



**ASX**

AUSTRALIAN STOCK EXCHANGE

25 February 2002

General Manager  
Corporate Governance and Accounting Policy Division  
The Treasury  
Langton Place  
Parkes ACT 2600

Australian Stock Exchange Limited  
ABN 98 008 624 691  
Exchange Centre  
Level 9, 20 Bridge Street  
Sydney NSW 2000

PO Box H224  
Australia Square  
NSW 1215

Telephone 61 2 9227 0254  
Facsimile 61 2 9227 0480  
Internet <http://www.asx.com.au>  
DX 10427 Stock Exchange Sydney

Dear \_\_\_\_\_

**Independence of Australian Company Auditors**

I enclose the Australian Stock Exchange Ltd (ASX) submission relating to the Independence of Australian Company Auditors.

Please contact me if you require any further information.

Yours sincerely

Stephen Mills

**Executive General Manager  
Corporate Relations & Investor Services**

# **ASX response to Ramsay Report on Independence of Australian Company Auditors**

Observations to Parliamentary Secretary,  
Senator the Hon Ian Campbell

25 February 2002



## Independence of Australian Company Auditors – (“The Ramsay Report”)

### Executive summary of ASX response

ASX believes auditor independence is vital. The Australian public needs an effective and transparent system of oversight concerning the accounting profession and a system that ensures auditors are not subject to conflict. ASX agrees that the audit relationship must be the subject of a framework that promotes transparency and accountability.

If a regulatory response is needed, and ASX does not believe this should automatically be assumed, then the appropriate vehicle is a legislative one – the Corporations Act.

The role of the listing rules is to support markets of efficiency and integrity. The primary ‘enforcement’ focus is disclosure. The ‘enforcement’ weapon is suspension from trading privileges. The appropriate province of the listing rules is matters core to the efficiency and integrity of ASX market operations.

The temptation to use the listing rules or ASX guidance notes as a convenient forum for ‘regulating’ broader corporate governance issues must be avoided. ASX’s customers are but a subset of corporations impacted by the issue of auditor independence. ASX is not an extension of government, it does not regulate corporate Australia, and it is not invested with the powers of inspection and enforcement which accompany ‘regulatory’ office. ASIC is the appropriate regulator in this area.

ASX does not agree that mandating audit committees is a necessary or efficient component of a strategy to ensure auditor independence.

The size, type and range of corporate entities (and of the subset of them which are listed on ASX) varies considerably. The recommendations contained in the Report do not appear to take due account of this. We see no overriding regulatory benefit attendant upon a one size fits all prescriptive route that will outweigh its burden of cost and inflexibility.

When the issue was last examined in the context of mandating audit committees for listed companies, the Parliamentary Joint Statutory Committee on Corporations and Securities, in its report tabled in October 1999, recommended that there should not be a requirement for listed entities to establish an audit committee.

There are several reasons why audit committees should not be mandated, including the following:

- they impose a substantial cost burden on the majority of small to medium sized listed companies;
- they may stifle the development of corporate governance best practice aligned with market evolution;
- a prescriptive approach is not necessarily conducive to the promotion of a culture of disclosure and may inadvertently result in perceptions that directors are absolved of their responsibilities in this area;
- the mandate of a committee structure does not guarantee a pro-active approach and ensure the quality and integrity of financial reports. It does not necessarily equate to more meaningful investor protection. In particular, quantitative risk management over time should give way to wider, qualitative management of corporate risk across all areas.

## Background

The report by Professor Ian Ramsay titled "Independence of Australian Company Auditors" (The Ramsay Report) released in October 2001 outlines five key recommendations aimed to address audit independence. These are underpinned by the general requirement that an auditor must maintain independence from a client.

The recommendations outlined in the report cover five key areas:

- employment relationships between auditors and their clients;
- financial and business relationships between auditors and their clients;
- provision of non-audit services;
- establishment of an Auditor Independence Supervisory Board (AISB); and
- mandating companies (both listed and unlisted) to have an Audit Committee.

### The importance of auditor independence

Auditors perform a vital role in ensuring the financial integrity and accountability of Australia's public companies. Australia need an effective and transparent system to ensure that the accounting profession and its auditing specialists are themselves of integrity, their policies and procedures appropriate and transparent, and that they are and are seen to be, accountable. That system must ensure that the very important public responsibilities attendant upon the role of auditor are exercised without compromise and are free from conflicts between customer retention and revenue generation and ensuring the public's protection.

### The need to examine effective systems to promote this

There is a tendency to assume that the appropriate response to issues of public concern is or includes a regulatory one. The reality is that regulatory solutions are not always the most effective tool to achieve change.

The attendant costs and effectiveness of a regulatory solution need to be examined and other possible avenues explored such as the role of peer review and or other bodies designed to promote transparency in and accountability of, auditing practices.

The Ramsay Report suggests a variety of mechanisms to address the issue of auditor independence:

- **Amendment of the Corporations Act, with respect to:**
  - employment relationships between auditors and clients;
  - financial relationships and requirements for the auditor of a listed company to be present at the AGM at which the auditor's report is tabled;
  - the establishment and structure of audit committees (if the ASX does not implement such proposals in its Listing Rules and a separate Guidance Note);
- review of the **Professional Statement of the accounting profession**, with respect to business relationships between auditors and clients;

- review of professional ethical rules, with respect to the provision of non-audit services; and
- amendment of the ASX Listing Rules, with respect to the establishment and structure of audit committees.

ASX does not agree with the last of these or with the notion of mandating an audit committee structure. However ASX particularly welcomes and supports the suggestions to review professional standards and ethical rules and the notion of encouraging the profession to put in place an enhanced framework that is conducive to enhanced efficiency and transparency.

#### The solution has no home in the ASX Listing Rules

The Ramsay Report suggests that amendments should be made to the ASX Listing Rules mandating all listed entities to have an audit committee.

The proposed rule/s would mandate the existence of a qualified audit committee, specify the composition of that committee and require the board of directors of the entity to adopt a written charter to govern the audit committee.

In respect of the composition of the audit committee, the report proposes a detailed prescription of essential requirements and distinguishes between listed companies on the basis of market capitalisation.

Those companies which exceed a specified threshold (those at the higher end of the scale) would be required to have an audit committee consisting of at least three directors, and all of the members of the audit committee must meet the relevant definition of 'independent' (ie. have no relationship with the company that may interfere with the exercise of independent judgement). In addition, the chairperson of the board of directors of the company should not be the chairperson of the audit committee.

Where the market capitalisation of the listed company is below the specified threshold, the audit committee must contain at least one director meeting the independence criteria, instead of all directors of the audit committee being required to meet that criteria.

At least one member of the audit committee must have accounting and/or related financial expertise. The Board of Directors in its business judgment will determine accounting and/or related financial expertise. Accounting and/or related financial expertise includes past employment, professional certification or other comparable experience or background.

In addition, the Report suggests that a Guidance Note be introduced to supplement the Listing Rule to provide further detail in relation to the structure of the Committee and should reflect international best practice.

The Guidance Note would do the following.

- specify the general requirements, duties and responsibilities of a qualified audit committee. The general requirements would deal with the following.
  - Meetings
    - Structure and agenda for meetings
    - Attendance at meetings
  - Systems of Reporting

- Reporting to the Board of Directors
- Reporting in the external reports
- Related party transactions
  - review and monitor related party transactions and assess their propriety.
- Internal control and risk management
  - review and assess internal processes for determining, monitoring and assessing key risk areas specific board committee.
- External audit
  - review and assess key areas relating to the external audit of the company
  - consider whether taken as a whole, the various relationships between the company and the external auditor impairs or appears to impair the auditor's judgment or independence in respect of the company;
- Internal audit
  - review and assess key areas relating to the internal audit of the company.
- contain such other matters as are considered appropriate by ASX.

The Listing Rules are not an appropriate vehicle to deal with audit issues or prescribe corporate governance practices. It is not a valid part of ASX's supervisory province as a market operator to address issues of auditor independence or such broader matters.

ASX's role is to provide a fair and efficient market. ASX has a contractual relationship with a subset of public companies that utilise audit services. Of the 1.2 million companies in Australia, only 1,490 are listed on the ASX.

ASX does not regulate its listed entities in respect of all incidents of their public profile nor should we. We have neither the regulatory tools or expertise to do so. Our proper role is and ought be confined to matters core to the integrity and efficiency of the market services we provide.

The Corporations Act legislates auditors' relationships with their clients and if there is a need to improve the regulatory framework governing auditor independence, then the Corporations Act is the appropriate vehicle to do so with the benefit of ASIC's enforcement powers. This way Parliamentary sovereignty is assured, review is possible and appropriate sanctions are applicable for any breach.

#### **ASX's current position on audit committees**

ASX has facilitated enhanced corporate governance disclosure in its listing rules. We do not accept the rules are necessarily the appropriate forum for this and believe this requires further examination. We certainly do not consider it appropriate to extend our supervisory reach in this area.

Currently ASX listing rule 4.10.2 requires a listed entity to disclose in its annual report whether the entity had an audit committee as at the date of the director's report and if the entity did not, it must explain why.

In addition, listing rule 4.10.3 requires a statement of the main corporate governance practices that the entity had in place during the reporting period.

Attached to the Guidance Note on Corporate Governance is a list of Corporate Governance matters that an entity should take into account when complying with listing rule 4.10.3. Item 7 relates to audit matters and is reproduced below.

*“7. the main procedures the entity has in place for the nomination of external auditors, and for reviewing the adequacy of existing external audit arrangements (particularly the scope and quality of the audit).*

*If a procedure involves an audit committee, set out, or summarise, the committee’s main responsibilities and rights, and the names of the committee members. If a member of the committee is not a member of the entity’s governing body (eg, director of the entity), state that person’s position.”*

#### **Mandating audit committee requirements**

The Ramsay Report focuses on the top 100 listed entities and not the other 1300 listed entities. The Report suggests that market capitalisation should determine the detail of the composition of the audit committee. It is stated that such an imposition is not an undue burden on smaller companies. ASX disagrees.

ASX is of the view that mandating such a requirement will add further layers of cost and administrative burden for no perceived benefit. The recommendations, while envisaging a smaller audit committee for entities with smaller market capitalisation, will impose a disproportionate burden on smaller and medium companies.

The Parliamentary Joint Statutory Committee on Corporations and Securities, in its report tabled in October 1999 recommended that there should not be a requirement for listed entities to establish an audit committee.

In its submission to the Parliamentary Joint Statutory Committee on Corporations and Securities in 1998, ASX was opposed to mandating particular corporate governance practices, and therefore opposed mandating audit committees.

ASX did not support the mandating of audit or other board committees for listed entities for the following reasons:

- In respect of the proposal raised at the time, given the requirement for at least two non-executive directors, ASX believed that it would impose a substantial cost burden on the majority of small to medium sized listed companies.
- A flexible approach should be taken towards the regulation of corporate governance. The emphasis should be on disclosure and the development of corporate governance principles, not the prescription of specific practices or structures.
- Prescriptive approaches do not take into account the differing circumstances of listed entities. There is no one ideal set of corporate governance practices available to all listed entities. The appropriateness of particular practices is likely to vary between different entities (eg on the basis of size or industry) and over time.
- Prescriptive approaches may lead to myopic behaviour on the part of shareholders. Shareholders may rely on prescription and be less likely to question the affairs or integrity of the company on the basis that particular structures are in place.
- Prescriptive approaches may stifle the development of corporate governance practices over time. It may be seen by entities to be the norm or the easy option and may as a consequence lead to slower development of corporate governance practice over time as circumstances change.

These views remain current in light of the recommendations in the Ramsay Report.

## Foreign jurisdictions

The Report discusses the position in several jurisdictions, including the United Kingdom and the United States, which both incorporate listing rule requirements for audit committees. This is in contrast to the position in Canada, which mandates audit committees via legislation.

The requirements have not prevented corporate collapses in those jurisdictions, nor produced tangible benefits to greater transparency or accountability.

Donald Stokes and Stephen Taylor mention in the Financial Review (11/10/01) that while the Report states that *"recent high profile corporate failures and significant international developments have prompted a re-examination of the nature and role of audit committees..... at no point in his report does Ramsay demonstrate how the AISB would make alleged audit failures less likely, nor does he show that any similar body, for example in the UK, has reduced instances of allegedly poor auditing"*.

Further, they state that there is a *"consistent approach throughout the Ramsay report to cherry-pick certain requirements from overseas regimes without demonstrating their effectiveness in the country concerned"*.

The Report does not discuss the position in Singapore and Hong Kong, amongst other key regional Asia-Pacific exchanges.

## Conclusion

The impetus for the Ramsay Report lies to a large extent in the recent spate of corporate collapses (HIH, One.Tel and Harris Scarfe and others). The Report's recommendations aim to bring Australia's response to such failures into line with international developments in this area. On this view, the recommendations may be seen as reactive regulation - designed to prevent or minimise such corporate failures from occurring in the future. However, there is no empirical evidence available that the implementation of the recommendations will achieve this purpose or indeed that regimes currently operating in foreign jurisdictions achieve this purpose. For this reason, ASX does not consider that mandating audit committees as such will necessarily resolve the problem in question.

Equally it would be a matter of concern if the proposed mandating of audit committees were in any way seen as absolving directors from their fundamental duties.

For the longer term, it is probably also true that audit committees will need to evolve over time beyond their current focus on quantitative financial reporting issues -- as important and necessary as this focus is -- to become more widely responsible for qualitative business risk management issues. That is, they will need to be capable of appreciating medium to long term risks inherent in the company's wider operating environment including, but not limited to, financial reporting and extending to include technology/ systems risk management. This approach may better assist in the prevention of corporate collapses as described above. If this development were to take place, audit committee members would of course need a commensurately wide range of skills and expertise.

If it is decided however that audit committees are to be mandated, then ASX strongly believes that this should be via amendment to the Corporations Act rather than to ASX Listing Rules/Guidance Notes. Implementation of the recommendations would be a matter of corporate governance, and as such lies more properly in the legislative sphere; ASX Listing Rules and Guidance Notes serve solely to ensure the proper operation of ASX markets.

The legislative path would, while rendering the Listing Rules recommendation redundant, also take effect across the entire body of Australian corporate entities, rather than solely across those that are listed companies.