

PART 2

SUMMARY OF RECOMMENDATIONS

A. KEEPING ACCOUNTING FIRMS INDEPENDENT OF THEIR AUDIT CLIENTS **(Part 5 of the report)**

GENERAL STATEMENT OF PRINCIPLE REQUIRING INDEPENDENCE

The Corporations Act currently contains several provisions dealing with the independence of auditors (including prohibited employment relationships and prohibited financial relationships). However, it does not contain a general statement requiring an auditor to be independent. It is recommended that the Corporations Act be amended to include a general statement of principle requiring an auditor to be independent.

This provision of the Corporations Act would also provide that an auditor is not independent with respect to an audit client, if the auditor is not, or a reasonable investor with full knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement. In determining whether an auditor is independent, all relevant circumstances should be considered, including all relationships between the auditor and the audit client.

It is also recommended that the auditor must make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the Corporations Act and the rules of the professional accounting bodies.

LIST OF CORE CIRCUMSTANCES WHICH CREATE A LACK OF INDEPENDENCE

The following is a list of what can be regarded as core circumstances which, if they exist, necessarily mean that the auditor is not independent. These core circumstances are drawn from key international rules and principles (SEC rules on audit independence, IFAC exposure draft on independence and European Commission consultative paper on audit independence).

It is important to emphasise that these core circumstances are not an exclusive indication of circumstances where an auditor lacks independence. There will be other circumstances where, depending upon the facts, an auditor may lack independence. As is currently the case, it is appropriate that the ethical statements of the professional accounting bodies contain additional guidance for auditors dealing with other circumstances in which an auditor may lack independence.

The definitions relating to these core principles are contained in paragraph 5.35 of Part 5 of the report.

EMPLOYMENT RELATIONSHIPS

Section 324 of the Corporations Act currently deals with employment relationships between auditors and clients. Therefore, it is intended that the following provisions will replace sections 324(1)(f) and 324(2)(g) and (h) of the Corporations Act.

An auditor is not independent if any of the following employment relationships exist with the client. There are exemptions for inadvertent breaches of the rules if certain requirements are met.

The following rules for employment relationships do not apply if the client is a small proprietary company (as defined in section 45A of the Corporations Act).

For the purpose of determining who is an officer of the client, the definitions in sections 9 and 324(4) of the Corporations Act apply.

1 Employment by client of current auditor/employee of auditor

An auditor is not independent if a current partner or professional employee of the audit firm is:

- (a) an officer of the client;
- (b) a partner, employer or employee of an officer of the client; or
- (c) a partner or employee of an employee of an officer of the client.

2 Employment by client of certain relatives of auditor

An auditor is not independent if an immediate family member of a member of the audit engagement team is:

- (a) a director of the client; or
- (b) an officer or employee of the client who is in a position to affect the subject matter of the audit engagement.

3 Employment by client of former auditor/employee of auditor

An auditor is not independent if a former partner or professional employee of an audit firm is:

- (a) a director of the client; or
- (b) an officer or employee of the client who is in a position to affect the subject matter of the audit engagement;

unless the individual:

- (c) does not influence the audit firm's operations or financial policies and does not participate or appear to participate in the audit firm's business or professional activities;
- (d) has no capital balances in the audit firm; and
- (e) has no financial arrangement with the audit firm other than one providing for regular payment of a fixed pre-determined dollar amount which is not dependent on the revenues, profits or earnings of the audit firm.

4 Retired audit partner joining board of audit client

An auditor is not independent if a former partner of an audit firm who was directly involved in the audit of a client becomes a director of the client within a period of two years of resigning as partner of the audit firm.

5 Employment by audit firm of former employee of client

An auditor is not independent if a member of the audit engagement team has, during the period covered by the audit report, been:

- (a) an officer of the client; or
- (b) an employee of the client in a position to influence the subject matter of the audit engagement.

6 Remuneration from audit firm

An auditor is not independent if an officer of the client, or an employee of the client in a position to influence the subject matter of the audit engagement, receives any remuneration from the audit firm for acting as a consultant to it on accounting or auditing matters.

FINANCIAL RELATIONSHIPS

Section 324 of the Corporations Act currently deals with some aspects of financial relationships between auditors and clients. Therefore, it is intended that the following provisions will replace sections 324(1)(e) and 324(2)(f) of the Corporations Act.

There are exemptions for inadvertent breaches of the rules if certain requirements are met.

1 Investments in audit clients

An auditor is not independent if:

- (a) the audit firm, any member of the audit engagement team, or any of his or her immediate family has:
 - (i) a direct financial investment in the client; or
 - (ii) a material indirect financial investment in the client; or
- (b) the audit firm has a material financial interest in an entity that has a controlling interest in the client; or
- (c) any other client service personnel, or any of his or her immediate family, has a direct financial interest or a material indirect financial interest in the client.

2 Loans to and from audit clients

An auditor is not independent if:

- (a) subject to the exception contained in section 324(3) of the Corporations Act, a partner of the audit firm, or an entity which the partner controls, or a body corporate

in which the partner has a substantial holding, owes more than \$10,000 (or such other amount as may be prescribed by regulation) to the client; or

- (b) the audit firm, any members of the audit engagement team, or any of his or her immediate family:
 - (i) accepts a loan from a client; or
 - (ii) makes a loan to a client; or
 - (iii) has a loan guaranteed by a client; or
 - (iv) guarantees a client's loan;

unless the loan is made in the ordinary course of the client's business and the loan is made under normal lending procedures, terms and conditions.

BUSINESS RELATIONSHIPS

Business relationships between auditors and clients are not currently dealt with in the Corporations Act. Therefore, it is intended that the following rule will be included in the revised ethical rules of the professional accounting bodies.

An auditor is not independent if:

- (a) a member of the audit engagement team has a business relationship with the client or any of its officers which is not clearly insignificant to both the member of the audit engagement team, and also the client or the officer; or
- (b) the audit firm has a business relationship with the client or any of its officers which is not clearly insignificant to both the audit firm and also the client or the officer.

A business relationship for this purpose does not include professional services provided by the audit firm, or the audit firm or member of the audit engagement team being a consumer in the ordinary course business.

NON-AUDIT SERVICES

It is recommended that the provision of non-audit services by audit firms to their clients be dealt with in several ways:

- (a) by revised and updated professional ethical rules;
- (b) by mandatory disclosure of non-audit services and the fees paid for these services;
- (c) by strengthening the role of audit committees; and
- (d) by establishing an Auditor Independence Supervisory Board which would have, among its functions, the task of monitoring the adequacy of disclosure of non-audit services.

1 Regulation of non-audit services

It is recommended that the regulation of non-audit services provided by audit firms to their clients be dealt with in professional ethical rules, suitably updated to reflect the IFAC proposals.

2 Disclosure of non-audit services

It is recommended that the following provisions will form part of the Accounting Standards or, if the Accounting Standards are not amended, then they will form part of Chapter 2M (Financial Reports and Audit) of the Corporations Act:

- (a) the financial report for the year must disclose the dollar amount of all non-audit services provided by the audit firm to the client, divided by category of service, with appropriate discussion of those services; and
- (b) the financial report for the year must disclose whether the audit committee of the board of directors, or if there is no such committee then the board of directors, has considered whether the provision of non-audit services is compatible with maintaining the auditor's independence.

Attention is also drawn to the recommendations in this report regarding audit committees and the establishment of the Auditor Independence Supervisory Board as these recommendations affect non-audit services.

B. OTHER MEASURES THAT ENHANCE AUDIT INDEPENDENCE (Part 6 of the report)

ESTABLISHMENT OF AN AUDITOR INDEPENDENCE SUPERVISORY BOARD

1 The AISB

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.

2 Composition of the AISB

The AISB must not be controlled by the accounting profession. Although the expertise of the profession will provide a valuable contribution to the AISB, the majority of members must be independent of the professional accounting bodies. Key stakeholders should have board representation.

2.1 *AISB members*

The board of the ASIB will comprise 12 members. All appointments will be on a part-time basis and remunerated by a retainer and a sitting fee. The following bodies will be included and represented on the AISB:

- Two representatives from the professional accounting bodies:
 - one from CPA Australia (CPA); and
 - one from the Institute of Chartered Accountants in Australia (ICAA);
- One representative from the Investment & Financial Services Association (IFSA);
- One representative from the Securities Institute of Australia (SIA);
- One representative from the Institute of Internal Auditors Australia (IIA);
- One representative from the Australian Securities and Investments Commission (ASIC);
- One representative from Australian Stock Exchange Limited (ASX);
- One representative from the Australian Shareholders' Association (ASA);
- One representative from the Australian Institute of Company Directors (AICD); and
- Three representatives of the public interest.

2.2 *AISB employees*

The AISB will have one senior employee, being the executive director, and a small professional staff.

2.3 *Process for appointment of initial and future members*

The bodies specified above will nominate the members of the AISB in accordance with the number of representatives allowed to that body. The Minister will appoint representatives of the public interest following public advertisement, and will also appoint the Chair from the members of the AISB. The Chair will be a member who is not a representative of the professional accounting bodies.

3 *Funding for the AISB*

3.1 *Financial support*

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.

3.2 *Physical premises*

If the funding for the AISB is provided by the professional accounting bodies, premises for the AISB will be determined as part of the negotiations with the profession. The ASIB must be lodged in premises separate from the profession and the professional bodies, but the profession will provide the premises either directly, or indirectly through inclusion in the AISB budget.

4 Functions of the AISB

4.1 Obligation to prepare an annual report

The AISB will be required to prepare and publish an Annual Report which will be available to the public.

4.2 Monitoring of international developments in auditor independence

The AISB will assess not only how the regulatory arrangements contained in this report continue to reflect the public interest, but also how their practical application is achieving this end. In making this assessment, the AISB will look to and monitor future international developments in auditor independence and the adequacy of Australian rules in light of these developments.

The AISB will play a central role in the enhancement and development of the framework for auditor independence. The AISB will advise the Government and other key stakeholders in relation to international developments and the continuing suitability of the Australian regime to meet the public interest.

4.3 Advising professional bodies on issues of auditor independence

The AISB will advise the professional accounting bodies on appropriate standards dealing with auditor independence and will also advise on whether it believes these standards have been adequately implemented to serve the public interest.

4.4 Monitoring of audit firms

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 processes. 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. The objective is to ensure that the internal systems and processes of audit firms accord with best practice.

4.5 Monitoring of corporations

The AISB's obligation to monitor extends to compliance by companies with the new auditor independence regime. As part of this role, the AISB will monitor the adequacy of non-audit service fee disclosure and monitor the effectiveness of listed company audit committees. The results of this monitoring process will be communicated to the Government and other key stakeholders.

4.6 Monitoring of teaching of professional and business ethics

The AISB will monitor the adequacy of the teaching of professional and business ethics by the professional accounting bodies and universities as they relate to issues of auditor independence. The AISB should also promote the teaching of professional and business ethics by the professional accounting bodies and universities.

4.7 No role in conducting disciplinary proceedings

It is not appropriate for the AISB to conduct disciplinary proceedings given that disciplinary mechanisms are already in existence. However, as a part of its overall monitoring responsibilities,

the AISB should monitor and assess the adequacy of the existing investigation and disciplinary processes and, if it forms the view that improvements are required, this should be communicated to the Government.

5 Review of the AISB

The role of the AISB should be reviewed by the Government after five years of operation to determine if it continues to serve the public interest.

AUDIT COMMITTEES

There can be no doubt that a well structured and well functioning audit committee can play a very important role in ensuring that the auditor is independent of the company. It is recommended that the ASX Listing Rules be amended to require all listed companies to have an audit committee. The new Listing Rule would be accompanied by an ASX Guidance Note. The Listing Rule and associated Guidance Note should govern the structure of this committee, and should reflect international best practice in audit committees as outlined in Part 6 of this report.¹

The Listing Rule should:

- mandate the existence of a qualified audit committee;
- specify the composition of the audit committee as contained in section 3 of Appendix D; and
- require the board of directors to adopt a written charter to govern the audit committee.

The Guidance Note should:

- specify the general requirements, and duties and responsibilities, of a qualified audit committee as contained in sections 4 and 5 of Appendix D; and
- contain such other matters as are considered appropriate by ASX.

The Guidance Note should specify that the audit committee has special responsibilities in relation to the company's auditor. These special responsibilities are outlined in detail in Appendix D of this report (see in particular section 5.4 of Appendix D). Some of these special responsibilities are that the audit committee should:

- state in the annual report whether or not it believes the level of non-audit service provision by the auditor is compatible with maintaining auditor independence, and should include reasons where appropriate;
- make recommendations to the board on the appointment, reappointment or replacement, remuneration, monitoring of the effectiveness, and independence of the auditor;
- review and agree on the terms of engagement for the auditor at the start of each audit;
- review the scope of the external audit with the auditor including identified risk areas and any additional agreed upon procedures;

¹ These principles have been developed from international reports, best practice guides and standards. Particular reliance has been placed on the Blue Ribbon Committee, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (1999); the New York Stock Exchange, *NYSE Listed Company Manual: 303.01 Audit Committee*; and the Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors-Australia, *Audit Committees: Best Practice Guide* (2nd ed, 2001).

- review the auditor's audit fee, and be satisfied that an effective, comprehensive and complete audit can be conducted for that fee (this includes reviewing and assessing fees paid for non-audit service provisions);
- review with the auditor any significant disagreements between the auditor and management, irrespective of whether they have been resolved;
- monitor the number of former employees of the audit firm currently employed in senior positions in the company and assess whether this impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether taken as a whole, the various relationships between the company and the auditor impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether the compensation of the individuals employed by the auditor who are performing the audit of the company is tied to the provision of non-audit services and, if so, consider whether this impairs or appears to impair the auditor's judgment or independence in respect of the company;
- review the economic importance of the company (in terms of fees paid to the auditor for the audit as well as fees paid to the auditor for the provision of non-audit services) to the auditor, and assess whether the economic importance of the company to the auditor impairs or appears to impair the auditor's judgment or independence in respect of the company; and
- at least annually, meet with the auditor without the presence of management.

If ASX does not amend its Listing Rules the Corporations Act should be amended to reflect these recommendations regarding audit committees.

APPOINTMENT AND REMOVAL OF AUDITORS

It is recommended that the following Audit Review Working Party² recommendations (as amended as part of this review) be implemented:

- 1 The auditor of a listed company should be appointed and their remuneration determined on the recommendation of the company's audit committee. (Recommendation 7.2)
- 2 The auditor of a company which is not listed should be appointed and their remuneration determined on the recommendation of the company's audit committee where such a committee exists. (Recommendation 7.3)
- 3 There should be mandatory rotation of the audit partners responsible for the audit of listed companies. (Recommendation 7.7) The rotation is to occur after a maximum of 7 years but may occur sooner if considered appropriate by those involved in the audit. There is to be a period of at least 2 years before the partner can again be involved in the audit of the client.
- 4 The Corporations Act or the ASX Listing Rules (or the ASX Guidance Note relating to continuous disclosure) should be amended to provide that a proposed change to the auditor of a disclosing entity is a continuous disclosure matter. (Recommendation 7.14)
- 5 The Corporations Act should provide that any proposal for appointment of auditors of a disclosing entity must contain information on the proposed fees. (Recommendation 7.15)

² Report of a Working Party of the Ministerial Council for Corporations, *Review of Requirements for the Registration and Regulation of Company Auditors* (July 1997).

DISCIPLINARY MATTERS

It is recommended that:

- 1 The Australian Securities and Investments Commission Act (ASIC Act) be amended to:
 - (a) provide for the appointment of a deputy chairperson for the Companies Auditors and Liquidators Disciplinary Board (CALDB);
 - (b) allow the CALDB to sit in more than one Division simultaneously;
 - (c) provide that a Division of the CALDB be constituted by:
 - (i) the chairperson or deputy chairperson;
 - (ii) a member, deputy of the member or a reserve member nominated by the ICAA; and
 - (iii) a member, deputy of the member or a reserve member nominated by CPA Australia; and
 - (d) provide for the ICAA and CPA Australia to each submit a panel of not less than seven and not more than ten names from which the Minister will appoint:
 - (i) one ICAA member, a deputy of the ICAA member, and up to two ICAA reserve members; and
 - (ii) one CPA Australia member, a deputy of the CPA Australia member, and up to two CPA Australia reserve members.

- 2 In making the appointments, the Minister should have regard to the need to ensure that included in the appointments are some members, deputies or reserves who are current or former insolvency practitioners.

- 3 The ASIC Act or the Corporations Act, as appropriate, be amended to:
 - (a) enable the CALDB to enforce orders made during the pre-hearing period;
 - (b) provide that, in respect of each disciplinary proceeding, the nature of the matter, the decision and the reasons for the decision should be published; and
 - (c) enable the CALDB to provide information obtained by it during the course of a disciplinary proceeding to the investigation and disciplinary committees of the ICAA, CPA Australia and NIA, to facilitate the disciplinary procedures of those bodies.

ATTENDANCE OF AUDITOR AT AGM

It is recommended that the Corporations Act be amended to require the company's auditor or a representative of the auditor to attend the AGM at which the auditor's report is tabled unless

reasonable circumstances preclude the auditor's attendance. This requirement would only apply to AGMs of listed public companies.

C. OTHER ISSUES CONSIDERED DURING REVIEW (Part 7 of the report)

The following recommendations of the Audit Review Working Party, which deal with issues not addressed elsewhere in this report, should be implemented:

- 1 Educational requirements for registration as a company auditor should be enhanced by requiring all applicants to have completed a specialist course equivalent to the auditing module currently provided by the ICAA's Professional Year Program or CPA Australia's Certified Practising Accountant Program.
- 2 All registered company auditors, whether members of professional accounting bodies or not, should be required to abide by ethical requirements equivalent to the codes of ethics and other rules of the professional accounting bodies. This can be achieved by those registered company auditors who are not members of professional accounting bodies complying with rules or guidelines issued by ASIC or entering into a written undertaking with ASIC that they will comply with the ethical requirements and other professional rules of the professional accounting bodies as if they were members.
- 3 Competency standards should be adopted as the principal basis for determining whether a person has sufficient practical experience to be registered as a company auditor.
- 4 Where a registered company auditor has not undertaken any substantive audit work during a period of not less than five years, ASIC may require the auditor to show cause why his or her registration should not be cancelled.
- 5 The requirement that registered company auditors lodge a triennial statement with ASIC should be replaced by an annual statement containing the revised information outlined in paragraph 7.13 of this report.
- 6 Registered company auditors should be required to undertake a minimum amount of professional development, with the amount to be prescribed being similar to that required of ICAA and CPA Australia members who hold public practice certificates.
- 7 The work of all registered company auditors should be subject to periodic quality reviews.
- 8 The Corporations Act should be amended to provide that Auditors-General may, subject to any constraints contained in the legislation establishing their respective offices, delegate to a person responsibility for signing an auditor's report or an audit review prepared under Part 2M.3 of the Corporations Act.