the type recently uncovered in the United States. ASIC has assembled a special task force for the project comprising representatives from its Office of Chief Accountant and its Corporate Finance and Enforcement Directorates.

The primary focus of the project is compliance with accounting standards relating to capitalised and deferred expenses; recognition of revenue; and recognition of controlled entities and assets. The surveillance will relate to the

full-year financial reports of selected listed companies for the financial year ended 30 June 2002.

In announcing the project, the Chairman noted that ASIC had no reason to believe that abuses such as those recently uncovered in the United States are prevalent in Australia. Nevertheless, ASIC had decided that a targeted surveillance of these issues would assist to maintain confidence in the reliability of public company financial reporting. ASIC expects to report its preliminary findings by 31 December 2002.

10.1.2 Penalties for breaching the accounting and auditing requirements in the Corporations Act

Current Corporations Act penalties

The Corporations Act contains a range of civil and criminal penalties.

The maximum criminal penalties in the Corporations Act for breaches such as insolvent trading and breaches of directors' duties are 2000 penalty units ($220,000) and 5 years gaol. These penalties can be cumulative for multiple breaches.

The Corporations Act also contains a regime of civil penalties, which allow corporate misconduct to be pursued outside the criminal law framework. This system can overcome some of the difficulties in proving matters beyond reasonable doubt (as required by the criminal law, rather than proof on the balance of probabilities required by civil penalty provisions), and permits remedies such as the payment of civil penalties of up to $200,000, payment of compensation, and disqualifying officers from future involvement in corporations.

Some examples of offences which can be pursued by ASIC either as a civil penalty provision or a criminal offence are outlined below.

Offence	Corporations Act reference	Maximum criminal penalty (note: penalty unit = $110)
Failure to exercise powers with care and diligence.	180(1)	2,000 units and/or 5 years
Failure to exercise powers in good faith and for a proper purpose.	181(1)	2,000 units and/or 5 years
Must not misuse position to gain advantage or cause detriment to the company.	182(1)	2,000 units and/or 5 years
Must not misuse information obtained by virtue of their position to gain advantage or cause detriment to the company.	183(1)	2,000 units and/or 5 years
Breach the procedures under Corporations Act when giving a financial benefit to a related party of the company.	209(2)	2,000 units and/or 5 years
Failure to comply with the financial reporting requirements under the Corporations Act.	344(1)	2,000 units and/or 5 years
Breaches the duty not to trade while insolvent.	588G(2)	2,000 units and/or 5 years
Failure to comply with continuous disclosure requirements of a share market.	674(2)	200 units and/or 5 years
Failure to comply with continuous disclosure requirements to ASIC, where a share market does not require it.	675(2)	200 units and/or 5 years
Engage in various forms of market manipulation in relation to financial products.	1041A – 1041G	200 units and/or 5 years
Offences in relation to insider trading.	1043A(1)	2,000 units and/or 5 years

ASIC can also pursue actions under State Crimes Acts for fraudulently appropriating corporate property or making or publishing accounting entries intended to defraud, which can attract penalties of up to 10 years in prison.

Should penalties for breaches of the financial reporting requirements of the Corporations Act be increased?

There is a case for increasing penalties under the Corporations Act. Although changes have been made in specific areas, a general review of these penalties has not been carried out for a considerable period.

An example of a penalty that might be inadequate is for breach of section 1309 of the Corporations Act (misleading an auditor or other officer). Fabricating or 'covering up' the fabrications of others in relation to financial reports can cause significant damage and loss. The two year maximum gaol term imposed for this contravention is unlikely to be in line with comparable crimes of a similar significance.

However, it would be desirable to keep the increase of penalties in relation to financial reporting offences appropriately proportionate to other comparable penalties under the Corporations Act. Accordingly, a revision of penalties will

be undertaken covering all of the Corporations Act, focusing on financial reporting and officers' duties. This will encompass civil penalties, especially for bodies corporate,[1] and would take into consideration the findings of the Australian Law Reform Commission's report on civil and administrative penalties in Australian federal regulation.[2] ASIC has been asked to provide recommendations for this review.

Proposal 32 — Revision of civil and criminal penalties

ASIC will monitor the adequacy of civil and criminal penalties and make such recommendations as are required to ensure consistency and adequacy of penalties under the law.

10.2 AUDITORS DUTY TO DISCLOSE INFORMATION TO ASIC

This section discusses the requirements placed on auditors to disclose to ASIC information about breaches of the Corporations Act.

Under section 311 of the Corporations Act, a registered company auditor in the case of an audit of financial reports for a financial year or half-year, or a review of a financial report for a half year, must notify ASIC in writing as soon as possible if the auditor has reasonable grounds to suspect that a contravention of the Corporations Act has occurred, or believes that the contravention has not been or will not be adequately dealt with by comment in the auditor's report or by bringing it to the attention of the company directors.

To assist the auditor in performing his or her duties, section 1289 of the Corporations Act provides that an auditor shall not, in the absence of malice, be liable to any action in respect of defamation for any statement made in the course of duties as an auditor, whether the statement is made orally or in writing.

Although mandated by section 311 of the Act, there has been almost a total absence of reports made to ASIC by auditors under this provision.

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1 The potential inadequacy of the $200,000 maximum civil penalty for bodies corporate that breach continuous disclosure and other financial services civil penalty provisions was highlighted in Chapter 8. It is proposed to increase the maximum civil penalty payable by bodies corporate in breach of those civil penalty provisions to $1 million.

2 See Australian Law Reform Commission, Discussion Paper 65, *Administrative Penalties in Australian Federal Regulation*, April 2002.

To enhance the effectiveness of the provision, it is proposed that section 311 be amended such that an auditor must also report to ASIC if any officer or director of a company attempted to influence, coerce, manipulate or mislead the auditor during the performance of the audit.

Proposal 33 — Auditors' duties under the law will be expanded

The Government will amend the law to expand matters which auditors must report to ASIC to include any attempt to influence, coerce, manipulate or mislead the auditor.

10.3 DISCIPLINARY PROCEDURES FOR AUDITORS

Background

The report of the Audit Review Working Party contains a series of recommendations for streamlining the institutional arrangements for taking any disciplinary action against registered company auditors and the procedures for dealing with the disciplinary matters themselves. The Ramsay report provides an overview of the Working Party's proposals and examines whether it would be appropriate to implement those recommendations.

The Audit Review Working Party examined the following aspects of the requirements for disciplining auditors as part of its review:

- whether the existing institutional arrangements for dealing with disciplinary matters operate in an efficient and effective manner;
- whether the matters that may be dealt with by the CALDB are appropriate;
- whether the penalties that may be imposed by the CALDB are appropriate; and
- whether the CALDB and/or ASIC should be authorised to exchange information with the accounting bodies for the purpose of disciplinary proceedings.

The Working Party, following consultation with stakeholders, put forward a total of 17 recommendations designed to achieve three basic objectives:

- relieving the CALDB of the task of dealing with disciplinary matters of an administrative nature, thus enabling it to devote its resources to dealing with the more substantive conduct matters;
- broadening the membership base of the CALDB in order to increase the perception that it is independent of the accounting profession; and
- increasing publicity associated with disciplinary matters for the purpose of acting as a deterrent to others.

The Ramsay report noted that at the time the Working Party's report was released there was general support for most of its recommendations except the following:

- the proposal that the chair of the Board need not be a legal practitioner;
- the recommendation that the CALDB be relieved of the task of dealing with disciplinary matters of an administrative nature was not supported by either CALDB or ASIC on a number of grounds including that it is desirable that disciplinary action which affects the right of an auditor or liquidator to practise should be centralised in one body; and
- in addition, one other recommendation, that the CALDB should have the ability to impose fines, is no longer possible because the corporate regulation scheme is now based on Commonwealth constitutional powers and there are constitutional limitations on Commonwealth bodies imposing fines.

The Ramsay review's consultation with the CALDB indicates that there is still a high level of support for the Working Party's recommendations, other than those referred to in the preceding paragraph. The CALDB's principal concerns are with proposed changes to its composition. In this regard, the Board has formed the view that, in light of the very technical issues coming before it, the composition of the CALDB should not be expanded by the inclusion of nominees from outside the legal and accounting professions.

Nevertheless, as a result of difficulties recently experienced by the CALDB in forming a quorum for an important hearing, the Ramsay report concluded that some changes are needed to the CALDB's membership structure. The CALDB, for its part, has proposed that its membership be expanded through the appointment of reserve members for both the ICAA and CPAA. The CALDB envisages that reserve members would be used when neither the member nor deputy for a particular body is available for a hearing. It has also proposed that, when making future appointments, an effort should be made to include

in the appointments some members, deputies or reserves who are current or former insolvency practitioners.

Ramsay formed the view that it would be appropriate to proceed with the Working Party's recommendations, subject to the retention of the existing requirement that the chair have legal qualifications; omitting the proposals opposed by the CALDB and ASIC; and giving effect to the CALDB's proposal for the appointment of additional accounting and insolvency members in place of the Working Party's proposal for the appointment of people with other experience.

The Ramsay report recommendations

The Ramsay report recommended that:

- The ASIC Act be amended to:
  - provide for the appointment of a deputy chairperson for the CALDB;
  - allow the CALDB to sit in more than one Division simultaneously;
  - provide that a Division of the CALDB be constituted by:
    - : the chairperson or deputy chairperson;
    - : a member, deputy of the member or a reserve member nominated by the ICAA; and
    - : a member, deputy of the member or a reserve member nominated by CPAA; and
  - provide for the ICAA and CPAA to each submit a panel of not less than seven and not more than ten names from which the Minister will appoint:
    - : one ICAA member, a deputy of the ICAA member, and up to two ICAA reserve members; and
    - : one CPAA member, a deputy of the CPAA member, and up to two CPAA reserve members.
- In making the appointments, the Minister should have regard to the need to ensure that included in the appointments are some members, deputies or reserves who are current or former insolvency practitioners.

- The ASIC Act or the Corporations Act, as appropriate, be amended to:
  - enable the CALDB to enforce orders made during the pre-hearing period;
  - provide that, in respect of each disciplinary proceeding, the nature of the matter, the decision and the reasons for the decision should be published; and
  - enable the CALDB to provide information obtained by it during the course of a disciplinary proceeding to the investigation and disciplinary committees of the ICAA, CPAA and NIA, to facilitate the disciplinary procedures of those bodies.

Stakeholder response

There is broad support for the implementation of the Audit Review Working Party's recommendations as modified by the Ramsay report.

It is noted that the proposal by CPAA for a new financial reporting framework envisages a new umbrella body which would have responsibility for standard setting, monitoring and investigation and discipline. The new separate arm of the proposed umbrella body responsible for discipline would bring together the existing functions of CALDB and the separate disciplinary processes of CPAA and the ICAA. While the CPAA proposal calls for structural reform, it would necessarily impact on the existing disciplinary powers of CALDB.

Proposal

The Government agrees with the Ramsay recommendations in this area, with one exception. Consistent with the view of the Audit Review Working Party, the Government believes that, to enhance perceptions of independence of the disciplinary process, a majority of CALDB members should be non-accountants, with non-accountants comprising a majority of members for each hearing.

Proposal 34 — Streamline auditor discipline arrangements

The institutional arrangements for taking disciplinary action against registered company auditors will be strengthened to:

- provide a majority of members of the CALDB, with appropriate skills, who are non-accountants;
- allow the CALDB to sit in more than one Division simultaneously and provide for the appointment of a deputy chairman of the CALDB; and
- enable the CALDB to provide information obtained in the course of a disciplinary proceeding to the investigation and disciplinary committees of the ICAA, CPAA and NIA to facilitate the disciplinary procedures of those bodies.

10.4 Reporting of breaches to ASIC

To improve reporting of breaches of the corporate law, it is proposed that the law be amended so that any company employee who reports a suspected breach of the law to ASIC receives qualified privilege and protection against retaliation in employment.

This should directly assist ASIC in its enforcement of the law and in ensuring that the market receives corrected information where misstatements have been made. It should also help deter those who might otherwise be tempted to break the law.

There is a risk that protection for company employees could lead to some false reports about financial misconduct being made, tying up valuable resources of the regulator and the company. The provision would therefore protect company employees reporting suspected breaches of the corporate law to ASIC in good faith on reasonable grounds.

In the United States, the Sarbanes–Oxley Act contains penalties of fines or imprisonment for up to 10 years for employers who knowingly, with the intent to retaliate, take action against an informant, including interference with his or her employment or livelihood, for providing truthful information to a law enforcement officer about matters relating to the commission or possible commission or a federal offence. There is also a provision that allows civil action for compensation to be taken by employees if they have been victimised by their employer due to their lawful activities in assisting investigators with corporate fraud.

Proposal 35 — Reporting of breaches to ASIC

The Government will amend the law to provide qualified privilege and protection against retaliation in employment for any company employee reporting to ASIC, in good faith on reasonable grounds, a suspected breach of the law.

PART 11: SHAREHOLDER PARTICIPATION AND INFORMATION

The role of shareholders is recognised as critical for good corporate governance practice. Shareholders do not assume responsibility for day-to-day management of a corporation. However, they can influence the behaviour of the corporation over the longer term through exercising influence on fundamental matters. These matters include the composition of the board, amendments to the corporation's rules, and approving extraordinary transactions. Shareholders exercise their influence primarily through voting at and/or attending the corporation's general meetings.

The OECD Principles of Corporate Governance[1] have widespread acceptance as a framework for good corporate governance practices. The first of those principles refers to the basic shareholder rights to participate and vote in general meetings. In particular, the principle that shareholders should be given the opportunity to participate effectively and vote in general shareholder meetings is mentioned as a key component of a good corporate governance framework.

The practical opportunities for shareholders to effectively participate in general meetings are often limited due to a number of factors. This part contains proposals intended to enhance opportunities for effective participation by shareholders in Australian corporations, including proposals regarding:

- notices of meetings;
  - short form notices
  - bundling resolutions, and
- access to meetings;
  - web-casting
  - electronic proxy voting.

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1 *OECD Principles of Corporate Governance 1999*, available for download from www.oecd.org.

The proposals were developed by the Corporate Governance Roundtable ('CGR'), a forum which was convened by ASIC in 2001.[2]

Further proposals to facilitate the effective and informed participation by shareholders in the governance of companies considered in this part are proposals to:

- require the disclosure by directors in annual reports of offices held;
- facilitate the distribution of annual reports by electronic means; and
- convene a group representing shareholder interests to act as a consultative body to consider relevant future reform proposals.

11.1 Shareholders and Investors Advisory Council

The concept of a shareholder reference group has been considered as a way of ensuring that the concerns of retail investors are appropriately considered in the context of policy issues affecting them. Such a group would act as an external advisory body reporting directly to the Government on issues of corporate law and governance affecting shareholders.

The Council would be chaired by the Parliamentary Secretary to the Treasurer. Members would be appointed by the Government and include individual retail investors as well as nominees from appropriate retail investor bodies.

It is envisaged the Shareholders and Investors Advisory Council would be requested to consider future proposals to change aspects of the corporate regulatory framework. The Council would make its comments directly to the Minister responsible and where possible the Council would be consulted at an early stage of the policy development process.

2 The CGR met on three occasions in 2001 and two occasions in 2002. Its subcommittees also met on several occasions. The focus of the CGR was to promote better corporate governance by looking at ways of encouraging retail investors to become more active in the companies in which they invest, particularly through raising issues at annual company meetings and exercising their voting rights. Participants included representatives from government, regulators and leading stakeholder groups.

Proposal 36 — Shareholders and Investors Advisory Council

The Government will establish a Shareholders and Investors Advisory Council, to be chaired by the Parliamentary Secretary to the Treasurer, which it will consult on all disclosure-related reforms to ensure they meet the needs of retail investors.

11.2 Form of notices of meetings

The purpose of giving notices of meetings is to enable members to know what business will be conducted at the meeting so that they can decide whether or not to attend, as well as how to vote. Where notice is given that particular business will be transacted at a meeting, no other business can be proceeded with unless the whole body corporate is present and consents.[3]

Accordingly, notices of meeting serve an important function in the corporate governance framework. Without effective notices the only vehicle through which members may directly influence corporate behaviour — that is, attending and/or voting on resolutions at general meetings — will be rendered ineffective. Notices of meeting that fail to convey to members the nature of the proposed business of the meeting are not effective notices, even though they may meet legal requirements.

Against that background, the CGR considered ways to improve the effectiveness of notices of meetings.

11.2.1 Short form notices

Current legal requirements for notices

Division 3 of Part 2G.2 of the Corporations Act details the current method for calling meetings of members. Section 249L prescribes the requirements for the content of notices of meetings, detailing such aspects as: the place, date and

3 In general, a genuine amendment that comes within the scope of the business stated in the notice may be properly considered: *Efstathis v Greek Orthodox Community of St George* (1988) 6 ACLC 706.

time for the meeting; the general nature of the meeting's business; any proposed special resolutions; and the entitlement of members to appoint proxies and the method for doing so.

Directors have an obligation to ensure that the content of notices of meetings, as well as the accompanying explanatory documents sent to shareholders, are not misleading. They must present full and true disclosure of all relevant information. Where a notice of meeting is accompanied by information, that is false or misleading in a material respect, or has omitted information that makes it misleading, an officer who furnishes the information may be guilty of an offence under section 1309.

Concerns about the present framework

An issue of concern raised by the CGR is that corporate officers are worried about possible legal actions for defects in notices, and are providing large quantities of information such that it is often difficult to ascertain what the business of the meeting will be. There is anecdotal evidence that many shareholders are ignoring the notices altogether because it would take too much time to comprehend the information provided.

Clearly the desirability of making full and fair disclosure needs to be balanced against the need to avoid confusing the typical members to whom the notice is directed.

Possible responses to concerns

Three responses to these concerns have been considered:

- no change;
- change the Corporations Act to introduce a 'comfort' provision; and
- no statutory changes, but address the issue through a practice guide.

No change

One view is that the current legal requirements are appropriate and should not be feared by corporate officers. The courts have taken a reasonable

interpretation of the requirements.[4] The law already provides a good balance between safeguarding the interests of the shareholders in obtaining sufficient information to understand what will be discussed at meetings, and safeguarding the interests of the company which has in good faith provided information it considers sufficient for that purpose. Any winding back of the current requirements is unnecessary and will potentially adversely impact the rights of shareholders to be fully informed about the business to be conducted at meetings.

Introduce a 'comfort' provision

Another view is that in the absence of a clear statutory 'safe harbour' for corporate officers who provide information they consider sufficient in good faith, corporate officers will feel obliged to continue their practice of providing large quantities of information in notices of meetings to guard against any action.

To address this concern, a 'comfort' provision could be enacted to facilitate provision of 'short form' notices and to protect disclosures made in good faith.

It would be important to ensure that any such comfort provision did not have the effect of undermining the core element of the obligation to present true and full disclosure of all relevant information. Accordingly, companies that choose to use a short form notice of meeting would still be expected to make complete information available to shareholders that seek it, and to make the information available through other means (for example, posting on a website or, in the case of listed companies, making it available to the Australian Stock Exchange).

Practice guidelines

A further means to address the issue may be the development of best practice guidelines that could outline the legislative requirements and the interpretations taken by courts. The aim of the guidelines would be to promote a common sense approach encouraging companies to include in their notices of meetings only information that is useful in the circumstances.

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4 For example, in *Fraser v NRMA Holdings Ltd* (1995) 13 ACLC 132, a complex proposal about which there were difficult questions of commercial judgment was put to a large number of members. The Full Federal Court considered that it was appropriate for the information provided to be selective and confined to matters that were realistically useful in the circumstances.

Best practice guidelines concerning notices of meetings could be of assistance in encouraging more comprehensible notices of meetings whether or not a legislative change were to be made.

Best practice guidelines would be expected to cover such matters as:

- drafting style, use of jargon, font size, possible standard format for common types of business (such as elections of directors, related party transactions);
- any matters (such as related party benefits or qualifications in an expert's report) that are of such significance that they ought to be included in any notice.

To be most effective, the best practice guidelines would need to be authoritative and acceptable to all relevant parties. An appropriate body to develop the guidelines would be the ASX's Corporate Governance Council. It would also be appropriate for ASIC to be consulted on the guidelines.

Proposal 37 — Shorter, more comprehensible notices of meetings

To encourage shorter, more comprehensible notices of meetings:

- the Government will amend the law to introduce a 'comfort provision' to protect disclosures made in good faith in a short-form notice of meeting; and
- best practice guidelines concerning notices of meetings should be developed by the ASX Corporate Governance Council in consultation with ASIC.

11.2.2 Bundled resolutions

Often a number of resolutions to be put before a company meeting relate to essentially the same proposal. For example, if a proposal to restructure a corporate group is being considered, there is likely to be a number of member resolutions required to give effect to that proposal. In most cases, shareholders will make up their minds to vote for or against the proposal considered as a whole — they are unlikely to cast different votes on the individual resolutions that form the proposal.

The CGR considered a practice that has been developed, mainly by listed public companies, of 'bundling' the related resolutions, so that a whole set of

matters that would otherwise require a large number of individual resolutions at a general meeting are considered together. Most often, this will involve casting a resolution in a form that would, if passed, approve the proposal described generally, including the individual component actions referred to in another document (such as the explanatory statement). For example, a 'bundled' resolution for a merger of a large listed public company may read along the following lines:

> 'Subject to the passing of Resolution 2 below, the Company approves the merger between the Company and X Ltd, as described in the Explanatory Memorandum which accompanied the Notice of this Extraordinary General Meeting, including (without limitation):
>
> - the issue of Share A;
> - the authority to issue Share B; and
> - the execution of, and compliance by the Company with:
>   - Agreement A;
>   - Deed B; and
>   - Deed Poll C,
>
> in each case substantially in the form submitted to the meeting and signed by the Chairman for the purpose of identification.'

The advantage from the company's perspective of 'bundling' resolutions in this way is that, where large transactions are involved, they are likely to be interdependent in such a way that any failure of members to approve a single component in the form envisaged would be likely to result in a series of consequences for other components of the proposal that would be difficult, if not impossible, to anticipate or explain. A large restructure, for example, may entail shareholder approval for dozens of individual transactions, all of which are linked to the others, to form the whole proposal. Similarly, from the shareholders' perspective, an explanation of the proposal and its impact when viewed as a whole is likely to be far more useful in forming a decision to vote in favour or against it than a detailed explanation for each of the composite resolutions. Accordingly, to 'bundle' together the component resolutions and their explanations is preferable so that the proposal as a whole can be more easily considered.

However, there are also potential disadvantages of bundling from a shareholders' viewpoint. Considering resolutions in a 'bundled' way restricts the opportunity to debate particular component parts. There is a concern that bundling resolutions might permit the 'hiding', deliberately or otherwise, of important details about individual resolutions that should be specifically drawn to the attention of shareholders — such as proposals concerning executive remuneration.

It would not seem desirable to attempt to make laws about this matter. To draft a rule that would yield an appropriate result in all (or even most) cases would not be practicable. Rather, it is suggested that the best practice guidelines on notices of meeting, mentioned above, would be an appropriate vehicle to address bundling of resolutions.

Proposal 38 — Bundled resolutions

The proposed best practice guidelines on notices of meetings will include a section dealing with the explanatory material for 'bundled resolutions'. The guidelines will include material on best practice for:

- explaining 'bundled resolutions', including the primary purpose, impact and material implications;
- providing access to fuller information on the component resolutions for those shareholders who seek it (for example, through company websites);
- describing categories of resolution that should not be bundled but always dealt with as a separate item, with a separate explanation provided (for example, transactions affecting executive remuneration).

11.3 ACCESS TO GENERAL MEETINGS

A potential hurdle to greater shareholder participation in general meetings is the time and cost involved in attending them. Relatively few shareholders in large companies have an interest sufficient to warrant physical attendance at a general meeting, particularly if the meeting is held some distance away. Therefore, a potentially large proportion of shareholders do not have a realistic opportunity to personally attend general meetings due to those factors.

11.3.1 Web-casting general meetings

One mechanism that has the potential to greatly expand the opportunity for shareholders to participate in meetings is the broadcast of the meeting over the internet ('web-casting'). Web-casting a general meeting allows shareholders who are unable to attend the physical meeting to witness the meeting proceedings in real-time from any location.

Many foreign and domestic companies have successfully broadcast their annual general meetings over the internet[5]. There would not seem to be any legal impediments to doing so.

However, the broadcast of meetings over the internet is only a part of the access to meetings issue. For participation over the internet to be equivalent to physical presence, shareholders viewing the meeting on the internet would need to be able to provide real-time input, by asking questions and participating in debate, as well as voting. Providing that kind of shareholder access presents greater challenges than one-way web-casting, both legally and technically. Issues include the authentication of internet participants, the legal ramifications if the internet broadcast fails, and (if questions can be submitted to the chairman by email) the risk of very lengthy meetings. Options being explored in overseas jurisdictions for providing two-way access, including through e-mail and bulletin boards, were canvassed in a discussion paper by Professor Elizabeth Boros[6], which, among other sources, was considered by the CGR.

11.3.2 Use of proxies

Traditionally, shareholders unable to physically attend a meeting have used proxies. This device permits shareholders to nominate someone who is attending the meeting to act generally (including speaking) and vote on their behalf, by lodging a proxy form with the company prior to the meeting. Proxies may be given a discretion to vote how they see fit, or the shareholder may choose to direct a proxy to vote in a particular way. If the shareholder does not know someone who is attending, the shareholder can nominate the chair to act as their proxy.

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5 See, for example, Ben Wilmot. *'Gather round the terminal, the AGM's beginning'*, Australian Financial Review 14 August 2002, p.53.

6 Dr Elizabeth Boros, *The Online Corporation: Electronic Corporate Communications*, December 1999, available for download at www.asic.gov.au.

Electronic proxy voting

Electronic proxy voting ('EPV'), is currently being used in the United States and in the United Kingdom. It usually involves an intermediary that accepts electronic proxy votes for a number of corporate clients, although some individual companies operate an EPV service.

EPV dispenses with the requirement to send in a signed paper proxy form. EPV proxy directions may be lodged by telephone or over the internet. Shareholders are authenticated by various means.

Some benefits of EPV over traditional paper-based proxy forms are:

- *speed of responses*: electronic votes can be accepted much later than the 48 hours prior to the meeting usually required for paper proxy forms;
- *shareholder satisfaction:* the convenience of EPV has made it very popular in the United States because votes can be cast at any time;
- *cost savings:* EPV combined with electronic delivery of notices can save money compared with a paper-based system;
- *ease of processing:* an electronic proxy vote can potentially be more easily processed by the recipient than a paper proxy.

However, issues such as authentication of shareholders and of proxies might be problematic. As with two-way meeting participation, these issues involve both technical and legal aspects.[7]

Bodies corporate as proxies

The current law requires an individual person to be a proxy holder — it does not allow bodies corporate to be a proxy holder.

The Government indicated in its response to the Parliamentary Joint Statutory Committee report on the *Company Law Review Act 1998* (Cth) that it supported the Committee's recommendations that bodies corporate be enabled to act as proxies. This proposal is currently being progressed.

Allowing bodies corporate to accept proxies will facilitate shareholder participation in two possible ways:

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7 For a description of some of the possible legal aspects, see Professor Elizabeth Boros, 'Corporations Online', Vol 19 *Company and Securities Law Journal*, at page 492.

- it will facilitate organisations such as the Australian Shareholders' Association seeking out and collecting proxies from shareholders and voting them; and
- it will also assist persons wishing to operate an EPV business through a corporate vehicle (as most do in the United States and the United Kingdom).

11.3.3 Conclusions

There are obvious benefits of electronic communication in increasing shareholder access to meetings. There are some outstanding questions about whether the requirement for a physical meeting could ever be abandoned altogether.[8] However, overseas trends indicate that use of technologies at least as a supplement to the physical meeting (rather than a replacement) is likely to increase around the world and it would be desirable for Australia to follow those developments.

Legislative changes may be required to remove hurdles to two-way internet communication in meetings and EPV. The forthcoming legislative changes permitting bodies corporate to act as proxies will facilitate EPV but there are other potential obstacles.

It is not appropriate at this stage to require companies to offer these facilities. Rather, web-casting (including 2-way participation) and EPV should be encouraged through best practice guidelines developed by the ASX's CGC in consultation with ASIC.

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8 See, for example, Professor Ralph Simmonds, 'Why must we meet? Thinking about why shareholders meetings are required', Vol 19 *Company and Securities Law Journal*, at page 506.

Proposal 39 — Shareholder participation using new technologies

The Government will facilitate improved shareholder participation by electronic means (including electronic proxy voting, internet broadcasting and related technologies) by:

- removing unnecessary legislative hurdles to the use of the technologies, subject to the need to maintain the rights of shareholders who are not internet users; and
- requesting the ASX's Corporate Governance Council, in consultation with ASIC, to prepare guidelines for their use.

11.4 DISCLOSURE OF DIRECTORSHIPS IN ANNUAL REPORTS

The Corporations Act currently specifies a number of details about directors that must be included in the annual directors' report to shareholders. There are special requirements for public and listed companies.[9]

In the case of public companies, the details required include the number of board meetings directors attended during the year, qualifications and special responsibilities. In the case of listed companies, there are requirements concerning disclosure of interests in the company and related bodies corporate.

Directors are not required to disclose details of offices that a director holds in other companies. It has been suggested that this information may be relevant to shareholders in assessing the directors' performance, especially when considered in conjunction with the other information required in the annual report. The information may also assist shareholders to make judgements about potential conflicts of interest and relationships with other directors.

9 See subsections 300(10) and (11) of the Corporations Act.

Proposal 40 — Disclosure of other directorships

The Government will amend the law to require the annual directors' report for listed companies to disclose, with respect to each director holding office during the reporting period, details of all other directorship positions held currently and held over the past two reporting periods.

11.5 ELECTRONIC DISTRIBUTION OF ANNUAL REPORTS AND NOTICES

The distribution of annual reports to members can be costly and time consuming, notwithstanding that recent amendments to the Corporations Act allow members to elect not to receive them, or only receive a 'concise' version.[10] Similar considerations apply in relation to member notices.

There are likely to be considerable benefits, in terms of costs and timeliness of distribution, if members could opt to receive annual reports and notices through electronic means.

To safeguard the integrity of the information in electronic versions, and to ensure that all members who elect to receive them electronically do in fact receive them, corporations would need to establish appropriate internal processes and technology. It might be helpful for some guidance on those practicalities to be developed.

A facility permitting members to elect to receive reports and notices through electronic distribution would not prejudice the rights of members to continue receiving full printed versions of the documents. Further, even members who elect to receive electronic versions would be entitled to request a printed copy free of charge. Under the proposed amended requirements, failure to distribute electronically in accordance with valid instructions would be an offence.

10 See section 316 of the Corporations Act.

Proposal 41 — Electronic distribution

The Government will:

- amend the law to permit members to elect to receive annual reports and notices electronically; and
- support best practice guidelines concerning electronic distribution of annual reports being developed by the ASX's Corporate Governance Council in consultation with ASIC.

ABBREVIATIONS

AAC	Authorised Audit Company
AARF	Australian Accounting Research Foundation
AASB	Australian Accounting Standards Board
AFSL	Australian Financial Services License
AISB	Auditor Independence Supervisory Board
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
ASX	Australian Stock Exchange
AuASB	Auditing and Assurance Standards Board
BSX	Bendigo Stock Exchange
CALDB	Companies Auditors and Liquidators Disciplinary Board
CAMAC	Corporations and Markets Advisory Committee
CAP	Company Announcements Platform
CASAC	Companies and Securities Advisory Committee
CCAB	Consultative Committee of Accounting Bodies
CLERP	Corporate Law Economic Reform Program
CLERP Act 1999	*Corporate Law Economic Reform Program Act 1999*
Corporations Act	*Corporations Act 2001*
CPAA	CPA Australia
DPP	Director of Public Prosecutions

DTI	Department of Trade and Industry
ESB	Ethics Standards Board
FASB	Financial Accounting Standards Board
FRC	Financial Reporting Council
FRRP	Financial Reporting Review Panel
FSG	Financial Services Guide
FSR Act	*Financial Services Reform Act 2001*
IASB	International Accounting Standards Board
ICAA	The Institute of Chartered Accountants in Australia
IFAC	International Federation of Accountants
JCPAA	Joint Committee of Public Accounts and Audit
LRB	Legislation Review Board
LSE	London Stock Exchange
MINCO	Ministerial Council for Corporations
NASD	National Association of Securities Dealers
NIA	National Institute of Accountants
NSX	Stock Exchange of Newcastle
NYSE	New York Stock Exchange
PCAOB	Public Company Accounting Oversight Board
PDS	Product Disclosure Statement
SCAG	Standing Committee of Attorneys-General
SDIA	Securities and Derivatives Industry Association
SEATS	Stock Exchange Automated Trading System
SEC	Securities and Exchange Commission

SIA	Securities Institute of Australia
SME	Small and Medium Enterprises
SoA	Statement of Advice
"the law"	*Corporations Act 2001*
US GAAP	US Generally Accepted Accounting Principles