PUBLIC SECTOR SUPERANNUATION SCHEME

COMMONWEALTH SUPERANNUATION SCHEME

Background: Public Sector and Commonwealth Superannuation Schemes - Investment Governance Risk Management

The Public Sector Superannuation Scheme and Commonwealth Superannuation Scheme (PSS and CSS) aim to ensure pro-active monitoring of social, environmental and corporate governance risks in their portfolios. This risk management strategy is executed alongside monitoring and management of economic, interest rate, sovereign and other risks. External advisors may be engaged to assist with these matters.

PSS and CSS appointed Westpac Investment Management (WIM) in December 2001 to the role of primary governance adviser for their $3 billion in Australian share investments. PSS and CSS have total investment portfolios exceeding $10 billion. This governance advisory appointment is in line with global best practice for significant institutional investors. As primary governance advisor, WIM will provide ongoing advice to the PSS and CSS trustees in relation to environmental, social and corporate governance risks in their portfolios. Monash University Sustainability Enterprises have been appointed sub-advisors by WIM.

PSS and CSS, in consultation with WIM, identify *potential risks* to the portfolio that may arise from certain company practices. WIM's task is to conduct research and advise PSS and CSS on those risks, and to raise these risks with those companies, or relevant industry or government bodies, if it is determined that that course of action is appropriate. The primary concern of PSS and CSS is the maintenance and enhancement of long term shareholder value across all of their investment holdings.

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Corporate Governance and Audit Independence

As part of their investment governance risk management strategy, PSS and CSS asked WIM to look at the issue of audit independence. The question posed by the trustees was "how much faith can we place in the integrity of the financial reports produced by companies". This question was responsive to increasing concerns about the independence of audit reports, given recent cases both in Australia and overseas. The research undertaken by WIM looked closely at company risk and the company's responsibility to ensure that unbiased financial information is available to investors.

WIM Study

The focus of WIM's research was on corporate governance with respect to audit – the structures and processes that company Boards have established to ensure the independence of audits. The aim was to understand the current practices of companies as identified through publicly available information – the most recent annual reports and web site searches. The recommendations made in the Ramsay Report on Auditor Independence were used as a baseline as well as IFSA and AICD/IIA & AARF guidelines on audit committee composition

The major points addressed from Ramsay Report are outlined below.

1. Provision of Non-Audit Services by the Auditor
2. Audit Committee Presence and Composition
3. Appointment and Removal of Auditors

Considerations

WIM considered the following points under instruction from PSS and CSS

- Robust audit is vital to investment confidence and trust
- Following prominent company collapses, audit confidence has deteriorated markedly
- Audit is complex and the responsibilities of the auditor and companies is not clearly understood
- This lack of understanding of audit risks a policy response to correct a *perceived* rather than a real audit concern. The provision of other services by the auditor can in many cases be reasonable if explained effectively.
- There is a risk that policy over reaction could lead to significant company costs.

WIM tests

The following tests were applied to measurable material in publicly available information - the most recent company Annual Report – for all of the companies in the ASX 200 (measured by market weight). For results please refer to summary table.

1. Provision of non-audit services

Audit/non-audit proportionality - Audit/non audit fees *proportionality* was determined to gain insight into the potential impact that the size of non-audit services may have on the integrity of the external audit.

Audit/non-audit Disclosure – Breakdown of the non-audit fees provided in the annual report. This measure looks to the transparency policy of the company and its importance is considered high as it can mitigate the risk identified in item 1 (above).

2. Audit Committees

Existence of the Audit Committee – presence/absence of Board Audit committee

Board Audit Committee composition - Independence of the audit committee was assessed in relation to composition by Executive Directors and Non Executive Directors and the Chair of the Board as the chair of the Audit Committee.

WIM looked at
- Number in Audit Committee
- Number of Executive v Non-Executive Directors in the Audit Committee
- CFO as member of Audit Committee
- CFO as Chair of the Audit Committee
- Chair of Board as Chair of the Audit Committee

Statement of Independence – An underlying assumption was made that an Audit Committee's reference to independence is *indicative* of its commitment to the spirit of independence.

3. Audit Firm Partner Rotation

Audit firm partner rotation – WIMs examination tested for company audit partner rotation in the face of calls for mandatory periodic rotation.

PSS and CSS position on Ramsay Report

1. Non-Audit Services

PSS and CSS caution against a regulatory over reaction to separate the audit firm and the provision of 'other services'. There are practical advantages to the audit firm providing certain 'other services' to the audit client and a lack of solid evidence that the size of the non-audit fees detrimentally affects the independence of the external audit. Making generalisations based on perceptions of inequity could be costly and unnecessary. Improved disclosure of other services could mitigate perceived risks to auditor independence.

2. Board Audit Committees

Board Audit committees should be mandatory whether a company or a Trust. The presence of a Board Audit Committee is standard 'Best Practice'. Addressing independence of audit through a strong audit committee is a means of ensuring the integrity and reliability of the external audit.

The Board Audit Committee should be comprised of Non-Executive Directors. However, Executive Directors should be invited to attend as required. Having Executive Directors on the Board Audit Committee could produce a (perceived or actual) bias that compromises the process of independent audits. More specifically, having the Chief Financial Officer as a member of the audit committee (or Chair) raises immediate concerns regarding conflict of interest. However, the expertise and knowledge of the CFO and other executives should be a resource that the Board Audit committee draws upon to make sound analyses and decisions.

Board Audit Committees should disclose in the annual report whether they have ensured the independence of the external audit. Similar to the declaration of the Auditor, the Board audit Committee should state that they have followed process to ensure the integrity and independence of the external audit.

3. Audit Partner Rotation

The Ramsay recommendation that audit partners should change at least every seven years should be mandatory. Although no companies were found to exceed the 7-year limit in the past 10 years, PSS and CSS believe that over familiarity may lead to conflicts of independence.

Conclusion

PSS and CSS take the view that lack of audit independence represents a risk to the long-term value of their investments. Following detailed examination of company practices across the S&P/ASX benchmark, PSS and CSS are of the view that much of the audit independence risk to shareholder value can be significantly addressed by improved transparency of non-audit services and through Board audit management processes. Significantly, these processes already exist as best practice. It is the *execution* of these practices that appears to be lacking. Therefore adoption of existing guidelines and Best Practice Management is preferable to additional regulation.

Ramsay Report Measure	Ramsay Report Recommendation	Data Researched	Current Practice ASX 200	PSS and CSS Conclusion
A. Keeping Accounting firms Independent of their Audit Clients 1. Provision of non-audit services by audit firm	Disclosure of non audit services	Proportionality of non-audit/audit amounts. To look at the relationship of size of non-audit and audit amounts	Average proportionality of non-audit /audit was 150% across ASX 200. 8 companies paid the audit firm 500% or more (7.83% by market weight). 17 companies had 300-500% proportionality and represented 9.5% of ASX200 by market weight. In total the market weight of those companies with a proportionality non-audit/audit greater than 300% is 17.3%	No evidence that proportionality is of itself a risk. Each company is unique and has different requirements for the provision of non-audit services. Looking solely at the size of the non audit services relative to the audit amount is misleading
	Accounting Standards a) Financial Report for the year must disclose $ amount of all non-audit services provided by the audit firm	Breakdown of non audit amounts in notes of Financial Statements – whether an explanation was provided	180 companies (80% by market exposure ie $ value) do not disclose a breakdown of the audit amounts	Agreement with Ramsay's recommendation that disclosure requirements should be tightened
B Other Measures 2. Audit Committees	Mandate the existence of a qualified audit committee	Existence of Audit Committee	17 companies do not have an audit committee. 11 of these are Listed Property Trusts that lodge a compliance plan with ASIC and fall under Trust Law Provision of Corporations Law.	Agreement with Ramsay's recommendation that Audit Committees should be mandatory for all listed entities

2. Audit Committees (cont'd)	Specify the composition of the audit committee	Examination of composition of audit committee (where present) to determine *Independence of the Audit committee. Factors 1. Presence of non executives as members 2. Proportion of Non executive to executive directors 3. Presence of CFO on audit committee	25 companies have executives on their audit committee (13.3% by market weight) 9 companies have the Chief Financial Officer as a member of their audit committee (2 companies have the CFO as the *chair* of the Audit Committee) The combined market weight of these companies represent 18.9% by market weight of the ASX200	Board Audit Committees should comprise solely of non-executive directors with an independent chairperson. Company audit committees should be, and be seen to be, independent.
	b) The financial report for the year must disclose whether the audit committee of the board... has considered whether the provision of non-audit services is compatible with maintaining auditor independence	Reference to independence of audit in annual report in Corporate Governance section (ASX 200)	10 companies refer to independence of audit in their annual report. This represents 37.8% by market weight	Agreement with Ramsay's recommendation that audit committees should address independence in the annual report
3. Appointment and Removal of the auditor	Rotation of audit firm partner at least every 7 years	Review ASX top 160 companies (by size) over 10 year period to determine the extent of audit partner rotation	100% of companies changed audit partners at least every 7 years	Agreement with Ramsay's recommendation.

* Independence defined as independence from Management – so executive vs non-executive directors as members of the Board's Audit Committee. Therefore WIM looked for the presence of executives on the audit committee and particularly the CFO