Independent oversight required:
A response to calls for change.

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March 2002

Abstract

This paper addresses matters dealing with the monitoring of compliance regulation. It concludes that the Financial Reporting Council is the inappropriate body to manage that process. The FRC should have within its domain of influence the oversight of standard setting or rule making activity. Giving it oversight of what is ostensibly policing or monitoring work would be a convenient contravention of the doctrine of the separation of powers. Placing policing functions in the hands of the FRC can also pose risks to the maintenance of public confidence in the process should there be any lapse in performance of any of the bodies being overseen by the FRC. Future downturns in economic activity and the inevitable focus on the roles of accounting professionals in corporate calamities might lead to a loss of public confidence in the entire structure if the FRC is given responsibility for all areas. Limiting the FRC's role to oversight of standard setting would be responsible risk management and ensure the one structure is not seen as being rule maker, police force and the judiciary.

The paper recommends the creation of a new body tentatively called the Australian Corporate Governance Commission that should assume key responsibilities allocated to the body Professor Ian Ramsay calls the Audit Independence Supervisory Board or AISB. The corporate governance authority's mandate should be broader, however, and incorporate other areas in which the business community and general populace have an immense and understandable interest. Such areas include the conduct of administrators and receivers in charge of companies in financial distress. The corporate governance authority may also be called upon to set up select committees to conduct research and prepare reports on the state of corporate compliance with initiatives designed to improve transparency in corporate reporting. This response to the Ramsay Report and subsequent suggestions of reform by the Federal Government also looks at the areas that because of their nature remain out of the reach of the hands of monitoring or policing authorities.

Other matters addressed in the paper include the need for the Australian Accounting Standards Board to address the further development of the statements of accounting concepts in order to lay the groundwork for advances in the reporting of cash flow information, changes in financial position and other areas that have been the subject matter of much debate following recent corporate collapses. It is argued the FRC should spend more time harnessing funding and calling for greater resources so the board could comply more fully with its legislative mandate as set out in Section 227 of the ASIC Act 2001. The development of a conceptual framework is among those functions and no advances have been made on two outstanding theory monographs on solvency and measurement in financial reporting.

An expansion of existing regulatory activity in monitoring compliance with financial reporting standards is considered. Such an expansion of the present program of surveillance of financial reports done by the Australian Securities and Investments Commission could only be done with an increase in funding and human resources.

Introduction

Almost too much attention has been focused on auditor independence over the past 12 months. While the attention to whether auditors have satisfactorily fulfilled their duties is understandable in the light of recent examples of corporate failures and significant lapses in risk management in US and Australian companies the matters surrounding auditor independence have been given far too much airplay. Shining the spotlight on one aspect of the corporate governance framework has led to a distorted picture being painted by some commentators about the role auditors, auditor committees, the audit process and financial reporting standard setting play in ensuring the investor has a high quality of assurance provided on the financial statements produced by a reporting entity in accordance with accounting standards[1]. These factors are hardly the stuff of soap operas and have little appeal to journalists and those scribes are generally discouraged from pursuing what news editors would generally term 'arcane' accounting issues. Editors, it must be said, sometimes measure editorial decisions on accounting and auditing issues on how sensational an item is likely to be rather than use the introduction of new rules and regulations as an opportunity to educate the very investors that will see changes in financial statements.

The assurance role played by auditors when they audit financial statements is poorly understood. A similar assessment can be made about the community's understanding of what independence regulations currently exist. This is particularly the case with professional firms and how self-regulation within these practices operates. It is this fundamental lack of knowledge that drives much of the so-called mystique about what accountants and auditors do for a living and whether their independence is compromised in certain circumstances. Attempts to address the knowledge gap within the community have been plentiful since the rash of corporate misadventures such as HIH, Harris Scarfe and One.Tel began to unveil themselves during 2001. Accounting firms have been busy trying to fulfill what has at times been a neglected social responsibility and engaged in educational initiatives to bring greater knowledge about auditing to the average person out in the community[2]. These efforts have been in some respects a reactionary approach to the environment the accounting profession faces rather than a true demonstration of advocacy such as that discussed in an article written during the 1980s by Professor Stephen Zeff from Rice University, Texas. Zeff argued there was ample evidence to indicate accounting firms had lost their drive to provide thought leadership on financial

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[1] This submission will refer to reporting entities where appropriate. The reporting entity concept as embedded within the less than complete conceptual framework for general purpose financial reporting embeds within it the all important concept of reporting to all possible users of an entity's financial information. It is generally assumed the financial statements of these entities have been subject to audit and that they comply with all accounting standards. Some accountants and their clients have sought to find cause to classify some companies as non-reporting entities to dodge compliance with what are sometimes complex accounting rules.

[2] Ernst & Young recently published a corporate governance report focusing on auditor independence and accounting issues arising out of Enron and similar circumstances. PricewaterhouseCoopers published a booklet setting down its view of how the confidence of the capital market can be maintained with the interaction of all key players.

reporting and auditing matters through firm publications. The firms – there were eight major firms at that time – had placed a greater emphasis on client services, Professor Zeff asserted, than providing thought leadership in the public interest:

> *Publishing and writing have been assigned a lower priority within the Big Eight firms in recent years, principally owing to changes in the competitive environment, the reorganization of the standards-setting function, and increasing levels of litigation and congressional oversight. Most firms evidently do not see the benefit either in terms of enhancing their image or, when dealing with clients, from using their publications or partner writing time to advance the professional dialogue over the aims of financial reporting or the comparative merits of particular accounting standards. In the current competitive environment, the imperative of serving one's clients has become paramount. (Zeff 1986)*[3]

This observation, which was made in the context of the American profession during the mid-1980s, is equally true of the Australian accounting environment today. The firm impression left by some practitioners and their behavior is accounting standard setting issues with even the slightest bit of controversy do not merit the expression of a firm view in the open air for fear of inspiring client revolt or at least encouraging a client to put the external audit to tender. Most of the writings in the recent past generally fall into the category of avoidance of regulatory risk and understanding specific accounting treatments being introduced by a new standard. Very few experts engage in public debate on contentious accounting matters and some deliberately seek to avoid public discussion. Few writings propose a way forward in financial reporting and those that do tend to be driven from other parts of a global firm.[4] The absence of domestic and vocal thought leadership on standard setting and auditing reforms may have helped to contribute to the public perception that some auditors and financial reporting experts may be pliant and led to the inevitability of public misunderstanding of the audit function. It may also serve to support the case some parties are putting to have the profession lose some aspects of self-regulation despite the fact functions such as audit and assurance standard setting have generally been conducted satisfactorily under the auspices of the Australian Accounting Research Foundation. The above comments, however, are not intended to denigrate the current contributions to the debate. Those think pieces that have been produced since the collapse of some of Australia's corporations may well be an omen signifying the return to robust thought leadership within the top firms in Australia. The special technical staff of the major firms in particular should be encouraged by their firms to help the rest of the practice renew its covenant with the body of investors the auditors ultimately serve with the assurance product.

Educational and thought leadership initiatives alone are unlikely to produce the necessary level of public confidence the accounting profession – more particularly the auditors within its ranks – needs to ensure the respect for accounting professionals and their output is sustained. The report authored by Professor Ian Ramsay presents a scenario dealing with audit independence oversight within the limitations of scope of his review.

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[3] Zeff, S. A. "Big Eight Firms and the Accounting Literature: The Falloff in Advocacy Writing" *Journal of Accounting Auditing & Finance*, Spring 1986, p. 131-54.

[4] The work done by PricewaterhouseCoopers on improved corporate reporting as a part of its ValueReporting framework is an example where a concept has been rolled out internationally by PwC following research done by US and UK-based partners.

Independent oversight needs to be seen in a broader context when reforms to aspects of the accounting and auditing environments are being considered. The provision of independent oversight of the accounting profession, company directors and corporate management and the financial statements is critical to ensuring the integrity of the market. Independent oversight of auditors is important so the individuals charged with the task of standing in defense of the public interest have a more visible accountability to a body representing users of the audit product: large and small investors, employees, creditors and, of course, prospective investors that might use the financial statements as one part of making and investments decision. Another group – receivers and administrators - also needs to be subject to similar oversight because they have a role with the same if not a greater level of obligation to the public interest when a company is being wound up. Issues such as the independence of voluntary administrators when they are called in by a board of directors of a company are equally relevant to the matters being raised in the context of the current auditor independence debate.

Independent oversight should also be seen in the context of the role played by other actors within the Australian capital market. Oversight of auditors, company directors, administrators and receivers represents an important part of the process, but effective oversight of accounting standard setting and the oversight of the quality of financial reporting in the marketplace must also be taken into account when evaluating what initiatives might assist in improving the current environment.

The Ramsay vision

The report into auditor independence by Professor Ian Ramsay from the University of Melbourne released last October recommends that there be an oversight function specifically dedicated to policing the observance of independence regulations in the Australian financial market. Professor Ramsay's report embodies the oversight functions in a body he christens the 'Audit Independence Supervisory Board', or AISB. In his report he describes the AISB as having a critical role in maintaining a long-term focus on independence issues:

> *An independent supervisory board is an essential instrument in addressing the challenge of implementing new auditor independence requirements in Australia. The new board, which will be known as the Auditor Independence Supervisory Board (AISB), will play a vital role in ensuring public confidence in the independence of auditors by monitoring implementation of the new regime, compliance with it, and important international developments in the area of auditor independence. Transforming the system governing auditor independence goes beyond regulatory change and strengthening professional requirements. The proposed changes contained in this report are not the end of the process of continuing to ensure auditor independence. Continued supervision and monitoring of auditor independence is required.*[5]

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[5] Ramsay, Ian (2001) Independence of Company Auditors: Review of Current Australian Requirements and Proposals for Reform, Commonwealth Government of Australia, page 12 (referred to as the 'Ramsay Report' hereafter). The page numbering refers to the electronic version available on the Treasury web site (http://www.treasury.gov.au) in Rich Text Format, or RTF.

The AISB would have direct responsibility for the oversight of independence related issues, according to Professor Ramsay's magnum opus, including the review of corporate compliance with independence regulations among others. Members of the AISB would be drawn from a broad range of bodies under the Ramsay proposal because of the Professor's stated belief the independence supervisory body should strive to represent all potential users of the audit product as well as those involved in generating it. Groups Professor Ramsay believes need representation at the supervisory board level include the Investment & Financial Services Association, Securities Institute of Australia, Institute of Internal Auditors of Australia, Australian Securities and Investments Commission, Australian Stock Exchange, Australian Shareholders Association, Australian Institute of Company Directors, three representatives of the public interest and the two main professional accounting bodies: CPA Australia and the Institute of Chartered Accountants in Australia.

The report's recommendations propose the nominating organisations choose their representatives and those individuals would be appointed by the Federal Treasurer. Members of the AISB would be served by a secretariat consisting of an executive director and a small professional staff, the report states, and it would be located within accommodation provided by the accounting profession. The report is careful to state the AISB should not reside to close to any of the professional bodies. Professional accounting bodies, however, would foot the bill for the AISB under one of the funding scenarios set down by Professor Ramsay. If the funding was provided by the bodies it would need to be guaranteed for a fixed period and provided without any additional terms and conditions. Another funding proposal floated in the report is an increase in the fees for auditor registration. It is a part of the 'user pays' perspective that permeates that part of the Professor's report. The report spells out in no uncertain terms the profession has a stake in the independence issues being dealt with properly:

> *It is crucial that the AISB operate as an independent and autonomous body. However, funding for the AISB should not be a drain on scarce public resources. The profession has a large stake in the issue of auditor independence, and accordingly, the profession should be responsible for the financial support of the AISB. This method of funding is in line with the UK model, and represents the only realistic source of funds. The method of funding could either be direct funding by the professional accounting bodies or a small increase in the registration fee for auditors. Appropriate mechanisms, such as the balanced nature of the board, majority non-professional membership, and provision of a fixed sum, will ensure that the funding cannot compromise the independence of the AISB. If the funding is provided by the professional accounting bodies, it must be locked in for a predetermined period and provided on a 'no strings attached' basis.*[6]

The 12-member board under the Ramsay vision of audit independence oversight would have the responsibility to:

1. Prepare and publish an annual report for publication to the public;
2. Monitor international developments relating to auditor independence;
3. Advise the professional accounting bodies on matters of independence;
4. Monitor audit firm compliance with independence requirements;
5. Monitor corporate compliance with independence regulations; and,

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[6] Ramsay Report, page 13

6. Monitor the teaching of professional and business ethics.

Ramsay’s oversight vision: some criticisms

One of the problems with proposing any committee is that it will always attract criticism in the same way a lamington attracts flies. The concept underlying the oversight function is sound and it provides a much-needed balance to the other measures that are for all intensive purposes self-regulatory initiatives. Better-informed audit committees, for example, only become that way if the directors involved have an understanding of exactly what the finance director or the chief executive of the company are putting before them. The recommendation dealing with financial literacy is sensible and so self-evident that no reasonable basis could be mounted against the suggestion. The same goes for the incorporation of the recommendation from an initial report on audit registration and regulation released by the Coalition Government back in 1997. Those recommendations also merit urgent consideration. Few commentators have argued with those and other recommendations. The recommendation that has caused the greatest amount of fuss has been the oversight board.

One of the difficulties with the oversight board as outlined in the Ramsay Report is the focus on representation from all possible groups. That number could easily be expanded if, for example, the National Institute of Accountants (NIA) sought membership because it is a professional accounting body with members who do audits within its ranks. Any group that even has a general interest in financial accounting or auditing could begin agitating to become a part of the new governance structure. This is a problem that will plague all boards that have as a fundamental principle that appointment of members from each constituent group. This circumstance increases the potential for bodies placing individuals on such a board that have no personal interest in the issue and it may result in more harm being done than good. Appointments to such boards are better made if the basis for appointment is related to individual merit, professional reputation and personal interest in the independence debate rather than the color of the membership ticket. While the participating organisations may well have the best intentions at heart the mere fact they have a seat they must fill poses a great risk that the appointee could end up being a body going along for the ride.

The narrow focus of the funding base in the report could leave the system trying the regulatory equivalent of running the length of the Hume Highway with half a tank of petrol, a steaming radiator and four flat tyres. Assurance Standards Board structure currently funded by the two main accounting bodies. It should be noted that CPA Australia did indicate when the Ramsay Report was released it might be prepared to entertain the funding of an AISB-like body, but the funding of such a body would be at the expense of something else. A funding model that seeks to maintain some balance in the funding mix is to be preferred. While examples of funding models are providing by looking around the globe the initial model floated by the Federal Government for the funding of accounting standard setting, which is based on the UK model, called for the provision of a third of funds from government, a third from the accounting profession and a third from the corporate sector. The ‘City of London’ approach has not yet netted funding for the accounting standard setting process from the corporate community although it is understood some progress is being made to getting agreement from the corporate sector.

It is unclear from the report how some of the functions set down for the independence standards board would be implemented and to what extent additional committees and resources would be required to fully meet the key tasks as set down in the Ramsay Report. The implementation issues arising from the those functions mentioned in the report would presumably be ones the AISB itself will need to resolve when it meets as a body to contemplate how it will operate. There is an indicate of how at least one of the functions – the monitoring of accounting firms and their independence and quality assurance processes – would work according to the report:

> *The AISB will monitor the nature and adequacy of systems and processes used by Australian audit firms to deal with issues of auditor independence and advise on the adequacy of these systems and practices. The accountancy bodies should be prepared to enter into an agreement with the AISB to provide reasonable access to people and papers to help the AISB with this monitoring process.* [7]

Whether it is appropriate for the AISB to use other people’s resources in fulfilling these monitoring roles is a critical question and one that needs further contemplation. The proposal is made with the presumption that all parties will seek to cooperate with the oversight board at all times. One concern arising from this is that a regime that relies on voluntary parting of any information is some parties may at some stage in the future refuse to cooperate and lower the effectiveness of the review process. The government would want to avoid replicating the situation that plagues the accounting the disciplinary processes that are a part of the self-regulatory structure of the professional accounting bodies. While the bodies all have disciplinary committees the committees do not have the power to compel individuals or firms to part with documents that might assist in their decision making processes. Material documents could remain unseen by the disciplinary committee and a decision made solely on the basis of available evidence. That would be a handicap for a structure that has the role of policing the compliance with independence regulations. The Australian Securities and Investments Commission is in a different position when it pursues accountants and liquidators on disciplinary issues. It has specific powers allowing it to seek and obtain access to documents under its enabling legislation. The ability of one to attain information and, conversely, the inability of the other to do so could result in different findings if the same auditor or liquidator faces disciplinary proceedings before the Companies Auditors and Liquidators Disciplinary Board, the statutory body to which ASIC refers enforcement matters relating to the discipline of auditors and liquidators, and a disciplinary committee proceeding launched by the relevant accounting body of which he or she is a member.

One way of avoiding this situation would be to establish a separate team of independence reviewers that have powers to access documents provided for in legislation. Such a provision would ensure access to information remains unfettered and the public

[7] Ramsay Report, Pages 60-61

confidence in the process having the necessary resources and legislative backing to carry through what is clearly a necessary oversight role. To have an oversight body reliant on other resources and other people's goodwill merely imposes unnecessary shackles on a body that should be in both perception and reality self-sufficient from the very second its existence is enshrined in legislation. It must be a body that itself embodies the spirit of independence in its behavior towards those it is charged with policing and those in whose name the monitoring of the profession and company directors is being conducted. Sufficient power must be given to the oversight authority to ensure its inquiries have minimal chance of being obstructed by those the oversight body's review team is examining.

Post-Ramsay developments on oversight issues

The Ramsay Report is only one of the key discussion prompts being examined by commentators in the accounting profession as individuals contemplate what oversight model would be appropriate. It is useful to note at this point that a statement released by the chairman of the Securities and Exchange Commission, Harvey Pitt, mid-January[8] contemplated a radical shake-up of the way the accounting profession was held to account to the community. Chairman Pitt made strong suggestions that the processes of peer review needed reshaping and independent agencies should be formed to deal with reviewing audit practices. Among the changes recommended by the SEC chairman was a revamped process dealing with the disciplining of auditors. The changes advocated by the top securities watchdog included the following features:

1. The system should be subject to a new body that is dominated by public membership.
2. The SEC should decide whether conduct should be pursued as violations of law (in which case the SEC would handle it), or pursued as violations of ethical and/or competence standards (in which case they would be handled by the private sector regulatory body).
3. The body should be empowered to perform investigations, bring disciplinary proceedings, publicize results, restrict individuals and firms from auditing public companies.
4. The disciplinary proceedings should proceed expeditiously.
5. Disciplinary actions should be subject to SEC oversight.

The SEC Chairman also listed several factors that should be present in a refashioned system of quality assurance reviews:

1. There should be a reform of the current peer review process that avoids firm-on-firm review.
2. The new process should replace the current triennial firm-on-firm peer review with more frequent monitoring of audit quality and competence designed to produce better audits in the future.

[8] The relevant statement was released by the SEC chairman on January 17, 2002 and may be viewed in its entirety at http://www.sec.gov/news/speech/spch535.htm . Other speeches dealing with the SEC's position on improving the level of oversight in the profession and corporations generally may be viewed at the speech index that is found at http://www.sec.gov/news/speech.shtml .

3. There should be a permanent Quality Control staff, composed of knowledgeable people unaffiliated with any accounting firm.
4. The staff should be deployed and overseen by the new publicly dominated body and its staff.

The above ideas were canvassed by the Chairman of the US corporate regulator after the collapse of energy company Enron with all of the accompanying publicity about the alleged conduct of certain members of the partnership and staff of accounting firm Andersen with respect to the destruction of documents that may have assisted the investigations the SEC and other parties were commencing to understand the reasons why Enron descended into bankruptcy. Hearings into the Enron collapse and the general role of accounting and audit in the capital markets conducted by the US Congress have added further fodder for the consideration of these issues. A more recent development that has given greater impetus to the corporate governance policy debate has been the very public call by US President George Bush for the implementation of a 10-point plan to improve corporate behavior in the United States. His statements on the need to lift the standards of corporate governance follow on from his reference in his State of the Union address on the need to ensure accounting standards in the United States are strict:

> *Employees who have worked hard and saved all their lives should not have to risk losing everything if their company fails. Through stricter accounting standards and tougher disclosure requirements, corporate America must be made more accountable to employees and shareholders and held to the highest standards of conduct.*[9]

The President's post-Enron 10-point plan, which contains some recommendations affecting the accounting profession:

1. Each investor should have quarterly access to the information needed to judge a firm's financial performance, condition, and risks.
2. Each investor should have prompt access to critical information.
3. CEOs should personally vouch for the veracity, timeliness, and fairness of their companies' public disclosures, including their financial statements.
4. CEOs or other officers should not be allowed to profit from erroneous financial statements.
5. CEOs or other officers who clearly abuse their power should lose their right to serve in any corporate leadership positions.
6. Corporate leaders should be required to tell the public promptly whenever they buy or sell company stock for personal gain.
7. Investors should have complete confidence in the independence and integrity of companies' auditors.
8. An independent regulatory board should ensure that the accounting profession is held to the highest ethical standards.
9. The authors of accounting standards must be responsive to the needs of investors.

[9] President Bush's State of the Union address is located online at http://www.whitehouse.gov/news/releases/2002/01/20020129-11.html and his corporate governance platform may be viewed at http://www.whitehouse.gov/infocus/corporateresponsibility/ .

10. Firms' accounting systems should be compared with best practices, not simply against minimum standards.

These developments and numerous others need to be factored into any consideration of how best to implement the core notions embedded in the recommendations presented by Professor Ramsay in his report.

The inappropriateness of a 'one-stop' solution

Professor Ramsay's report seeks an independent oversight body that is independent of other organisations with a life of its own and an unenviable swag of responsibilities. The very government that commissioned the report has opened the field somewhat wider with a competing option. Should an independent oversight authority sit out on its own and oversee the auditing profession or is it better to integrate it into a single structure such as an existing standard setting regime in order to avoid setting up yet another organisation that deals with accounting or auditing matters? Senator Ian Campbell, parliamentary secretary to the treasurer, has proposed the Financial Reporting Council be considered as a possible alternative to the 'stand alone' model set down in the Ramsay Report. Senator Campbell has suggested tweaking the present constitution and functions of the existing oversight body that deals exclusively with the setting of accounting standards might be a way of avoiding the setting up of yet another statutory board. This concept is fatally flawed and could lead to public confusion about the respective roles of the authorities coming under the FRC's wing. It also has the potential to create a reputation risk for all concerned when the economy goes into another downward spiral. While the intent of the present process is to come up with a solution that enhances the public's confidence in the institutions of corporate governance such as the independent audit a body that might be looked at as a one-stop shop regulatory of accounting and audit must give accountants, companies, investors and other users of financial reports serious cause for concern. Several misgivings related to the concept are set out below.

The pursuit of a comprehensive regulatory model that does everything imaginable in the accounting and audit arena is a betrayal of the basic convention governments in most countries follow. A comprehensive model established under the FRC, which is a statutory oversight body, would be an immediate violation of the separation of powers, a concept that has clearly been enshrined in our system of government. This concept is deemed crucial for the maintenance of checks and balances within a society. Curtis (1968) outlines the concept in the context of the American system:

> *[The separation of powers] involves the establishment of three separate departments or institutions, a legislature, an executive branch of government and a judiciary, each of which is almost exclusively responsible for the exercise of one of the three functions of governments, and has little to do with the other two functions. Separation of function is reinforced by separation of personnel, which is created by forbidding any person to be a member of more that one institution.*

> *The model exemplifying the concept of the separation of powers is the American Constitution which incorporates all three features of the theory: tripartite division of governmental functions, the creation of three institutions corresponding to those functions and the separation of personnel.*[10]

If the principle of separation of powers is applied to the proposed notion of providing standard setting and policing functions under the FRC, the FRC model would clearly fail that test. It would also be inconsistent with the public policy governance structures that are in place within the general community. The system of government in Australia places great weight on the concept of the separation of powers and no one body is said to assume or oversee every single function in society. Parliaments debate, draft and pass documents that become parts of a jurisdiction's books of law. Policing or enforcement agencies are charged with the task of ensuring to the best of their ability those laws as set down by elected representatives are observed. It goes without saying that the role of the judiciary is to rule whether allegations brought against individuals by the state or through a civil action can be sustained and what sanction, if any, should be handed down to the party receiving the adverse finding. A case for why the accounting profession should be singled out for special treatment and be subject to a superstructure that makes sets standards and then polices compliance with them is yet to be established with any credibility.

A reason for folding in the oversight functions delineated by Professor Ramsay in his report into the FRC's domain appears to be a reluctance to entertain the establishment of a body that oversees auditor independence matters that is independent and not beholden to other structures. It is insufficient to set down the reluctance to establish yet another statutory authority as a reason for dropping audit independence oversight matters within the FRC's charter. Each of the tasks delineated by Professor Ramsay in his report is important in its own right and the appropriate respect should be given to each one of those functions of an oversight body. An unwillingness to create another statutory board is insufficient reason to fold the oversight of audit independence functions into the FRC's realm and probably indicates a partiality to sloth rather than a provision of a workable solution relating to oversight. The FRC has other responsibilities under legislation and should not be distracted from pursuing those effectively. These responsibilities are discussed in more detail later.

Placing the oversight of audit independence within the remit of the FRC would be out of step with the two bodies that have a role in the setting of financial reporting standards in both the United Kingdom and the United States. The UK Financial Reporting Council is responsible for overseeing two bodies, the UK Accounting Standards Board and a body known as the Financial Reporting Review Panel[11]. No mention is made of the regulation and oversight of auditors within that structure. The Financial Accounting Foundation[12], which is the body that oversees the Financial Accounting Standards Board (FASB), only has the oversight of the accounting standard setting process within its governance

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[10] Curtis, Michael (1968) Comparative Government and Politics: An Introductory Essay in Political Science, Harper & Row, New York

[11] The functions of the UK Financial Reporting Council are spelt out usefully on its web site at http://www.frc.org.uk .

[12] Details of the FAF and FASB are available on http://www.fasb.org .

responsibilities. Those two organisations have little in common with the general direction of what appears to be an initial preference on the part of the government. A body known as the Accountancy Foundation in the UK, however, deals with audit standard setting, business ethics and disciplinary procedures[13]. While this model looks attractive it does not adequately cater for the potential for the risk of a loss of public confidence in any one of the committees under its watchful eye about which more will be said below. This model also contravenes the very principles of separation of powers even taking into account the fact that every board or committee involved is constituted as an entity in its own right. Even the suggestions made by SEC chairman Pitt regarding an oversight body that looks after both the policing and discipline contains that fundamental flaw. The UK model and the Pitt proposals might provide some inspiration to some individuals who have experienced a momentary flush of reformist zeal, but it is far from being the ideal model for dealing with the many issues raised in a debate that is ostensibly about ensuring confidence in capital markets. This type of solution may threaten rather than enhance the public's ability to have faith in the system.

Placing a number of functions under what could be characterised as a 'circus tent' solution to accounting and audit regulation has some severe repercussions in the event of a further economic downturn. In the current circumstances most functions have a home separate from each other and this has the effect of ensuring that one underperforming piece of the regulatory structure overseeing corporate governance does not bring the other functions down with it. Putting policing functions into a structure that also oversees rule making as well as potentially being in charge of discipline places the entire 'Big Top' at risk. The circus tent analogy is most appropriate here. If one tent pole collapses the entire structure is affected. It looks less than stable and while other tent poles might be dong their damned best to stay up it is the one that has collapsed that captures the attention of the outside world. Depending on which tent pole has fallen over the result could be the entire tent collapsing. Those examining the process would then have every right to ask whether audit oversight functions are being properly run if the accounting standard setting body is being a bit slow or is having difficulties in generating output. An entire structure can be placed under a cloud because one component is being less than efficient or is operating poorly. What the government's spin doctors might want to sell as a foundation stone upon which to build the confidence of the Australian capital market could very well turn a quagmire that causes greater problems because of a decline in public confidence.

A structure that has all of the individual components of the governance framework operating within their own independent structures has a greater chance of avoiding the potential decline of public confidence in the system during a time of controversy. A problem with a standard setter remains the problem of a standard setter and not a policing or judicial-type body. Imagine this model to be much like the internet where things are generally connected but if one part of a network goes down for a while the other elements can continue without being knocked out of action. While sources of funds to establish some additional structures will need to be firmed up the ideal model is one that improves the current state of play without placing all the regulatory 'eggs' in one basket.

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[13] Ramsay Report, pages 56-57

An additional concern about proposals to reconfigure the FRC as it currently exists to accommodate other structures is the relative youth of the new accounting standard setting structure. The structure has only been in place formally since January 2000, which is when the legislation establishing the FRC and the AASB was proclaimed. That legislation, which was passed by the Federal Parliament in October 1999, created a new accounting standard setting regime. It would be an unfortunate disruption to the processes of standard setting to have yet another structural upheaval. Important work is presently being done by the AASB. The FRC also has sufficient work to do with regard to fundraising and monitoring the existing processes to ensure the AASB has access to adequate resources so all of the necessary projects and other initiatives can be completed in a timely manner. Members of the FRC, furthermore, should be considering what the board should be doing to fulfill all of its responsibilities under Section 227 of the Australian Securities and Investments Commission Act (ASIC Act), which includes the further development of the conceptual framework for general purpose financial reporting.

An alternative solution: a corporate governance commission

Rejection of an FRC-based model then begs the question regarding what other structure could possibly deal with the oversight of auditor independence matters. This body cannot be seen merely as a siphoner of overseas developments or the equivalent of a Sunday afternoon tea party for a group of people keen to ensure standards of independence are kept high. It needs to have within its remit the ability to make legislative instruments that set down specific guidelines regarding corporate governance, audit independence and the conduct of insolvency practitioners during engagements. It must have the capacity to have access to its own resources to monitor or police the compliance with independence regulations. Where serious breaches of the Corporations Act are evident the oversight body must have a legislative obligation to pass those instances directly to the ASIC for enforcement action. Such a body might be called the Australian Corporate Governance Commission.

The Australian Corporate Governance Commission would be a body with whom the responsibilities for the oversight of corporate governance behavior, particularly those aspects dealing with the independence of auditors and the conduct of directors and management in the course of external audits, would be addressed. This body cannot be a mere high-level discussion group that results in general understandings about appropriate behavior. That would be a waste of everybody’s time. It must be a body that is given the right to develop delegated legislation in the form of regulations or standards that would be enforceable by the Australian Securities and Investments Commission should the recommendation to incorporate a general provision dealing with the general recognition that auditors must be independent is made in the legislation[14]. It is one of the key recommendations in the Ramsay Report and operationalising it would be a challenge

[14] Things that might be the subject of regulations or guidance issued by the Corporate Governance Commission might be the setting of guidance on continuous disclosure practices or procedures to determine how non-audit services should be allocated.

without being able to put some flesh on the general requirement for auditors to be independent.

The corporate governance body contemplated in this submission would begin life with at least three committees within its structure. A board of trustees would need to be established. This board of trustees consisting of eminent persons should be empowered to appoint the members of the oversight boards and have within its legislative remit the responsibility to create committees to research and report back to the oversight board and the general community on matters concerning trends in corporate governance. It should also have within its responsibilities the funding and provision of resource such as staffing and accommodation. The staff for the Australian Corporate Governance Commission would need to be substantial enough so a range of tasks such as the ones identified in the Ramsay Report can be fulfilled.

Membership of the board of trustees should be no greater than seven individuals and no fewer than five. Those individuals should be appointed by the Federal Treasurer. While the individuals appointed to the board of trustees may represent different elements of the business community appointments to the board of trustees must be made on the basis of merit. An ideal board of trustees might consist of a former regulator, a professional director, a former or currently serving chief financial officer, a former partner of an accounting firm with experience in either audit or financial reporting matters, an academic with a specialisation in audit or corporate governance matters and a retired or currently employed investment analyst. This type of line-up would cover a range of disciplines that might be useful in evaluating issues the board of trustees might want to request one of the oversight boards examine in more depth. It is merely an illustration of what might be possible within the constraints of a small group. It is unlikely, however, the board of trustees would ever be made up of individuals from only one part of the business or general community.

The board of trustees would have the responsibility to appoint an oversight board that would review of the conduct of relationships between auditors, company directors and company management. Members of the board of trustees would also appoint an oversight body that would monitor insolvency practitioners in a similar manner to which the auditors, company directors and company management would be overseen by the audit oversight board. A third committee monitoring the teaching of business and professional ethics as advocated by the Ramsay Report should also be a matter for consideration. Care should be taken that the size of these committees is large enough to have reasoned and broadly based debate on the issues before them, but also that the numbers are not so great that they make the exercise unworkable. Seven or nine members on the audit independence oversight board, for example, might be all that is necessary if there is also a due process associated with anything that board might issue as a pronouncement.

The audit oversight board would have a range of responsibilities that should include:

- Review of reports produced by corporate governance body's staff on accounting firms and their adherence to best practice independence measures. The professional staff of the corporate governance commission should have several individuals dedicated to quality assurance and independence reviews of practices so the reviews are done by independent parties rather than by professional accounting firms looking at each other.

- Review of corporate compliance with independence regulations. Research to identify the trends in corporate compliance could be commissioned by the oversight board to a university or an accounting firm and done annually.
- Provision of advice to professional accounting bodies on independence matters and monitoring the international scene in order to ensure Australian practice remains at global best practice.
- Issuance of guidance to auditors and company directors on appropriate conduct in specific circumstances such as the creation of processes to ensure engagements between the external audit firm the company that relate to matters other than the external audit have gone through an approval process.
- Consult at least annually with a group of constituents representing the various lobby groups affected by corporate governance and independence matters. This could be run along the same lines as the consultative group meetings run by the AASB.
- The review of legislation and how it impacts on the way in which auditors, directors and company management interplay. This should be a continuous process.

Similar duties with the appropriate modifications should be set down for the insolvency practitioners' oversight board, but the emphasis would clearly be on matters that are specific to that area of practice. Analysis of issues such as conflicts that might arise when directors appoint voluntary administrators could be discussed by this board as well as having a constant monitoring of market trends. The insolvency practitioners' oversight board might also review the operations of legislative provisions related to insolvency practitioners and whether the law is working appropriately. It may be appropriate for meetings held to have direct contact with constituents be held in conjunction with the audit oversight board so a full appraisal of the work being done by the corporate governance commission can take place.

A memorandum of understanding should existence between the corporate governance commission and the ASIC that would mean any contravention of the Corporations Act would be directly forwarded onto the corporate regulator for enforcement action.

Financial and audit reporting reform

A significant feature of the present debate has been the great emphasis on improving the oversight of the accounting profession. Few participants have sought to step back and view the landscape with the requisite perspective so attention is paid to other parts of the regulatory environment that need to be bolstered. Improved audit quality, independent oversight bodies and more thorough audit committee processes are merely smaller components of a greater mosaic. Two of the other critical components of the mosaic are the development of financial reporting standards and standards of auditing. Some steps could be taken to improve aspects of the financial reporting framework so both sound accounting standards and longer, more discursive audit reports can be developed in an environment that is coherent and comprehensive.

The conceptual framework for general purpose financial reporting sets down a broad template for the purpose of financial reports. By stipulating in general terms the purpose of financial statements the statements of accounting concepts set parameters for thinking about the accounting treatments used and whether those accounting techniques help meet the overarching principles and goals of financial reporting. The domestic conceptual framework for general purpose financial reports is far from complete and that poses a danger that accounting rules – whether they be introduced as unique domestic documents or are a part of Australia's general commitment to international convergence – might have no logical reason underlying their existence other than the fact somebody thought it was a pretty good idea at the time.

There are currently four statements of accounting concepts. Those statements cover the definition of a reporting entity (SAC 1), the purpose of general purpose financial reports (SAC 2), qualitative characteristics of financial information (SAC 3) and definition and recognition of the elements of financial statements (SAC 4). The SACs, particularly SAC 4, have been used by standard setters to attain some level of consistency between standards and to also ensure where possible that there is a logical link between accounting rules and why those rules or standards are there in the first place. The SAC 4 definitions of assets, liabilities, revenues and expenses, for example, appear in accounting pronouncements, giving the pronouncements that element of consistency a conceptual framework approach delivers. What is meant by an asset in one standard incorporating the definitions from SAC 4 should be consistent with other standards it the conceptual framework is used to build the financial reporting pronouncements.

The existing statements represent only a portion of the entirety of the framework as it is identified in Policy Statement 5, which was reissued in July 2001 by the Australian Accounting Standards Board. Significant areas such as measurement in financial reporting, the reporting of solvency and liquidity, corporation's capacity to adapt and financial structures o reporting entities are yet to be covered by concept statements. An area such as solvency and liquidity has assumed great importance in an environment when toughening economic times push entities to the edge. Better reporting in these areas is desirable but that cannot be achieved in an intellectual vacuum where there is no set of general guidelines the standard setter would even begin to use to develop improved reporting criteria for cash flow information. The issue of cash flow and solvency is deliberately highlighted in this context. An accounting theory monograph authored by Janice Loftus and Malcolm Miller was published by the Australian Accounting Research Foundation in 2000 recommending improvements in the reporting of what Loftus and Miller refer to as 'solvency and cash condition'. Among the recommendations is a proposal for entities to be disclosing much earlier when they believe they have entered a period where they might be struggling to pay their debts as they fall due and also fail to meet other cash needs:

> *An important form of discipline on, and protection for, the participants in the economic system is high quality financial reporting that communicates reliably, at the reporting entity level, on*

financial stability and vulnerability. Although it is unrealistic to expect that there will never be sudden changes in financial viability, this monograph explores how financial reports could be made ore transparent in reflecting solvency and cash condition. The aim is the avoidance of unnecessary surprises in respect of serious financial difficulties that have emerged in earlier periods.[15]

Nothing has been done with respect to this theory monograph despite the fact it clearly enunciates within it pathways to improve the quality of financial reporting so financial statements may be more transparent to those out in the community using them to better understand a company's business. This specific topic is also critical for the auditing profession because some audit experts are advocating the use of an expanded audit report that discusses in some detail the types of risks a company faces with regard to solvency issues, liquidity and financial vulnerability. The task for the auditor drafting such an audit report would be less troubling if there were a set of pronouncements dealing with the types of information on which an auditor is providing assurance. Without a comprehensive concept statement as well as supporting standards that spell out the detail for company reporting advances in the development of more discursive audit reports will take longer than necessary. Once a concept statement on improvements in reporting cash condition and solvency exists then the audit standard setter has solid grounds on which to set down guidelines for how an auditor should aim to report on these specific factors.

The cash flow and solvency issues come from the component of the conceptual framework that concerns itself with the display of information. This is of direct relevance to the great body of users of financial statements because it concerns itself with the manner in which companies communicate their financial performance, financial position and cash flows. It is these areas of the framework that must be brought closer to completion so there is a greater likelihood that disclosures of financial performance and that state of a company's assets and liabilities may have greater meaning to users. There is another factor at play here, however. No standard setter can predict the level of understanding all users will bring to the task of reading a set of company accounts. "The key user-specific quality," according to Pacter [16](1983)," is understandability. Information can't be useful if it isn't understandable by those for whom it is intended. **Understandability is partly within the control of the standard setter, but it also depends in part on the knowledge level of the user**". This does not obviate the need to improve the quality of what companies are reporting to the market place and laying the foundation blocks of the conceptual framework in place will assist in focusing minds on better reporting.

A monograph on measurement in financial reporting was released late in 1998. This monograph tackles the contentious issue of how things should be measured in financial reporting. It contemplates various measurement models such as historical cost accounting and fair value accounting. Little has been done to move on the development of concept statements dealing with measurement in financial statements – an area that is constantly mentioned by corporate finance executives and group accountants as leading to

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[15] Loftus, Janice and Miller, Malcolm (2000) Accounting Theory Monograph 11: Reporting on Solvency and Cash Condition, Australian Accounting Research Foundation, Caulfield.

[16] Pacter, Paul (1983) *The Conceptual Framework: Make No Mystique about It,* published by the American Institute of Certified Public Accountants in the Journal of Accountancy in July 1983, pages 76-78, 86-88.

inconsistencies within company financial statements. Some business executives have in recent times called on people to do something about the mixed measurement model and end inconsistencies. Other commentators have argued the current model of accounting does not give investors the true indication of the worth of the resources a company commands. Individuals with this view will usually argue the virtues of fair value or market value accounting. The arguments will continue to take place in an environment of incoherence and inaction if there is no real movement toward dealing with the absence of statements of accounting concepts dealing with the basis and techniques of measurement.

The Members of the FRC should seriously consider whether the AASB is presently able to fulfill all of the objectives set down for it in Section 227 of the ASIC Act with its existing resource. Those objectives include the development of statements of accounting concepts for the evaluation and development of accounting pronouncements. While the AASB has been in the thick of international convergence activities it has neglected the task of further developing the conceptual framework. Given the urgency of the work on cash flow disclosures and solvency the Federal Government should consider giving the AASB a tied grant so the board can proceed with projects such as improving the quality of the reporting of a reporting entity's cash condition. The importance of this cannot be stressed highly enough. The reporting frameworks and other authoritative literature of most countries have come under scrutiny because of the rather prominent examples of corporate distress. This phenomenon is understandable, but regrettable. Completing the framework on which future national and, indeed, international accounting standards will be based should be considered just as important as keeping up with what some are calling the International Accounting Standards Board's relentless pace. Having a partially built conceptual framework is better than having nothing but an incomplete framework is also about as useful as having a partially built brick veneer home still exposed to the elements of nature. What happens if and when it rains?

The Australian Accounting Standards Board should also given serious consideration to publishing an assessment of where financial reporting practices – including accounting for complicated off balance sheet transactions - today contravene the basic intent of financial statements as emphasised within the concept statements. Such a document may also serve as a road map for the AASB when it thinks about the elimination of undesirable and less than transparent accounting techniques.

Expansion of accounts surveillance

Independent oversight is not just a role for a specific oversight body that looks at the integrity of corporate governance structures and whether the parties operating within a reporting enterprise have the best interests of external stakeholders at heart. Corporate regulators also fulfill an important role with their enforcement of accounting and corporate disclosure requirements. For the capital market to operate at its optimum here in Australia a boost in the regulator's oversight of financial reporting activity is essential. This is particularly the case with the surveillance of financial reports. Companies must have reason to believe actions that are in substance non-compliance with accounting pronouncements will result in a market place backlash through a fluctuation in the company’s share price and also bring with them regulatory risk.

The Australian Securities and Investments Commission conducts a financial reporting surveillance program about twice a year and its most recent effort resulted in the review of the financial statements of 80 companies to ascertain what problems, if any, existed in the financial statements of listed companies applying the new rules relating to the new format of the profit and loss statement or statement of financial performance. A string of concerns was communicated by the Commission in correspondence forwarded to the Australian Accounting Standards Board during February following the Commission having consulted with technical experts in Big Five accounting firms. The AASB is trying to patch up some of the holes in the fabric to ensure the standard will be consistently interpreted in future reporting periods. While the efforts of the Commission in this area over the past few years are to be commended there is no reason why this program cannot be expanded and a greater number of financial statements reviewed for compliance with specific accounting pronouncements.

Funding tied to a greater expansion of this valuable initiative should be considered in order to heighten the chances of sloppy and aggressive reporting being picked up by the corporate regulator. The Commission must be given the resources to ramp up its activities in the monitoring of financial reports so it can do between a fifth or a quarter of listed entities each year. A target should be set for the ASIC’s accounting division to have reviewed every listed company financial statement at least once in a four or five year period. That will assist in ensuring that companies seeking to play games when they account for transactions that have an impact on their results going forward know that they will be unable to keep it hidden forever. It will also ensure market confidence is maintained by investors knowing the Commission has an active policy of reviewing financial statements of companies listed on the Australian Stock Exchange. The reviews should focus on a broad range of issues and not be limited to new accounting pronouncements or hot topics. Boosting the Commission’s resources and increasing the accounting knowledge within the corporate regulator may also allow the Commission to do some spot checks for compliance with new accounting pronouncements within specific industries.

There is a great danger that if the present focus on audit independence and audit quality continues in the present manner other issues will remain untouched and continue to be neglected. The continued credibility of financial reporting and the maintenance of a reasonable high level of regard for the accounting profession relies on a range of initiatives not just the singling out of auditors and the need for them and client audit committees to lift their game. Some initiatives such as the completion of the conceptual framework are quite unremarkable and could be progressed with the right level of goodwill and an increase in resources to the standard setter. The same could be said for the corporate regulator, Establishing oversight mechanisms for the accounting profession’s audit and insolvency specialists is only one piece of the corporate governance puzzle. Enhancing the capability of existing organisations to do their jobs more effectively and finish tasks set down for them in the corporate law should also be a high priority. The test for the Federal Government is whether a preparedness to fund the types of measures that would improve the reporting of corporate performance to the capital market exists.