

PART 4

AUDIT INDEPENDENCE

THE IMPORTANCE OF AUDITS

4.01 Audited financial statements are an important part of the financial information that is available to the capital markets and an important part of effective corporate governance. According to the Panel on Audit Effectiveness:

‘Audits improve the reliability of financial statements, make them more credible and increase shareholders’ confidence in them. Auditors constitute the principal external check on the integrity of financial statements. As former SEC Commission Steven M H Wallman has noted, “Without accountants to ensure the quality and integrity of financial information, the markets for capital would be far less efficient, the cost of capital would be far higher, and our standard of living would be lower.” Accordingly, a fundamental assumption underlying the Panel’s study and recommendations is its belief that, for many reasons, the value of audits and the public’s need for effective audits remain undiminished and in fact may be greater than every before.’³

4.02 It has been said that audits:⁴

- (a) add value to financial statements by improving their reliability;
- (b) add value to the capital markets by enhancing the credibility of financial statements;
- (c) enhance the effectiveness of the capital markets in allocating valuable resources by improving the decisions of users of financial statements; and
- (d) assist to lower the cost of capital to those using audited financial statements by reducing information risk.

THE IMPORTANCE OF AUDITOR INDEPENDENCE

4.03 It is often said that independence is fundamental to the reliability of auditors’ reports.

‘Those reports would not be credible, and investors and creditors would have little confidence in them, if auditors were not independent in both fact and appearance. To be credible, an auditor’s opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with generally accepted accounting principles.’⁵

³ Panel on Audit Effectiveness, *Report and Recommendations* (2000) (chaired by Shaun F O’Malley).

⁴ Independence Standards Board, *A Conceptual Framework for Auditor Independence*, Discussion Memorandum (February 2000), paras 11-14.

⁵ Panel on Audit Effectiveness, above n 3, para 5.1.

4.04 According to Carey, ‘independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession’s strength and its stature’.⁶

THE CURRENT REGULATORY ENVIRONMENT

4.05 The current regulatory environment for the independence of auditors in Australia can be described as co-regulatory. The major role is played by the professional accounting bodies through their professional requirements and codes of ethics. At the same time, the Australian Securities and Investments Commission plays a role in ensuring that auditors of Australian companies remain independent by enforcing those provisions of the Corporations Act (notably section 324) which deal with the independence of auditors. A role is also played by the Companies Auditors and Liquidators Disciplinary Board (CALDB) in the independence of auditors as this body deals with disciplinary matters concerning auditors.

4.06 This type of co-regulatory environment exists in many countries. The recommendations contained in this report have, as one of their key objectives, continuing this co-regulatory environment. We recommend strengthening and updating section 324 of the Corporations Act in relation to the independence of auditors. The requirements in section 324 have not changed in any substantive way for at least 40 years. At the same time we see a strengthened role for the professional accounting bodies in updating their professional requirements and codes of ethics and providing leadership to the profession in terms of auditor independence. We believe the professional accounting bodies are well placed to play a central role in ensuring that auditors remain independent of their clients. It is appropriate to look to these bodies to fulfil this task. Market outcomes can be improved and there can be lower regulatory costs on business where professional bodies are both willing to, and have the ability to, play a key role in regulation.⁷

DEVELOPMENTS IN AUDITOR INDEPENDENCE

4.07 With the increasing globalisation of capital markets, there has been a growing recognition of the desirability of achieving uniformity and harmonisation not only in the areas of financial reporting and auditing, but also in the ethical requirements that underpin the work of members of the accounting profession.

4.08 Key elements of the profession’s ethical rules are those dealing with independence and the circumstances in which independence may be impaired.

4.09 The notion of professional independence is fundamental to auditing, ‘since the auditor’s objective is to enhance, through the expression of an independent opinion, the credibility of the reported financial information of an entity. The value of the independent audit lies both in the fact that the auditor is, and is seen to be, independent of the audited entity, and hence is able to carry out the audit free of any externally imposed constraints.’⁸

⁶ John L Carey, *The Rise of the Accounting Profession: To Responsibility and Authority, 1937-1960* (1970) 182, quoted in Panel on Audit Effectiveness, above n 3, para 5.1.

⁷ In relation to the development of effective self-regulation, see the report of the Task Force on Industry Self-Regulation, *Industry Self-Regulation in Consumer Markets* (August 2000).

⁸ Australian Statement of Auditing Practice AUP 32 *Audit Independence*, para 6.

4.10 'Independence requires a freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure, any of which could lead to a belief that the audit opinion was determined other than by reference to the facts of the audit alone.'⁹

4.11 In Australia, interest in the issue of audit independence has been increased by speculation about what, if any, role audit independence matters played in a number of high-profile corporate failures during the first half of 2001.

4.12 Internationally, developments in the area of audit independence have recently been given prominence by:

- (a) the release of proposals by the accounting profession's peak international body, the International Federation of Accountants (IFAC), aimed at updating its ethical requirements on audit independence;
- (b) the release by the European Commission of a consultative paper containing proposals designed to achieve greater uniformity in the requirements in force in the Member States of the European Community; and
- (c) the United States Securities and Exchange Commission's (SEC) decision to remake its rules on audit independence to address issues associated with recent independence violations by auditors in the US.

4.13 The following paragraphs outline the basis on which independence rules are currently set in Australia. An outline is also provided of proposed amendments to IFAC and European Commission requirements and the revised rules made late last year by the SEC.

Australia

4.14 In Australia, measures designed to ensure that accounting firms are independent of their audit clients are contained in the Corporations Act 2001, Professional Statement F1 of the Code of Professional Conduct¹⁰ (issued jointly by the ICAA and CPAA) and Statement of Auditing Practice AUP 32 Audit Independence¹¹ (also issued jointly by the ICAA and CPAA). Statement F1 deals more generally with professional independence of accountants (although it does contain specific requirements in respect of audit work) while AUP 32 is concerned specifically with audit independence.

4.15 Australian legislative provisions on audit independence specify a range of employment and financial relationships which, if they existed, would preclude an individual or accounting firm from accepting appointment as auditor of a company. Details of these relationships, which have seen no substantive changes since the introduction of the Uniform Companies Acts in all States and Territories in the early 1960s, are outlined in Part 5 of this report.

4.16 Following a series of corporate failures in the late 1980s, the Ministerial Council for Corporations (Minco) established a Working Party of Minco officers to prepare a report concerning

⁹ AUP 32, above in n 8, para 8.

¹⁰ The text of Professional Statement F1 is in Appendix E.

¹¹ The text of AUP 32 is in Appendix F.

professional liability in respect of claims arising from the Corporations Law or under related common law.

4.17 One of the recommendations in the professional liability report was that there should be a review of the regulation of company auditors with a view to ensuring that there is an appropriate legal framework for the supervision, independence and disciplining of company auditors in relation to their functions under the Law. This review,¹² which was undertaken by a separate Minco Working Party (referred to throughout this report as the Audit Review Working Party) was completed in July 1997, and contained a series of recommendations addressing a range of issues, including the registration of auditors, post-registration supervision of auditors, appointment, independence and discipline (a list of the recommendations appears in Appendix C). To date, none of the substantive recommendations have been implemented, although most recommendations are supported by Minco and it is understood that it is the intention of the Government to proceed with their implementation.

4.18 Shortly after the review of the regulation of company auditors was completed, the ICAA and the ASCPA issued an exposure draft outlining proposals for revising the bodies' ethical requirements on professional independence. Informal advice from the ICAA indicates that the proposed revision of the ethical requirements was put on hold pending the outcome of both the SEC's proposal to amend its rules on audit independence and IFAC's subsequent proposals for a revision of professional rules on independence. Following the release of a revised IFAC exposure draft in April 2001, the ICAA and CPAA (formerly ASCPA) issued that draft in Australia with the intention of using it as the basis for revising the bodies' ethical requirements on independence. Further action by the professional bodies is dependent on whether IFAC issues revised rules based on the exposure draft.

Overseas developments

4.19 While there are significant differences of approach between the proposals of IFAC and the European Commission and the SEC's rules, there are two broad principles underlying both the rules and the proposals:

- (a) an accounting firm must be, and must be seen to be, independent of its audit clients;
and
- (b) an auditor must not audit his or her own work.

4.20 Similarly, in addressing issues of audit independence, the proposals of IFAC and the European Commission and the SEC's rules focus on three key relationships between accounting firms and their audit clients:

- (a) employment relationships;
- (b) financial relationships; and
- (c) provision of non-audit services.

¹² *Review of Requirements for the Registration and Regulation of Company Auditors* (July, 1997).

International Federation of Accountants

4.21 The international accounting community's rules on professional independence are contained in section 8 of IFAC's 'Code of Ethics for Professional Accountants'. In June 2000, IFAC issued an exposure draft which proposed a significant revision of its rules on professional independence. The exposure draft advocated a move to a conceptual framework approach that would require the identification and evaluation of threats to independence and the application of safeguards to reduce any threats created to an acceptable level. The approach proposed by IFAC was supported by respondents and the exposure draft, after revision to reflect comments received, was re-exposed in April 2001 with a comment deadline of 30 June 2001.¹³

4.22 IFAC's conceptual approach to independence uses a framework, built on principles, for identifying, evaluating and responding to threats to independence. The framework establishes principles that the firm and the assurance team should use to identify threats to independence, evaluate the significance of those threats, and identify and apply safeguards to eliminate the threats or reduce them to an acceptable level.

4.23 Table 4.1 lists the threats to independence identified by IFAC and the safeguards that are available for countering those threats.

¹³ The text of IFAC's April 2001 exposure draft is in Appendix G.

TABLE 4.1: THREATS TO INDEPENDENCE IDENTIFIED BY IFAC AND SAFEGUARDS FOR COUNTERING THOSE THREATS	
Threats	
Self-interest	Occurs when a firm or member of the assurance team could benefit from a financial interest or other self-interest conflict with an assurance client.
Self-review	Occurs when any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement, or a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to affect the subject matter of the assurance engagement.
Advocacy	Occurs when a firm, or a member of the assurance team, becomes an advocate for or against an assurance client's position or opinion to the point that objectivity is, or is perceived to be, impaired.
Familiarity	Occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests.
Intimidation	Occurs when a member of the assurance team may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.
Safeguards	
Created by the profession, legislation or regulation	Safeguards should include requirements for entry into the accounting profession, continuing educational requirements, professional disciplinary processes, external reviews of a firm's quality control system and legislation governing the independence requirements of the firm.
Within the audit client	Safeguards should include a corporate governance structure, such as an audit committee, to provide appropriate oversight and communications regarding a firm's services. Other safeguards could include the employment of high-quality staff in sufficient numbers to ensure that a member of the assurance team would not be required to make managerial decisions for the entity and having internal procedures to ensure an objective choice when commissioning non-assurance engagements.
Within the firm's own systems and procedures	Safeguards include firm-wide measures, such as firm leadership that stresses the importance of independence, documented independence policies and procedures to monitor compliance with the firm's policies, and engagement specific safeguards, such as carrying out reviews of work done, removing an individual from the assurance team when his or her financial interests or relationships create a threat to independence and discussing independence issues with the audit committee or others charged with governance

Europe

4.24 The European Commission's existing requirements on audit independence are contained in the Eighth Council Directive [84/253/EEC] of 10 April 1984 (approval of persons responsible for carrying out the statutory audits of accounting documents). Under the Directive, Member States were required to enact legislation providing that:

- (a) persons approved for the statutory auditing of accounting documents shall not carry out statutory audits if they are not independent in accordance with the law of the Member State which requires the audit; and
- (b) the members and shareholders of approved firms of auditors and the members of the administration, management and supervisory bodies of such firms who do not personally satisfy the qualification requirements for being an auditor in a Member State must not intervene in the execution of audits in any way which jeopardizes the independence of the natural persons auditing the documents on behalf of such firms of auditors.

4.25 At the time the Eighth Council Directive was adopted, it was not possible to obtain agreement among Member States on a common definition of statutory auditors' independence. As a consequence, this issue has been dealt with differently in Member States, based on different traditions and experiences. Current national rules on statutory auditors' independence differ in several aspects such as scope of persons, within and outside an audit firm, to whom independence rules should apply, the different kind of financial, business or other relationships with an audit client, the type of non-audit services to audit clients that are permitted or prohibited, and the safeguards that need to be put in place.¹⁴

4.26 To overcome these concerns, the Commission proposes issuing a Recommendation providing a principles based approach to audit independence which requires auditors and audit firms to consider:

- (a) the expectations of those directly affected by their work;
- (b) the public interest;
- (c) the threats to independence which may arise in practice; and
- (d) the safeguards available to eliminate those threats or reduce them to an acceptable level.

4.27 The Commission's proposals are divided into two parts: a framework which sets out the basic principles that should apply and specific requirements to apply in particular situations. The framework deals with issues such as objectivity, integrity and independence, responsibility of scope, independence threats and risk and a system of safeguards (which include prohibitions, restrictions, other policies and procedures and disclosures) while the specific requirements deal with financial involvement, business relationships, employment with the audit client, managerial or supervisory role in audit client, establishing employment with the audit firm, family and other personal relationships, non-audit services, audit and non-audit fees, litigation and senior personnel acting for a long period of time.

¹⁴ *Consultative Paper on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles* (European Commission, Brussels, 2000).

4.28 The consultation period for the European Commission's proposals, which, at least in part, appear to be based on IFAC's June 2000 exposure draft, commenced in December 2000 and ended on 2 March 2001.¹⁵

United States of America

4.29 The existing US rules were made in November 2000, when the SEC responded to a range of independence violations by one of the Big 5 firms, as well as a perceived need to update generally its audit independence rules. In doing this, the SEC adopted a strong prescriptive approach to independence. The revised rules were made following a consultative process that commenced in mid 2000 and were effective from 5 February 2001.¹⁶

4.30 Although the SEC's new rules are prescriptive in nature, they were developed using four principles, which are based on the philosophy that auditors must be independent in fact and appearance, for measuring an auditor's independence. Under these principles an accountant is not independent when the accountant:

- (a) has a mutual or conflicting interest with the audit client;
- (b) audits his or her own firm's work;
- (c) functions as management or an employee of the audit client; or
- (d) acts as an advocate for the audit client.

4.31 In addition to the rules on audit independence made by the SEC, the US accounting profession also has ethical requirements in the area of professional independence. However, it is our understanding that many of the requirements in the profession's rules are now addressed in the SEC's rules.

Other developments

4.32 In addition to the abovementioned international developments dealing specifically with audit independence, the last few years have seen the publication of a number of reports which address issues either associated with or having the potential to enhance audit independence. These reports include:

- (a) *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (New York Stock Exchange and the National Association of Securities Dealers, New York, 1999); and
- (b) *Report and Recommendations of the Panel on Audit Effectiveness* (Public Oversight Board, Stamford, 2000).

4.33 There have also been a number of overseas reports dealing more generally with corporate law reform, including issues associated with audit independence. Perhaps the most significant of these has been a series of reports on modern company law for a competitive economy (*Developing*

¹⁵ The text of the European Commission's consultative paper is at Appendix H.

¹⁶ The text of the SEC's amended rules is at Appendix I.

the Framework; Completing the Structure; and Final Report) prepared by the British Company Law Review Steering Group.