

CLERP 9 REPORT (SECOND PART): SUPPLEMENTARY REMARKS

AUSTRALIAN DEMOCRATS
SENATOR ANDREW MURRAY

Executive summary

In these Supplementary Remarks I have briefly outlined Democrat views on some CLERP 9 areas we have concerns with, and areas in which we will be seeking to amend the CLERP 9 Bill.

Our amendments will include:

- all public appointments by Government under the Act should be governed by the overriding principle of appointment on merit;
- an audit committee is not independent, and an auditor is not independent, if either is subject to the patronage or direction of the dominant shareholder/s, and an auditor is not independent if they receive non-audit services of a kind prohibited in Australia, the European Union (EU), or the United States of America (USA).

Introduction

I support the Report of the Committee, but have a number of additional points that I think are important to make.

As I said in my Minority Report to the first of the Committee's two reports into the CLERP 9 bills, the Australian Democrats are and have been strongly supportive of the process and intent of the Corporate Law Economic Reform Programme (CLERP).

The Democrats recognise that the majority of changes proposed by the CLERP 9 legislation will improve corporate governance, accountability and good process.

CLERP 9's provisions will be supported by us and should be commended. These proposals will be assisted by further amendments, both arising from the Committee's Report, and some that will be moved in the Senate by the Democrats and Labor.

Nevertheless the Report does not get to the heart of the difficulties surrounding auditor independence.

We are particularly supportive of the recommendations to:

- clarify the functions of the Financial Reporting Council and require that its meetings are conducted in public;

- require an auditor to attend the annual general meeting of an entity to answer shareholders' questions; and
- allow the CEO and CFO sign-offs to take into account the practicalities of their reliance on the information provided by others.

Auditor Independence

A considerable part of the CLERP 9 changes relate to the role of the auditor, and auditor independence.

The Joint Committee of Public Accounts and Audit, *Report 391, Review of Independent Auditing by Registered Company Auditors*, August 2002, concluded with:

The Committee considers that Section 324 of the *Corporations Act 2001* would be the appropriate section of the Act to incorporate a general statement on the independence of the auditor.¹

It is notable that the Corporations Act and the Bill still lack definitions or clear criteria for independence.

While the Bill does not have a definition of auditor independence, it does impose a general independence requirement on auditors. This requirement is not met if a 'conflict of interest situation' exists in relation to an audited body at a particular time and, at that time, the auditor knows but does not take reasonable steps to ensure the conflict of interest ceases to exist.

It seems convoluted, but you could say that in the Bill, the definition of 'conflict of interest situation', in setting a general standard of auditor independence, is really the Bill's definition of what constitutes auditor independence. A conflict of interest situation exists when:

1. the auditor, or a professional member of the audit team is not capable of exercising objective and impartial judgement in relation to the conduct of the audit of the audited body; or
2. a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgement in relation to the conduct of the audit of the audited body.²

1 See pp. 96-8 (paras. 4.20 - 4.29).

2 See proposed subsection 324CD of the Bill and Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, Parliament of the Commonwealth of Australia, House of Representatives, pp. 112-113.

That JCPAA Report 391 did pick up the essence of the auditor independence argument as the following excerpt demonstrates:

The concept of independence is open to various definitions depending on the context in which it is used. In a very general sense, being ‘independent’ refers to a person or group being self-governing and unwilling to be under obligation to others. More specifically, independence can be seen to have two complementary characteristics:

- a state of mind that allows for opinions to be arrived at without being affected by external influences; and
- a matter of appearance in that facts and circumstances are avoided that would lead a third party to conclude that a person’s ability to arrive at an independent opinion has been compromised.

The independence of the stakeholders in Australia’s financial reporting environment is a critical issue and it forms a major part of the analysis and indeed the solutions proposed in this report. Independence is important to ensure that a person or group of persons undertake their work professionally, with integrity and objectivity and free of bias and undue influence.

There are many relevant stakeholders in this process but for the purposes of this report, the Committee has focussed on three central groups – namely, directors, audit committees and auditors. Importantly, these groups have not been considered in isolation because the independence of directors, for example, can impact on the independence of the other stakeholders and they should take an active role in ensuring their independence.

Overall, the independence of these stakeholders is important to ensure that the operation of corporations, including the provision of information to the financial markets, is in the best interests of the wider community. More specifically the independence of directors is important because they must be in a position to effectively monitor the management of a company and be able to ask management the right, and often difficult, questions in the best interests of both shareholders and the company.

The independence of audit committees is important in ensuring that the external auditor is free from management interference. Audit committee independence is also associated with raising the quality of the audit and safeguarding the integrity of corporate financial reporting.³

The independence of the external auditor is fundamental to the reliability of and public trust in, the audit reports. The U.S. Securities and Exchange

3 Ramsay, Ian, *Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury, Canberra, 2001, pp.71-9.

Commission has provided a compelling description of the importance of the independent audit function:

Independent auditors have an important public trust. Investors must be able to rely on issuers' financial statements. It is the auditor's opinion that furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an objective, impartial, and skilled professional, and that investors, therefore, can rely on them. If investors do not believe that an auditor is independent of a company, they will derive little confidence from the auditors' opinion and will be far less likely to invest in that public company's securities.⁴

The importance of probity and independence, and the need for audit firms to abide by good corporate governance practices was emphasised in the evidence to the JCPAA Committee's auditor independence inquiry:

By the very ethical nature of the auditing function, one should not need to be reminded about independence. Nothing should compromise this independence. The external auditor must not only be independent but be seen to be independent. This must be at the forefront of every external auditor.⁵

For each of these stakeholders, the Committee has explored a number of mechanisms to enhance independence. However, a core set of mechanisms and criteria in each of the following areas, are common to enhancing the independence of each group:

- appointment;
- security of tenure;
- termination; and
- remuneration.⁶

At paragraph 5.5 of Chapter 5 (Audit Reform—General Auditor Independence Provisions) the Committee Report quotes what is described as '...the comprehensive definition provided in the ICAA and CPAA *Professional Statement F.1 – Professional Independence...*' This definition covers independence of mind and independence in appearance. The Committee's references here are similar to the JCPAA references.

While these are essential ingredients of a definition of auditor independence, they are incomplete.

4 SEC, *Final Rule: Revision of the Commission's Auditor Independence Requirements*, Release No. 33-7919, www.sec.gov/rules/final/33-7919.htm

5 Mr John Hammond, *Submission* No.19, p. S153

6 Quoted from the JCPAA report, paragraphs 1.23-1.30, pp. 6-7.

What is missing is the vital third part of a definition: 'Independence in fact'.

Full independence is only possible when:

- the method of appointment is objective, on merit, and not subject to patronage, favour, or inducements;
- remuneration is sufficient, profitable and secure for a reasonable period, and not hostage to other services or retainers;
- tenure is reasonable and secure; and
- objective fair and consistent separation or contract-ending mechanisms exist.

Without these elements in place, full independence is not possible for many, apart from the very strong, the very virtuous, or the very uncommercial.

Turning to remuneration briefly, the Democrats believe that an independent auditor is vital for an effective audit, but to quote Charles Macek, Chairman of the Financial Reporting Council, as reported in the May 2004 CFO Magazine:

Where does your obligation, where does your loyalty lie? It's going to lie with whoever is paying our salary. It's just human nature.

The greatest weakness is the method of appointment.

Intertwined with any discussion on the appointment of auditors is the relatively new institution of the audit committee.

The audit committee has been held out as a guarantee of probity and good process. It is nothing of the sort.

The problem starts and ends with the board. I will repeat what I said in my Minority Report in the Committee's Part 1 report for CLERP 9, that the board is the central institution in the relationship between shareholders and the company, stakeholders generally, and auditors specifically.

It is self-evident that many boards, directors and companies operate to high standards, but it is the task of legislators to attend to those who do not, and to appraise the public interest.

Companies have such an effect on our society that serious weaknesses in corporations law must be attended to. A major weakness lies in director election processes.

Regrettably, the election of directors is often either deliberately or effectively rigged in favour of dominant shareholder interests. I am told that 52% of ASX corporations have **a** dominant shareholder, and many of the rest have a few dominant shareholders.

Such dominant shareholders frequently control the boards of our companies through their voting power. That means many (most?) directors are directly placed by or under the patronage of a dominant shareholder or shareholders, who will quite naturally seek to ensure that their interests are put first.

This dominance and patronage over many directors is reinforced by company constitutions and board behaviour that allow or foster poor director election processes.

This dominance and patronage of the dominant shareholders is reinforced by the absence of compulsory voting by institutional investors, or by their voting apathy, or by their giving proxies to the Chair, or (worst of all) the often disgraceful way in which proxies are voted at the Chair's discretion. Stephen Mayne told the Committee of this instance:

When I ran for the NRMA board in 2000 they did the usual: 'I'm sorry, there's no vacancy, sir.'

This is what they wrote to the shareholders:

...four candidates are standing for three Board positions. Only three candidates may be elected. In order to be elected a candidate must receive more votes ... in favour ... than against.

That is, from those presenting votes. They went on to state:

If more than four candidates receive such a majority, the three candidates receiving the most votes in favour of their election will be elected as Directors. If you vote in favour of more than three candidates your vote will be invalid.

So they told shareholders, 'Only tick three of the four boxes.' So most shareholders ticked the three incumbents and left my box vacant, as you would because it said, 'Your vote will be invalid if you tick in favour.' But the then Chairman of the NRMA, Nicholas Whitlam, deemed that it was not invalid to have voted against me. He assumed all those people who left my box vacant, as instructed here, as open proxies and voted them all against me. I had 45 per cent of the primary vote, if you like—the proxy vote: I had 60 million in favour and 72 million against. So it was a reasonable performance: 45 per cent of the vote. He then used 163 million open proxies and got my vote down to 17 per cent when he had put out information to the shareholders saying, 'Don't tick the four boxes.'⁷

The only way to diminish dominant shareholder voting power is to dilute it. The greater the vote and the more thoughtful the vote exercised, the lower will be the real power of the dominant shareholders. These are public companies, but are sometimes treated as private fiefdoms ruled by oligarchs who are openly contemptuous of their often small fellow shareholders.

7 *Committee Hansard*, 14 April 2004, p. CFS 29.

This combination of methods and practices minimising votes effectively results in the shareholders at large being unable to prevent a dominant shareholder dominating the board.

Under our system non-executive directors are not much protection either, because many are far from independent. This is because they have often been appointed under the dominant shareholders' patronage, a patronage reinforced by the conformity imposed by the board collegiality rule.

It all ends up being very neat and cosy for the dominant shareholder.

So, here is a likely scenario. The directors under the patronage or subject to the dominant shareholder/s appoint the director members of the audit committee who are also under the patronage or subject to the dominant shareholder/s, and therefore are highly likely to act in the interests of the dominant shareholder/s.

The subordinate/patronised audit committee recommend which auditor should be appointed. The board in turn forwards that appointment to the shareholders, who duly elect the auditor.

The selected auditor is obviously going to be one the board can work with.

Unscrupulous boards might flavour the auditor appointments with some nice non-audit service goodies (a practice so common and so repellent to independence that Sarbanes-Oxley has pretty much ruled it out).

The audit committee dutifully conveys to the auditor the wishes and interests of the dominant shareholder/s, and later on perhaps, the auditor is rewarded by a seat on the board, under patronage of course. Then the whole cycle starts again.

A company appoints an auditor and therefore has a certain amount of power. As recent history and the demise of Arthur Andersen show, sometimes the company has a dangerous level of power over the auditor.

What legislatures and regulators the world over are trying to do is to tighten up on these processes, but without addressing board election practices, compulsory voting of shares by institutional investors, and reducing the power of dominant shareholders, they will be much less effective than they otherwise might be.

I think we should be saying an audit committee is not independent, and an auditor is not independent, if either are subject to the patronage or direction of the dominant shareholder/s, and an auditor is not independent if they receive non-audit services of a kind prohibited in Australia, the EU, or the USA.

Now *that* would be principles-based law!

Let the auditors carry on auditing under the new CLERP 9 regime, but let us not pretend that they will be able to satisfy the full strict criteria of independence.

Without independence being guaranteed through the method of appointment, sufficient remuneration, reasonable tenure, and objective separation/contract-ending mechanisms, despite the changes made by CLERP 9 there will remain a perception that an auditor can almost never be fully independent.

As awkward as it is, regrettably we Democrats can see no other solution than independent tendering and appointment for auditors.

The Democrats' proposal is for a panel comprising representatives of ASIC, corporate representatives and at least representatives of major audit firms to determine on an ASIC-developed basis, the auditor for the top 300 listed entities by market capitalisation.

The audit appointment panel would also be responsible for determining the audit fee.

An alternative to all the new law and to this proposed process of ours would be if the tendering and appointment process was taken out of the hands of the board, but kept in-house.

To repeat what I said in my Minority Report for the Committee's Part 1 Report into CLERP 9, this could be done if the current responsibilities of a board were to be split between a main board and a governance board.

The main board would continue to be elected by shareholding and concentrate on strategic, business and operational issues. It would contain executive and non-executive directors and because of its election method would continue to have a bias towards the dominant or large shareholders.

A small Corporate Governance Board (CGB) would be composed of non-executive independent directors (perhaps three).

It would have a limited remit and would call and chair shareholder meetings, propose changes to the company constitution, resolve conflicts of interest, determine the remuneration of directors and executive management, *appoint auditors* and other advisors such as valuers and manage the process of electing directors.

To protect the interests of *all* shareholders, not just the dominant shareholders, voting rights to elect these CGB directors would be determined democratically by numbers rather than by power based on the number of shares held. In other words it would be determined by shareholder not shareholding. It would be completely free from the dominant shareholder's control or patronage.

Because of its election method, it would have a bias towards all shareholders rather than just the large shareholders.

The greatest danger to corporate governance and ethical corporate behaviour is when the selfish interests of the dominant shareholder and the executive and non-executive directors coincide and are exercised to the detriment of the shareholders at large.

This 'separation of powers' seems a difficult concept for the traditional business community to fully appreciate at present. It has worked well in our broader political democracy.

The Democrats do not seek to attempt amendments to create a CGB requirement in law at this stage. The idea needs to be better understood first.⁸ Nor will we move amendments for external audit appointment. It is another idea that lacks sufficient support.

Appointments on Merit

In my Supplementary Report to this Committee's report on the Corporate Law Economic Reform Program Bill in 1998 and in the subsequent Senate debate, I raised the issue of appointments on merit.

Every Democrat Senator has at one time or another called for an end to jobs for the boys and girls. Twenty-three times the Democrats have moved appointments on merit amendments to various bills, and twenty-three times (so far and still counting), the Liberal, Labor and National parties have voted them down. They do love *their* patronage!

Wherever appointments are made to the governing organs of public authorities, whether they are institutions set up by legislation, independent statutory authorities or quasi-government agencies, the processes by which these appointments are made should be transparent, accountable, open and honest.

It is still the case that appointments to statutory authorities are left largely to the discretion of ministers with the relevant portfolio responsibility.

There is no umbrella legislation that sets out a standard procedure regulating the procedures for the making of appointments. Perhaps most importantly there is no external scrutiny by an independent body of the procedure and merits of appointments.

An independent body should be given the responsibility of scrutinising government appointments against a set of established criteria.

This system works well in the United Kingdom after the 1995 Nolan Commission. Lord Nolan managed to persuade the UK government to accept that appointments should be based on merit.

Lord Nolan set out key principles to guide and inform the making of such appointments:

8 Dr Shann Turnbull is a well-known thinker on such matters, and his international and domestic essays are well worth reading.

- a minister should not be involved in an appointment where he or she has a financial or personal interest;
- ministers must act within the law, including the safeguards against discrimination on grounds of gender or race;
- all public appointments should be governed by the overriding principle of appointment on merit, except in limited circumstances;
- political affiliation should not be a criterion for appointment;
- selections on merit should take account of the need to appoint boards that include a balance of skills and backgrounds;
- the basis on which members are appointed and how they are expected to fulfil their roles should be explicit; and the range of skills and backgrounds that are sought should be clearly specified.

In response to the Nolan Committee's recommendations, the United Kingdom government subsequently created the office of Commissioner for Public Appointments, which has a similar level of independence from the government as the Australian Auditor-General, to provide an effective avenue of external scrutiny.

The Democrats have used the Nolan Committee's recommendations in our amendments for the last five years because they are tried and tested. Meritorious appointments are the essence of accountability.

Until this notion of jobs for the boys or girls is nipped in the bud, there is not that much moral difference between our system and the political patronage that is prevalent in countries where nepotism and favouritism run rife.

We will seek to amend CLERP 9 accordingly.

SENATOR ANDREW MURRAY