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Australian Securities & Investments Commission

ADDRESS BY

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AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

'PROTECTING THE INVESTOR: THE REGULATOR AND AUDIT'

TO

THE CPA CONGRESS 2002 CONFERENCE

PERTH, WESTERN AUSTRALIA

ON

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Front piece

(Introduction, acknowledgements, etc)

Financial Services Reform Act (FSRA)

Amidst all the other issues confronting us, the working environment at ASIC over the past 16 months has been greatly influenced by development of the FSRA and its introduction in March. It is the largest single logistical exercise that we have been called upon to implement and it will continue to form a substantial part of our regulatory workload for at least the next two years.

I do not intend to dwell too long on this subject because I'm confident that by now most of you are up to speed with the way it will impact your work and the affairs of your clients. So I will keep my comments short.

It is reasonable that each business sector affected by FSRA will be focussed on those particular aspects of the legislation that most directly impact on them. ASIC, on the other hand, must stand back to review the total landscape of the legislation which, in its entirety, may well represent the single most important piece of law reform for the financial services sector over the past 50 years. That may seem like a big statement, but when you consider that the purpose of this reform is to establish a common licensing, conduct and disclosure regime across all providers of financial products - and advisers in relation to those products – it is difficult to think of anything more ambitious having been attempted over that time.

Last night's budget increase for ASIC will be primarily designated to implementation of FSRA and its subsequent administration. It is a significant increase reflecting the dimension of this new law.

While ASIC has sought to influence certain aspects of the new law, and the regulations which are vital to its operation, we accept neither credit nor criticism for its final content. The law as enacted represents Government policy, concluded through the normal political process under the guiding hand of Treasury. In the period since the Government announced its response to the first CLERP 6 consultation paper, our emphasis has been to influence those areas that in our view raised specific implementation or on-going administration issues for ASIC. Our views were not always accepted, but we believe that we are well prepared to give effect to the law in accordance with its terms and intention.

An important part of that preparation was the issue of a number of policy proposals by ASIC which were the subject of consultation with industry groups, including the accounting profession. These proposals related to our intended implementation and interpretation of the law, and they were substantially influenced by the consultation process.

The FSRA has an impact across all persons in the financial services industry. Accountants have long been an important part of the financial industry and this will no doubt continue. Many accountants hold proper authorities under the old Corporations Act enabling them to provide financial services to their clients. Many others have been providing services incidental to their traditional accounting business. The industry has moved on, as has the nature and extent of services provided by accounting practices, and that process of change is likely to continue.

You will be aware that the definitions of 'financial product advice' under FSRA is very broad, but has been limited by exemptions for certain conduct.

There are transitional arrangements for TWO years extending the old 'incidental advice' exemption for pre-existing activities of individual accountants. Going forward, the Corporations Act does not contain an incidental advice exemption (as it did prior to the FSRA). Instead, there are a number of specific exemptions (eg tax agents: section 766B(5)). In addition, the regulations provide that certain activities of accountants, where they do not involve the provision of financial product advice as defined under FSRA, may not require an AFS license (reg. 7.1.29).

There has been much discussion within the industry about the impact of these provisions. We are aware that accounting bodies have been looking at the wording in that regulation to determine what guidance they can provide to their members. ASIC will publish some guidance by way of a Q&A format discussing the application of the FSRA provisions to those in the accounting profession. I expect this to address such questions as:

- Do I need a licence?
- What exemptions might apply to me?
- What rules apply through the transitional period?

I do not want to say more until we finalise this guidance, except to emphasise that the regulation will only apply to persons covered by an ASIC declaration that they are 'recognised accountants' (described as 'qualified accountant' until recent legislative amendments). We are today releasing a declaration as to which categories of members of the three largest Australian accounting bodies are 'recognised accountants'. I am pleased to tell you that all members of CPA Australia who are entitled to use the post nominals 'CPA or 'FCPA', and who are subject to and comply with CPA Australia's continuing professional education requirements, will be recognised under the law. The declarations will similarly recognise members of the ICAA and the NIA. We will also consider applications from foreign accounting bodies for their members to be declared as 'recognised accountants'.

ASIC expects that many accountants will continue to hold proper authorities or authorisations under the new legislation and no doubt some accounting firms will seek their own licence.

Fortunately, the transition timetable allows time for all of this detail to be clarified in coming weeks. In the meantime, I note that CPA Australia has commenced a series of roadshows on FSRA which will be coming to Bunbury and Perth next month. I have reviewed that material and strongly recommend attendance by all CPAs – it will answer a lot of questions and help you to meet your compliance needs before the two-year transition period expires.

The Regulatory Environment

Last March I called upon the new Chairman of the SEC in Washington, Mr Harvey Pitt. I found him to be a likeable and engaging man, with fond recollections of time spent in Australia on his honeymoon many years ago. I opened the conversation by remarking that we had something in common – that within a few months of taking office we both faced major corporate collapses which had not been fully factored into our career decisions. We had an interesting talk.

It is still quite difficult to identify any rational explanation for the extraordinary spate of corporate failures in Australia last year. Any one of HIH, One-Tel, Harris Scarfe, Pasminco or Ansett would have caused concern, but to have them all occur in rapid succession gave rise to the understandable supposition that some underlying causal linkage must exist.

On the other hand, it has been plain from the outset that there are as many differences between these failures as there are similarities. And as to timing, it remains entirely possible that the sequence of failure owes as much to chaos theory as to anything else. It is too early to write up considered conclusions on these issues, but it is possible to venture some observations and to test them in the context of on-going investigations and litigation. These then are some of my – not yet fully tested - observations:

First, that we had entered a period of complacency about corporate governance after many years of sustained growth and our own remarkable survival of the Asian financial crisis. The initial focus on corporate governance in the aftermath of the 1980s collapses was vibrant and innovative. Over time it became institutionalised and compliance focussed; more driven by process and legalistic liability management than by notions of shareholder wealth creation and protection. Not surprisingly, Directors started to question its relevance. Corporate governance became formalistic, even ritualistic. It lost momentum as an effective program for corporate risk management. We probably paid a price for that.

Secondly, that in more than one case, the seeds of failure were planted long ago and have flourished undetected, in part because of buoyant market conditions and relatively easy access to both equity and debt. It is very rare for companies to fail overnight. What sometimes present as suddenly emerged deficits are, in reality, the legacy of long accumulated ones brought into sudden relief by diminished cash flow which no longer permits a ‘going concern’ accounting treatment. It is possible that changing market conditions throughout 2000 played a part in the timing of some failures, by helping to bring buried problems to the surface. I think we can venture that observation quite

confidently in respect of the dot com sector. I am less confident about it in the cases of other high profile failures, but time will tell.

Thirdly, that in some (but not all) of the failures there is emerging evidence of management neglect or misconduct that is culpable. You will understand my reticence in exploring this theme in detail. But for the record I remind you of the following enforcement actions already initiated by ASIC:

- We brought criminal charges against the former CFO of Harris Scarfe, Mr Alan Hodgson, alleging failure to act honestly as an officer; dishonesty as an employee; and disseminating false information to the ASX. Mr Hodgson pleaded guilty and awaits sentence. Other aspects of this investigation continue.

- Civil proceedings have been commenced against a number of former directors of One.Tel seeking declarations that they contravened their responsibilities under the Act; orders that they be banned from managing corporations or acting as directors; and compensation of up to $75 million. In the interim, appropriate orders have been obtained to restrict dealing in assets and to monitor travel.

- Civil penalty proceedings have already been successfully prosecuted against three former officers of HIH in relation to a specific breach of the Corporations Act, involving an improper use of company funds and breach of duty. Again, ASIC has sought declarations, banning orders and compensation, plus pecuniary penalties. We now expect the Court's determination on the issue of remedies and penalties within the next few weeks. In the meantime, ASIC's investigation into possible offences connected with the collapse of HIH continue, as do the increasingly interesting proceedings of the Royal Commission.

There are, of course, many other proceedings already on foot relating to the conduct of officers and directors. They cover similar alleged breaches of duty, insolvent trading offences, insider trading offences and a range of other conduct and market offences. By any measure the past 12 months has been an active period for ASIC, during which we have placed high priority on responding to market circumstances quickly and effectively. Diligent, honest and competent directors have nothing to fear from this process. No-one is being prosecuted by ASIC for making a mistake. On the contrary, all company officers who promote ethical conduct and good governance should take comfort that there is a day of reckoning for the less scrupulous. My feedback tells me that this is so.

My fourth observation is that there has been a failure of accounting and auditing to deliver acceptable outcomes. There are many complex issues here. Some of them go to the content and style of accounting standards and the manner in which they are set. Others go to the quality and rigour of the audit process, raising some now well canvassed questions about auditor independence and conflict. In my opinion, at the very centre of this minefield, is the paradox that auditors are expected to reconcile a commercial service provider/client relationship with a watchdog/whistleblowing responsibility. All of the commercial incentives support their service provider/client

relationship; and there is very little legislative or other incentive to support their public responsibility role. No-one would accept that a regulator could properly function in such circumstances, yet we hold an expectation that auditors will perform as 'contracted regulators' of financial reporting. Not only that, but we permit this to take place under a regime where audit standards and their application are almost entirely self-regulatory; where those standards do not have the force of law; where the audit market for listed entities is dominated by a small number of major firms; and where the disciplinary and enforcement avenues available to the official regulator are limited and complex.

Quite obviously we need to see some changes to this environment if public confidence in accounting and audit is to be restored. Some responses, from both the profession and from Government, can be expected to further address conflict issues. In Australia we await the Government's response to the Ramsay Report which recommended several initiatives in this area, including audit partner rotation and additional oversight of independence standards. In the USA – and indeed most other parts of the world enjoying developed capital markets – the same issues are high on the agenda. Meanwhile, the convergence towards upgraded international accounting standards, covering risks that are inadequately dealt with presently and adopting a 'principles' approach in place of overly complicated rules, is gaining strong momentum.

All of this is good. Whether it will be good enough to redress the inherent relationship issues to which I have referred, and whether it will be accompanied by a genuine corporate commitment to financial reporting which tells the story warts and all – are questions yet to be answered. The next 12 months will be a crucial time for influencing the future.

With that in mind I commend CPA Australia for its initiative and leadership in publishing its reform proposals last month. While ASIC does not necessarily agree with all aspects of those proposals, it was refreshing to see the profession embracing significant policy shifts – including a five-to-seven yearly review of firm rotation - instead of defending the status quo, which I do not consider sustainable. I congratulate you for going onto the front foot.

In recent months we have seen a number of different contributions to this debate, both in Australia and overseas. Some have come from the profession, some from Government and regulators and some from the corporate sector. Recent contributions by the ANZ Bank and the Group of 100 are examples of how far the debate has advanced since ENRON imploded.

Many have cautioned against knee jerk responses. I entirely endorse that sentiment. It is essential that we take time to consider these issues from a 'first principles' perspective; to carefully restate the objectives and expectations of audit, and to ensure a process of consultation and counsel in the formulation of amended policy. ASIC has an important role to contribute perspectives which respond to investor concerns; and to promote a market in which the reported financial condition of corporates is reliable and credible.

In making this contribution it is not constructive for ASIC to be inflexible or dogmatic. On many of these issues under debate there is no absolute right and wrong; there is room for a range of possible outcomes.

Ten Measures for Accounting and Audit Reform

What is clear, however, is a pressing need for measures which will restore confidence and credibility to accounting and audit. Some time ago President Bush outlined a ten-point reform plan. I do not propose to be quite so ambitious this afternoon. However, I will now discuss ten measures which we place on the table as a contribution to this debate.

1. Australia should remain committed to the development and adoption of a complete and consistent package of international accounting standards. Those standards must address key areas of current international disparity and plug holes that currently exist. I include by way of examples: accounting for acquisitions and the resulting goodwill; accounting for other intangibles: accounting for executive and other stock options; recognition of off-balance sheet commitments resulting from leasing and similar arrangements; accounting for financial instruments including derivatives; and accounting for debt/equity instruments.

2. Those international accounting standards should redress the current dominance in some jurisdictions of form over substance – and reintroduce to the law an overriding qualitative accounting consideration and audit opinion that the accounts truly and fairly report the financial condition of the corporation. The 'true and fair override' was removed in Australia some years ago because it was perceived that it was abused by preparers, who simply used it to avoid standards they did not agree with. If, as we hope, it is reintroduced here through the international harmonisation process, it must be accompanied by enforcement sanctions to prevent the repetition of past abuses.

3. Australia should commit to the *wholesale* adoption of these updated international accounting standards. It is not acceptable that the efficacy of international standards should be undermined by selective fine-tuning by user countries. Our commitment to adoption should be unconditional. The AASB should, by the end of this decade, be almost entirely concerned with providing input into the international accounting standard setting process and only in extremely rare circumstances be issuing national standards that deal with uniquely Australian situations.

4. The principle of rotating audit firms should be embraced to underpin the independence of auditors and to counter-balance the influence of any long-term service provider/client relationship.

   I have previously stated that firm rotation should be seriously considered. I hold that view because I believe that partner rotation, while useful during the life of

an audit engagement, will not achieve the same result as firm rotation. It is not credible that one partner will seriously challenge the established audit practice and advice previously provided by his firm through another partner. Rotation of firms, as encouraged by CPA Australia, is the more credible process.

Nevertheless, I also accept the significant pragmatic obstacles that confront firm rotation, particularly in light of increased concentration of the profession. I accept that this is a worldwide issue and that Australia's interests would not be served by adopting a unilateral reform. This therefore is one of those 'first principle' issues which we place on the table for serious discussion and consultations, but without pre-judging of the outcome.

I also make the point that it doesn't have to be all or nothing. For example, one might contemplate firm rotation every seven years for listed companies as a 'default' position, but one which could be deferred by shareholder vote at the annual general meeting in the year preceding rotation. It is, after all, the shareholders we are trying to protect. If they are persuaded by their Directors that compulsory rotation might do more harm than good – taking account of the company's particular circumstances – then their voice should be heard. But at least a default position of rotation would ensure active shareholder participation in the decision. In our view that is something that should be put to shareholders at each AGM after the rotation period has expired until a replacement firm is appointed. I also make the point that voluntary adoption of this process by companies would send strong signals to their shareholders and the market about a genuine commitment to increased standards of governance and shareholder protection.

5. Audit and consultancy services should not be provided to the same clients. This is not the same as saying that audit firms should be banned from being engaged in consultancy. There is validity to the argument that diversity of service is desirable in order to maintain the attractiveness of firms to future generations of accountants. An ability to generate revenue streams across different business lines should not be readily dismissed.

   However, there is no denying the conflict that arises when audit and consultancy services are provided to the *same* clients. In such circumstances, it is natural and predictable that the firm will seek to optimise its overall financial return from the relationship. No amount of disclosure or Chinese walls will alter the dynamic of that commercial relationship. What is most likely to suffer? The rigour and independence of audit.

   For these reasons, we believe that firms should be precluded from providing consultancy services to their *audit* clients, but should be permitted to consult to other clients.

That is also something that might help to preserve a degree of pluralism of specialist accountancy services within the listed market segment, notwithstanding consolidation of the profession.

6. The law needs to more clearly set out its expectations for corporate whistleblowing. Consideration should be given not only to strengthening current reporting obligations of auditors to the regulator, but extending those obligations to a nominated officer of the corporation itself. Financial misconduct within corporations usually requires the transactional assistance of staff who know that things are wrong, but who feel unable to influence the outcome. The law should encourage, even oblige, such people to make known their concerns to the Board, the auditor and even directly to the regulator. One possibility that could be seriously considered is to impose such a reporting obligation on the most senior line financial manager of the corporation who is not a Board member. At first blush this may seem radical, yet in the insurance sector direct reporting obligations by the auditor to the regulator and by the in-house actuary already exist. Indeed, those obligations are being extended under general insurance reforms.

   Such obligations should be accompanied by adequate statutory indemnity to ensure full protection against recrimination by the corporation or other parties.

   The almost total absence of misconduct reports to ASIC by auditors in the past reflects the ambivalent nature of their existing legal obligation and the absence of incentive and protection. It is time to do something about it.

7. Existing auditing standards need to be reviewed to increase the rigour of audit. Those standards should have the force of law (as with accounting standards) and ASIC should have effective powers to police them.

8. At least for the listed sector, it should be compulsory for the Board (in the absence of full-time management representatives where the company structure permits) to agree to the audit mandate and to review audit issues with the auditors at least six monthly. Whether this is achieved through Audit Committees or not does not seem crucial. The much more important imperative is to reinforce the need for active dialogue between the Board and auditors, independent of management sanitization. In most cases an Audit Committee may well be the best way to manage that dialogue.

9. It should be compulsory that auditors attend AGMs of listed companies and that they be available to answer questions from shareholders. When this was last considered seven years ago objections were raised on the grounds that Directors are not themselves obliged to attend meetings. In my opinion, that is an anomalous situation which should be rectified. In the absence of valid excuse by reason of ill-health or other indisposition, directors and auditors should be present to account to shareholders on their one day of the year. I believe that this proposal should be back on the table.

10. Rather than mandating quarterly reporting, as recommended by CPA Australia, the current continuous disclosure regime should be reviewed to ensure that it captures the timely publication of relevant information to shareholders and the broader market. That review should examine the subjectivity inherent in the current ASX Rules; and the sanctions available to the Regulator. A robust regime of continuous disclosure, supported by proportionate and timely sanctions, remains the best means of sustaining a well-informed and transparent market.

There are two other aspects of the CPA Australia proposals that I wish to address briefly.

- The first is auditor liability. I am sympathetic to the concerns expressed by the profession, particularly about joint and several liability. I consider it reasonable that there should be some recognition of this concern in the total package of reform. However, it will always remain critical that adequate capital and insurance arrangements are in place to support the reasonable obligations of the firm.

- The second issue is CPA Australia's suggestion that a new umbrella body be established which, through an appointed committee, would investigate, monitor and provide discipline in relation to professional conduct.

  In ASIC's view, it is important that ultimate enforcement of the law should continue to reside with the government regulator – and that powers of intervention and available sanctions need to be flexible enough to ensure that the enforcement is effective.

  ASIC's roles in policing disclosure across a wide range of business sectors and in a variety of transactions, makes it impractical to treat financial reporting differently. For example, we are responsible for the continuous disclosure regime; for disclosure in prospectuses, schemes of arrangement and takeover documents – all of which involve us in considering financial statements and working directly with accountants and auditors as well as directors and officers. The direct connection with our enforcement work is also obvious. While some review of the current arrangements may be desirable it would not in our opinion be sensible, or publicly acceptable, to seek to reduce the role of the independent regulator. Indeed, we should be looking to enhance the regulator's oversight in some areas.

End piece

Ladies and Gentlemen, accountancy is an honourable profession, which plays a central role in the efficient management of our free enterprise economy. It is going through a testing time during which the vast majority of hard working and diligent members of the profession are under scrutiny. Most would agree that any recent failures of the

profession have to be assessed in the context of the more culpable shortcomings of corporate managers who have been in the driver's seat.

Yet this is a wake up call about the need for all professions to be vigilant in safeguarding their traditional values.

A culture which places optimisation of financial reward above all else is inconsistent with professional values and endangers professional ethics.

Now is the time for all individual accountants who value the profession's history of integrity and honour to reclaim lost ground. If I am right, the biggest battles lie not with public policy makers or regulators, but within the profession itself and within corporate Australia. Don't be passive. Take up this fight. This is your reputation we are talking about.

CPA Australia has made a valuable contribution to the current debate about the future of accounting and audit in our economy. I have been grateful for this opportunity to comment on that contribution and to explore some of the issues with you this afternoon.