

PART 5

KEEPING ACCOUNTING FIRMS INDEPENDENT OF THEIR AUDIT CLIENTS

5.01 When considering whether accounting firms are independent of their audit clients, three key issues need to be considered:

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

Each of these matters is considered below.

5.02 In addition, regard must also be had to a number of related issues that can affect the independence of an auditor. These issues are discussed in Part 6.

GENERAL STATEMENT OF PRINCIPLE REQUIRING INDEPENDENCE

5.03 It is notable that the Corporations Act currently contains several provisions dealing with the independence of auditors. As discussed below, these include prohibitions on the auditor occupying certain employment positions with the audit client and prohibitions on certain financial relationships between the auditor and the audit client. However, the Corporations Act does not contain a general statement requiring an auditor to be independent. Other countries, such as Canada and New Zealand, which have in their corporations legislation provisions dealing with the independence of auditors, also have in their legislation a general statement requiring an auditor to be independent. For example, section 161 of the Canada Business Corporations Act states that a person is disqualified from being an auditor of a company if he or she is not independent of the company, any of its affiliates, or the directors or officers of any such corporation or its affiliates. Section 204 of the New Zealand Companies Act states that an auditor of a company must ensure, in carrying out the duties of an auditor, that his or her judgment is not impaired by reason of any relationship with or interest in the company or any of its subsidiaries.

5.04 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.

5.05 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.

EMPLOYMENT RELATIONSHIPS

5.06 The expression ‘employment relationships’ is used in this report to cover the following broad areas of involvement between an accounting firm and its audit client:

- (a) employment of an accounting firm’s current and former members and professional staff by an audit client;
- (b) employment of close relatives of an accounting firm’s members and staff by an audit client; and
- (c) employment of directors and senior management of a company by its auditor.

Australian position

5.07 Subsections 324(1), (2) and (4) of the Corporations Act contain provisions dealing with employment relationships. Subsections 324(1) and (2) provide that an individual or accounting firm must not consent to be appointed as auditor of a company, act as auditor of a company or prepare a report required by the Act to be prepared by a registered company auditor or by an auditor of a company if:

- (a) except where the company is a proprietary company, the individual or a member of the firm is:
 - (i) an officer of the company;
 - (ii) a partner, employer or employee of an officer of the company; or
 - (iii) a partner or employee of an employee of an officer of the company; or
- (b) except where the company is a proprietary company, an officer of the company receives any remuneration from the firm for acting as a consultant to it on accounting or auditing matters.

5.08 An officer of a company is defined in section 9 of the Corporations Act to include a director or secretary of the company as well as a person who makes or participates in making, decisions that affect the whole, or a substantial part, of the business of the company. In addition, subsection 324(4) of the Corporations Act provides that, for the purposes of subsections 324(1) and (2), a person is taken to be an officer of a company if:

- (a) the person is an officer of a related body corporate or of an entity that the company controls; or
- (b) except where ASIC, if it thinks fit in the circumstances of the case, directs that this paragraph not apply, the person has, at any time within the immediately preceding period of 12 months, been an officer or promoter of the company, of a related body corporate, or of an entity that the company controlled at that time.

5.09 Professional Statement F1 and AUP 32 both contain requirements that reinforce those in subsections 324(1), (2) and (4). In addition, F1 provides that no person in an accounting firm shall:

- (a) personally take part in the audit of a client if, during the period in respect of which the audit is to be performed or at any time in the 12 months prior to the first day of the period in respect of which the audit is to be performed, a near relative of the person has been an officer (other than an auditor), partner or employee of the client (F1 para 8);
- (b) act as auditor of a company if any person in the practice is an employee of the company (F1 para 9); or
- (c) accept or retain a directorship of a company which, through ownership of shares or otherwise, exerts significant influence over another company of which the firm or any person in the firm is auditor (F1 para 23).

5.10 The ICAA and CPAA have proposed that the professional requirements should be amended along the lines of the proposals in IFAC's April 2001 exposure draft (see below for the IFAC proposals).

Overseas developments

International Federation of Accountants

5.11 IFAC's April 2001 exposure draft identifies five categories of employment relationship that may have the potential to threaten an auditor's independence:

- (a) employment with an assurance client;
- (b) recent service with an assurance client;
- (c) serving as an officer or as a director on the board of an assurance client;
- (d) long association of senior personnel with an assurance client; and
- (e) family and personal relationships.

5.12 Table 5.1 sets out the nature of the threats to independence that may be caused by each of the above categories of employment relationship and the measures that should be adopted to safeguard independence.

**TABLE 5.1: EMPLOYMENT RELATIONSHIPS IDENTIFIED BY IFAC
AS A POTENTIAL THREAT TO INDEPENDENCE**

Category	Nature of threats to independence	Safeguards to protect independence
Employment with an assurance client	Self-interest, familiarity and intimidation threats could arise where an assurance client's director, officer or member of management has been a member of the assurance team or partner of the firm.	Ensuring the individual concerned: (1) is not entitled to any benefits or payments from the firm (unless made in accordance with fixed pre-determined arrangements); and (2) does not continue to participate, or appear to participate, in the firm's business or professional activities.
Recent service with an assurance client	Self-review and self-interest threats could occur where a former officer, director or employee of the assurance client serves as a member of the assurance team.	Where employment with the assurance client ended during the period covered by the assurance report, the individual should not be assigned to the assurance team. In other cases, it may be necessary to conduct additional reviews of the work performed and to discuss the matter with those in the assurance client who are charged with corporate governance.
Serving as an officer or a director on the board of an assurance client	Self-review and self-interest threats would be created by a partner or employee of the firm serving as an officer or director of an assurance client or its related entities.	Refuse to perform, or withdraw from, the assurance engagement.
Long association of senior personnel with an assurance client	A familiarity threat may be created where the same lead audit engagement partner or senior personnel are used over a long period of time.	The lead audit partner should be rotated after a pre-defined period (normally 7 years); such a partner should not resume his or her lead role for at least 2 years. In the case of team members, they could be rotated off the assurance team or additional reviews of work carried out.
Family and personal relationships	Self-interest, familiarity or intimidation threats could occur where there are family and personal relationships between a member of the assurance team	Where the relationship involves an immediate family member of a member of the assurance team, the individual should be removed from the team or the firm should

	and a director, an officer or certain employees of the assurance client.	withdraw from the assurance engagement. Where the relationship involves a close family member of a member of the assurance team, it may be sufficient to remove the individual from the team.
--	--	--

Europe

5.13 Under the Eighth Council Directive, Member States are required to enact legislation providing that persons approved for the statutory auditing of accounting documents shall not carry out such audits if they are not independent in accordance with the law of the Member State which requires the audit.

5.14 In the United Kingdom, the requirements of the Eighth Council Directive were implemented by the Companies Act 1989. Subsection 27(1) of the Act provides that a person is ineligible for appointment as auditor of a company if he or she is an officer or employee of the company, or a partner or employee of such a person, or a partnership of which such a person is a partner. While subsection 27(2) of the Act provides that the Secretary of State may also make regulations specifying further connections between an audit firm and its audit client that would make the firm ineligible for appointment, no regulations to this effect appear to have been made.

Proposed changes

5.15 The consultative paper issued by the European Commission in December 2000 identifies five employment relationships that are considered to have the potential to affect the independence of auditors. The relationships, and the safeguards that should be used to avoid or minimise the independence risks posed by each relationship, are listed in Table 5.2.

TABLE 5.2: EMPLOYMENT RELATIONSHIPS IDENTIFIED IN THE EUROPEAN COMMISSION'S PAPER AS A THREAT TO INDEPENDENCE	
<i>Category</i>	<i>Safeguards to protect independence</i>
Dual employment	Dual employment of any individual who is in a position to influence the outcome of the audit in either the audit firm or its client should be prohibited.
Member of engagement team joins audit client	Where a member of an engagement team is leaving the audit firm to join an audit client the policies and procedures of the audit firm should provide for the immediate removal of the person from the audit team and the adoption of any other measures needed to ensure independence is not compromised.
Other member of firm joins audit client	Where a former engagement team member, or an individual within the chain of command, joins an audit client the policies and procedures of the audit firm should ensure that there remain no significant connections between itself and the individual.

Director or manager of audit client joins firm	Where a director or manager of an audit client joins the audit firm, the individual should not be involved in the audit of the client for a period of two years after leaving the client. Similar considerations apply where a former employee of the audit client joins the audit firm unless the responsibilities he held and the tasks he performed at the audit client were insignificant in relation to the statutory audit function.
Involvement of close family member	An individual who is a statutory auditor should not accept an audit engagement if a close family member holds a senior management position with the audit client or is in a position to exert direct influence on the preparation of the audit client's accounting records or financial statements.

5.16 The European Commission's paper also notes that independence risks can occur where certain members of the engagement team work regularly and for a long period of time on an audit client engagement. To reduce risks to independence, the paper proposes that the audit partner should be replaced within a reasonable period of time (5 to 7 years is suggested) and the partner should not be allowed to return to the audit until a two-year period of time has elapsed.

United States of America

5.17 The SEC's new rules seek to preserve audit independence in the area of employment relationships by preventing:

- (a) a current member¹⁷ of an accounting firm from being employed by the audit client or serving as a director of the audit client;
- (b) a former member of an accounting firm from being in an accounting role or financial reporting oversight role at an audit client (although exemptions to this requirement are provided where the individual does not influence the accounting firm's operations or financial policies, has no capital balances in the accounting firm and has no financial arrangement with the accounting firm other than one providing for regular payments of a fixed dollar amount such as under a fully funded retirement plan where the payment is independent of the revenue, profits or earnings of the audit firm);
- (c) a former officer, director or employee of an audit client from becoming a member of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client covering any period during which he or she was employed by or associated with that audit client; and
- (d) a close family member of a covered person¹⁸ in the firm from being in an accounting role or financial oversight role at an audit client during a period in which the covered person was involved in the audit of the client.

¹⁷ A member of an accounting firm includes a partner, principal shareholder or professional employee.

¹⁸ 'Covered person' is defined in the SEC rules to mean the following members of an accounting firm: (a) the audit engagement team; (b) the chain of command; (c) any other member of the firm who has provided 10 or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the

Adequacy of Australian requirements

5.18 The existence of employment relationships between an accounting firm and an audit client can give the impression that an auditor is not independent of the client, irrespective of the actual situation. Where such relationships exist, there may be a range of circumstances which, collectively or individually, make it difficult for the auditor to adopt an unbiased approach to the audit engagement, with the result that the audit client could receive a more favourable audit report than the facts or circumstances justify. Consequently, in the English-speaking world at least, legislators have long been minded to include in corporate legislation provisions which have the objective of prohibiting or restricting employment relationships. More recently, professional accounting bodies have also amended their ethical codes to include prohibitions or restrictions on employment relationships.

5.19 In keeping with these broad objectives, the IFAC and European Commission proposals and the SEC rules all seek to safeguard independence by ensuring that:

- (a) partners or professional employees of an accounting firm are not employed by the audit client or serve as a director of the audit client;
- (b) where a former partner or professional employee of an accounting firm is employed in an accounting role or a financial reporting oversight role at an audit client, there are (with limited exceptions) no residual links with the accounting firm;
- (c) where a former officer, director or employee of an audit client becomes a member of an accounting firm, the person is not in a position to audit, or influence the audit, of financial statements concerning a period during which he or she was employed by, or associated with, the audit client; and
- (d) relatives of a member of an audit team are not directors of an audit client or employed by the audit client in a senior management position, in an accounting role, or a financial oversight role.

5.20 The IFAC and European Community proposals also seek to limit long-term associations between members of the audit team and the audit client. In both cases it is proposed that the partners involved should be replaced after not more than 7 years and that they should not be able to return to the audit until a two-year period of time has elapsed.

5.21 The Australian legislative requirements are largely designed to ensure that partners and employees of an accounting firm do not serve as officers of an audit client. In addition, there is a prohibition on an accounting firm being an auditor of a company if an officer of the company receives remuneration from the firm for acting as a consultant to the firm on accounting or auditing matters¹⁹ while paragraph 324(4)(b) of the Corporations Act effectively restricts an accounting firm from employing former officers of an audit client during the period of 12 months after they ceased to be an officer of the client.

date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide 10 or more hours on non-audit services to the audit client on a recurring basis; and (d) any other member from an office of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

¹⁹ While the history of this provision is unclear, it appears to be an attempt to address the issue of former partners of accounting firms who are retained as consultants following their retirement from the firm.

5.22 The requirements of the Australian accounting profession, as set out in Statement F1 and AUP 32, build on the legislative requirements. In particular, the professional requirements prohibit a person in an accounting firm from taking part in the audit of a client if a near relative of the person is, or has recently been, an officer or employee of the audit client and add a more general requirement that an accounting firm will not act as auditor of a company if any person in the firm is an employee of the company.

5.23 Differences in terminology used in the various legislative and professional requirements examined during the course of this review make precise comparisons of Australian and overseas requirements difficult. Nevertheless, it is evident that Australian legislative requirements, in particular, have not been updated to address key issues such as relatives of the auditor or other members of the accounting firm being directors of, or employed by, the audit client. While the profession's ethical requirements deal with some matters not in the Corporations Act, they are in need of revision to reflect the philosophies that underpin the overseas proposals.

5.24 There are three basic ways in which the Australian requirements on employment relationships could be reformed:

- (a) retention of a co-regulation model, in which both the Corporations Act and the ethical rules of the professional bodies contain requirements dealing with audit independence;
- (b) exclusive reliance on independence requirements in the ethical rules of the professional bodies; or
- (c) exclusive reliance on independence requirements in the Corporations Act.

5.25 With a co-regulation model, the legislation would set the core requirements, and the ethical rules of the professional bodies, revised in line with the IFAC proposals, would provide additional guidance for considering the threats to audit independence associated with employment relationships and the safeguards available for eliminating or minimising those threats.

5.26 A model in which exclusive reliance is placed on ethical rules of the professional bodies may not sufficiently reflect the public interest in the important issue of auditor independence and there can also be benefits in terms of enforcement in having some legislative provisions. It is also to be noted that at least one of the recommendations detailed below would be very difficult, if not impossible, to include in the ethical rules of the professional accounting bodies. In particular, the recommendation concerning retired audit partners joining the boards of their former clients could not be enforced by the professional bodies, if it was part of their ethical rules, if retired audit partners were no longer members of the professional bodies.

5.27 At the same time, a model in which exclusive reliance is placed on independence requirements in the Corporations Act does not allow a legitimate role for professional bodies to develop appropriate ethical rules.

5.28 While each of these three options is worthy of consideration, the high level of importance that Australian legislators have previously placed on seeking to ensure audit independence by prohibiting or restricting employment relationships has led us to the view that the preferred option is the retention of a co-regulation model. Under this model the legislative requirements should be revised to include provisions dealing with:

- (a) the employment of current and former professional employees of an accounting firm by an audit client;
- (b) the employment of relatives of partners or employees of an accounting firm by an audit client; and
- (c) the employment by an accounting firm of former employees of an audit client.

5.29 The amendments to the Corporations Act proposed under a revised co-regulation model are detailed below under recommendations.

5.30 We note that a particular concern in Australia has been retired audit partners joining the boards of their audit clients. A significant number of the stakeholders consulted during the course of the review identified this as a concern. Where this occurs, it is often seen as a particular threat to the independence of the audit firm. The threat to independence can arise not only when the former partner joins the audit client but also if the former audit partner retains some financial arrangement with his or her audit firm or continues to exercise influence with the audit firm.

5.31 The potential threats to independence in these circumstances have been summarised as follows:²⁰

‘The concerns expressed when professionals leave firms to join audit clients are generally threefold:

- (a) That partners or other audit team members who resign to accept positions with audit clients may not have exercised an appropriate level of scepticism during the audit process prior to their departure.
- (b) That the departing partner or other professional may be familiar enough with the audit approach and testing strategy so as to be able to circumvent them once he or she begins employment with the client.
- (c) That remaining members of the audit team, who may have been friendly with, or respectful of a former partner or other professional when he or she was with the firm, would be reluctant to challenge the decisions of the former partner or professional and, as a result, might accept the client’s proposed accounting without exercising appropriate scepticism or maintaining objectivity.

The perceived threats to auditor independence when the former partner or professional has retirement benefits or a capital account with the audit firm are as follows:

- (a) It may appear that ties between the audit firm and the partner or other professional have not been severed – that the firm has placed its “own man or woman” at the client, functioning as management, and is in effect auditing the results of its own work.
- (b) If the retirement benefits of the former partner or other professional vary based on the firm’s profits, then the former partner or other professional may

²⁰ Independence Standards Board, *Independence Standard No 3, Employment with Audit Clients* (July 2000).

be inclined to pay the firm higher fees to inflate his or her retirement benefits (or to increase the likelihood of receiving benefits in unfunded plans). As a result, the firm may be less rigorous in its scrutiny of the client's accounting policies because its fees are overly rich.

- (c) If the former partner's or other professional's unfunded retirement benefits or other monies held by the firm are material to the firm and the firm is experiencing cash flow problems, the firm may be less rigorous in its audit of the client's financial statements in exchange for forbearance on the amounts owed to the former partner or other professional.'

5.32 We have formulated recommendations as part of the review which we believe are appropriate to deal with these threats to auditor independence. In particular, to deal with threats to auditor independence when a former partner or professional retains retirement benefits with the audit firm or is in a position to influence the audit firm's operations or financial policies, we recommend that 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.

5.33 To deal with the threat to independence when a retired audit partner joins the board of an audit client, we recommend that there be a mandatory period of two years following resignation from the audit firm before a former partner of an audit firm who is directly involved in the audit of a client can become a director of the client. This proposal received the support of a number of key stakeholders who were consulted during the course of the review, including the support of the big five accounting firms. We are conscious, in formulating this recommendation, of not wanting to unduly impede employment opportunities for those who want to move from audit firms to companies. Indeed, we recognise that it can be of benefit to the economy to allow those who have financial expertise to take this expertise to companies, by becoming directors or employees of those companies. In this regard, we stress the limited nature of our recommendation. It only restricts a former partner of an audit firm directly involved in the audit of a client becoming a director of the client within a period of two years of resigning as partner of the audit firm. This means that it is still possible for:

- (a) someone at the audit firm, other than a former partner of the audit firm directly involved in the audit of a client, to join the client in a capacity as director, officer or employee;

- (b) a former partner of the audit firm directly involved in the audit of a client to join the client in some capacity other than as a director; and
- (c) a former partner of the audit firm directly involved in the audit of a client to become a director of the client once the period of two years has expired since the date of resignation as a partner of the audit firm.

5.34 We believe the recommendations achieve an appropriate balance between the important objective of putting in place mechanisms to ensure auditor independence while, at the same time, not unduly impeding professionals in audit firms joining companies and bringing with them to those companies financial expertise.

Recommendations

5.35 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.

It is important to emphasise that these employment relationships 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 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).²¹

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

²¹ The Corporations Act currently provides that the prohibitions in section 324 on employment relationships between accounting firms and audit clients do not apply if the audit client is a proprietary company. The Audit Review Working Party recommended that the exemption for proprietary companies be removed (recommendation 9.1). This was on the basis that the exemption could provide for two standards of audit. However, the Working Party noted that its recommendation could impose additional cost burdens on closely held family companies and that its major concern was with the independence of auditors of proprietary companies which are substantial in size and likely to have minority shareholders and substantial liabilities. Given these considerations, we believe that the most appropriate way forward is to exclude from the employment prohibitions in section 324 only small proprietary companies (as defined in section 45A of the Corporations Act). This accommodates the main concern of the Working Party to ensure that large proprietary companies are subject to auditor independence rules. However, it does not impose cost burdens on small proprietary companies as they will be exempt.

- (c) a partner or employee of an employee of an officer of the client.

[Note: Paragraphs (a), (b) and (c) are drawn from subsections 324(1) and (2) of the Corporations Act. However, section 324 is limited to members of the firm. The recommendation also applies to professional employees of the audit firm. This is consistent with international rules and proposals which prohibit such relationships (see IFAC proposals, paragraph 8.134 and SEC Rule 210.2-01(c)(2) (i)).]

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.

[Note: This recommendation is drawn from the IFAC proposals (paragraph 8.124) and the SEC rules (Rule 210.2-01(c)(2)(ii)) which prohibit these employment relationships. The difference between the two is that the IFAC proposal applies to immediate family members while the SEC rule applies to close family members. On balance, we prefer the IFAC proposal and note that this is more consistent with the European Commission proposal.]

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.

[Note: This recommendation is drawn from the IFAC proposals (paragraph 8.129) and the SEC rules (Rule 210.2-01(c)(2)(iii)) which prohibit these employment relationships.]

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.

[Note: See paragraphs 5.30 to 5.34 of the report for discussion of this recommendation.]

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.

[Note: This recommendation is drawn from the IFAC proposals (paragraph 8.132) and the SEC rules (Rule 210.2-01(c)(2)(iv)) which prohibit these employment relationships.]

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.

[Note: This recommendation repeats what is currently in subsection 324(2)(h) of the Corporations Act but has been expanded to include employees of the client who are in a position to influence the subject matter of the audit engagement.]

7 Inadvertent breaches

It is appropriate that there be protection for inadvertent breaches of the independence rules concerning employment relationships, provided certain requirements are met. Therefore, an auditor's independence will not be impaired solely because a person in the audit firm is not independent because of a breach of the rules concerning employment relationships provided:

- (a) the person did not know of the circumstances giving rise to the lack of independence;
- (b) the person's lack of independence was corrected as promptly as possible under the relevant circumstances after the person or the audit firm became aware of it; and
- (c) the audit firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the audit firm's practice, that the audit firm and its employees do not lack independence.

[Note: This recommendation is drawn from the IFAC proposals and the SEC rules (Rule 210.2-01(d)) which provide exemptions for inadvertent breaches of the independence rules provided certain requirements are met. This recommendation draws in particular upon the SEC rules but does not go as far as the SEC rules which require specific quality control systems for audit firms

that annually provide audit services to more than 500 companies whose securities are registered with the SEC.]

Key definitions

Audit engagement team:

- (a) all professionals participating in the audit engagement; and
- (b) all others within a firm who can directly influence the outcome of the audit engagement, including:
 - (i) those who supervise or have direct management responsibility for the audit engagement (this includes those at successively senior levels through the firm's chief executive);
 - (ii) those who provide consultation regarding technical or industry-specific issues, transactions or events for the audit engagement;
 - (iii) those who provide quality control or other oversight of the audit; and
 - (iv) those who provide direct supervisory, management, compensation or other oversight of the audit engagement partner including those who evaluate the performance or recommend the compensation of the audit engagement partner.

Client:

An entity in respect of which a firm conducts an audit engagement. When the client is a listed entity, client includes related entities.

Immediate family:

A spouse (or equivalent) or dependent.

Other client service personnel:

Partners and managerial employees who provide non-audit services to a client, except those whose time involvement is clearly insignificant.

Related entity:

- (a) an entity that has direct or indirect control over the client provided the client is material to such entity;
- (b) an entity with a direct financial interest in the client provided that such entity has significant influence over the client and the interest in the client is material to the entity;
- (c) an entity over which the client has direct or indirect control;
- (d) an entity in which the client has a direct financial interest, provided the client has significant influence over such entity and the interest is material to the client; and

- (e) an entity which is under common control with the client (a “sister entity”) provided the sister entity and the client are both material to the entity that controls both the client and sister entity.

[Note: These definitions are drawn from the IFAC proposals (see definitions of audit client, assurance team, immediate family, other client service personnel, and related entity) and the SEC rules (Rule 210.2-01(f)), see definitions of audit client, audit engagement team, immediate family members, covered persons in the firm, and affiliate of the audit client.]

FINANCIAL RELATIONSHIPS

5.36 The expression ‘financial relationships’ is used to cover the following broad categories of transaction between an audit firm and an audit client:

- (a) investments in, or other business relationships with, audit clients; and
- (b) other financial interests in audit clients including loans, savings and cheque accounts and insurance products.

Australian position

5.37 Subsections 324 (1) and (2) of the Corporations Act provide that an individual or accounting firm must not consent to be appointed as auditor of a company, act as auditor of a company or prepare a report required by the Act to be prepared by a registered company auditor or by an auditor of a company if the individual, a body corporate in which the person has a substantial holding, a member of the firm, or a body corporate in which a member of the firm has a substantial holding, owes more than \$5,000 to the company, to a related body corporate or to an entity that the company controls.²²

5.38 Statement F1 provides that a practice must not have as an audit client a company in which any person in the practice, or a near relative of any person in the practice, is:

- (a) the beneficial owner of shares forming a material part of the equity share capital of the company, or forming a material part of the assets of that person;
- (b) a trustee of a trust having a material interest in that company; or
- (c) a director or employee of a company which acts as trustee of a trust having a material interest in the client company.

5.39 Statement F1 also contains a number of general requirements which are applicable to practices that perform audit work. These requirements include that no person in the practice, or near relative of any person in the practice, shall:

- (a) accept or make or guarantee a loan from or to a client except for a loan negotiated at arm’s length in the ordinary course of the client’s business; or

²² Subsection 324(3) provides an exemption from this requirement for home loans by financial institutions for a principal place of residence.

- (b) accept from a client goods or services on terms more favourable than those generally available to others.

5.40 In addition, AUP 32 contains a range of requirements about financial relationships which reinforce, but do not go significantly beyond, those in the Corporations Act and Statement F1.

5.41 The 1997 report of the Audit Review Working Party proposed a number of amendments to the indebtedness levels contained in the corporations legislation:

- (a) the level of indebtedness by an auditor to a client (referred to in paragraphs 324(1)(e) and (2)(f) of the Act) should be increased from \$5,000 to \$10,000 or such other amount as may be prescribed by regulation;
- (b) a prohibition should be placed on the indebtedness of a company to its auditor, with the exception of professional fees and amounts up to a maximum of \$100,000 deposited with a financial institution or life insurance company by a natural person on normal commercial terms and in the ordinary course of business of the financial institution or life insurance company; and
- (c) the monetary indebtedness provisions should only apply to partners of a firm of auditors who are directly engaged on the audit assignment and relatives of such partners.

5.42 In addition to the proposed legislative amendments, ICAA and CPA Australia have proposed that the professional requirements be revised along the lines of the proposals in IFAC's April 2001 exposure draft.

Overseas position

International Federation of Accountants

5.43 The IFAC exposure draft identifies three categories of financial relationship that may have the potential to threaten an auditor's independence:

- (a) financial interests in an assurance client;
- (b) loans and guarantees; and
- (c) close business relationships with an assurance client.

5.44 Table 5.3 sets out the nature of the threats to independence that may be caused by each of the above categories of financial relationship and the measures that should be adopted to safeguard independence.

TABLE 5.3: FINANCIAL RELATIONSHIPS IDENTIFIED BY IFAC AS A THREAT TO INDEPENDENCE		
Category	Nature of threats to independence	Safeguards to protect independence
Financial interests in an assurance client	A self-interest threat may be created by having a financial interest in an assurance client.	If a firm has a direct or material indirect financial interest in an assurance client, it should dispose of the interest or refuse to perform the assurance engagement. If a member of the assurance team, or their family member, has a direct or material indirect financial interest in an assurance client, the person should be removed from the assurance team. Other partners and employees, or their immediate family, in the office in which the lead engagement partner practices in connection with the audit should not hold a direct or material indirect financial interest in the audit client.
Loans and guarantees	A self-interest threat may be created where the firm, or a member of the assurance team: (1) makes a loan to an assurance client that is not a bank or similar institution, or guarantees such an assurance client's borrowing. (2) accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution.	Such transactions should not be undertaken. (Modified rules apply for transactions involving banks and similar institutions. Generally, they are acceptable provided they are made under normal lending procedures, terms and requirements.)
Close business relationships with an assurance client	Self-interest and intimidation threats may be created by a close business relationship between a firm or a member of the assurance team and the assurance client or its management.	Such transactions should not be undertaken.

Europe

5.45 The Eighth Council Directive does not specifically refer to financial relationships, although it does provide that persons approved for the statutory auditing of accounting documents shall not

carry out such audits if they are not independent in accordance with the law of the Member State which requires the audit.

5.46 Similarly, the UK Companies Act does not contain provisions dealing expressly with financial relationships between a company auditor and any company the person may audit although subsection 27(2) of the Act provides that the Secretary of State may make regulations specifying connections between an audit firm and its audit client that would make the firm ineligible for appointment. To date, no regulations to this effect appear to have been made.

Proposed changes

5.47 The European Commission's December 2000 consultative paper proposes that Member States significantly strengthen independence requirements in the area of financial relationships. Financial relationships that are identified in the paper as being incompatible with an auditor's independence include:

- (a) the auditor or any other person in a position to influence the outcome of the audit holding a direct or indirect financial interest in the audit client or its affiliates;
- (b) business relationships, or commitments to establish such relationships (unless the relationship is in the normal course of business and insignificant);
- (c) a close family member of the auditor having a financial interest in, or a business relationship with, the audit client; and
- (d) any person who is in a position to influence the outcome of the audit should not be a member of any management or supervisory body in an entity which holds directly or indirectly more than 20% of the voting rights in the client, or in which the client holds directly or indirectly more than 20% of the voting rights.

United States of America

5.48 The SEC's new rules seek to preserve audit independence by preventing:

- (a) an accounting firm, any covered person in the firm, or any of his or her immediate family members:
 - (i) having a direct investment in stocks, bonds, notes, options or other securities of the audit client;
 - (ii) serving as a voting trustee of a trust, or executor of an estate, containing securities of the audit client;
 - (iii) having a material indirect interest in the audit client; and
 - (iv) having other financial interests in audit clients, including loans, saving and cheque accounts, broker-dealer accounts, futures commission merchant accounts, credit cards and insurance products (although the rules provide some relief or exemptions in respect of interests such as loans);

- (b) an audit client having any direct investment in an accounting firm, such as stocks, bonds, notes, options or other securities, or the audit client's officers or directors being owners of more than 5% of the equity securities of the accounting firm; and
- (c) an accounting firm or any covered person in the firm having a direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity such as an audit client's officers, directors, or substantial stockholders.

5.49 The SEC's rules on financial interests have been framed so that, except where the interest is held by the firm, their application is limited to a covered person and his or her immediate family members.

Adequacy of Australian requirements

5.50 As with employment relationships, the existence of financial relationships between an accounting firm and an audit client can give the impression that an auditor is not independent of the client. Legislators in much of the English-speaking world have included in their legislation provisions which have the objective of prohibiting or restricting financial relationships, although the scope of such provisions ranges from general requirements that an auditor's judgment not be 'impaired by reason of any relationship with or interest in the company'²³ to specific provisions about loans and investments. More recently, professional accounting bodies have also amended their ethical codes to include prohibitions or restrictions on a range of financial relationships.

5.51 The IFAC and European Commission proposals and the SEC rules seek to ensure that financial relationships do not impair audit independence by prohibiting or restricting the following categories of relationship:

- (a) investments in audit clients;
- (b) loans to and from audit clients; and
- (c) business relationships with audit clients.

5.52 The Australian legislative requirements are largely concerned with the loans that partners and employees of an accounting firm may have received from an audit client. The requirements of the Australian accounting profession, as set out in Statement F1 and AUP 32, build on the legislative requirements primarily in the area of investments in an audit client.

5.53 Australia's legislative and professional requirements in respect of financial relationships require significant updating to bring them into line with current and proposed overseas requirements. In particular, the Corporations Act contains no requirements in respect of investments in audit clients or about business relationships between auditors and their audit clients. The professional rules contain minimal requirements in respect of business relationships.

5.54 As with employee relationships, there are three basic ways in which the Australian requirements on financial relationships could be reformed:

²³ New Zealand Companies Act, section 204.

- (a) retention of a co-regulation model, in which both the Corporations Act and the ethical rules of the professional bodies contain requirements dealing with audit independence;
- (b) exclusive reliance on independence requirements in the ethical rules of the professional bodies; or
- (c) exclusive reliance on independence requirements in the Corporations Act.

5.55 Under a co-regulation model, the legislation would set the core requirements, while the ethical rules of the professional bodies, revised in line with the IFAC proposals, would provide additional guidance for considering the threats to audit independence associated with financial relationships and the safeguards available for eliminating or minimising those threats.

5.56 Unlike employment relationships, there has not been a consistent approach by legislators on the aspects of financial relationships that need to be regulated to ensure audit independence. Some jurisdictions (such as Australia) have been primarily concerned with transactions involving loans while others (for example, Canada) have focussed on the issues such as material investments in the securities of an investment client. The issue of business relationships, on the other hand, does not appear to have been addressed by legislators or regulators until the inclusion of requirements on such relationships in the SEC rules and the European Commission proposals. However, the ethical rules of professional bodies have generally dealt with all three aspects of financial relationships referred to above.

5.57 It is proposed that a co-regulation model should continue to be used for ensuring financial relationships between an auditor and an audit client do not impair audit independence. In view of the significant effect investments in audit clients and loans to and from clients could have on the independence of an auditor, it is proposed that the basic requirements in respect of these relationships should be included in the Corporations Act rather than left partly or solely to the ethical rules of the accounting bodies. The ethical rules would supplement the legislative requirements of these matters and would deal exclusively with the issue of business relationships.

5.58 The proposed amendments to the Corporations Act and professional ethical rules under a revised co-regulation model are detailed in the recommendations listed below.

Recommendations

5.59 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.

Definitions of a number of these terms contained in these recommendations are outlined in paragraph 5.35. For other definitions relevant to the recommendations, see the definitions in the IFAC proposals (Appendix G of this report).

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

It is important to emphasise that these financial relationships 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.

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;
- (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.

[Note: This recommendation is drawn from the IFAC proposals (paragraphs 8.103, 8.105 and 8.111) which prohibit all these financial relationships. The SEC rules also prohibit these financial relationships (Rule 210.2-01(c)(1)), although the SEC rules are more prescriptive in a number of respects and include additional prohibitions. Both the IFAC proposals and the SEC rules prohibit partners and managerial employees who provide non-audit services to clients, as well as members of their immediate families, from having a direct financial interest or a material indirect financial interest in the client. There is a slight difference in language. The IFAC proposals exclude from the prohibition personnel whose time involvement in providing non-audit services to an audit client is clearly insignificant – see the IFAC definition of ‘other client service personnel’. The SEC rules exclude from the prohibition personnel who provide less than 10 hours of non-audit services to an audit client during the period relating to the relevant financial statements – see the SEC definition of ‘covered person in the firm’.]

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 member 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.

[Note: Paragraph (a) of this recommendation repeats what is currently in subsections 324(1)(e) and (2)(f) of the Corporations Act. However, two changes have been made. First, the amount of \$5,000 currently in section 324 has been increased to \$10,000, or such other amount as may be prescribed by regulation. This is in line with a recommendation made by the Audit Review Working Party. Secondly, the prohibition currently in section 324 has been extended beyond partners of audit firms and bodies corporate in which partners have a substantial holding, to include entities which partners control. It is appropriate not to restrict the prohibition to bodies corporate.

Paragraph (b) of this recommendation is drawn from the IFAC proposals (paragraphs 8.114 to 8.118). The recommendation does not go as far as the SEC rules which are more prescriptive and include additional prohibitions concerning loans. However, the recommendation in paragraph (b) does extend the IFAC proposals by applying to the immediate family of members of the audit engagement team. We note that Professional Statement F1 currently provides that no person in a practice or a near relative of any person in the practice, shall accept or make or guarantee a loan from or to a client except for a loan negotiated at arm's length in the ordinary course of the client's business.]

3 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 professional 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.

[Note: This recommendation is drawn from the IFAC proposals (paragraph 8.119.)]

4 Inadvertent breaches

It is appropriate that there be protection for inadvertent breaches of the independence rules concerning financial relationships, provided certain requirements are met. Therefore, an auditor's independence will not be impaired solely because a person in the audit firm is not independent because of a breach of the rules concerning financial relationships provided:

- (a) the person did not know of the circumstances giving rise to the lack of independence;
- (b) the person's lack of independence was corrected as promptly as possible under the relevant circumstances after the person or the audit firm became aware of it; and

- (c) the audit firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the audit firm's practice, that the audit firm and its employees do not lack independence.

[Note: This recommendation is drawn from the IFAC proposals and the SEC rules (Rule 210.2-01(d)) which provide exemptions for inadvertent breaches of the independence rules provided certain requirements are met. This recommendation draws in particular upon the SEC rules but does not go as far as the SEC rules which require specific quality control systems for audit firms that annually provide audit services to more than 500 companies whose securities are registered with the SEC.]

PROVISION OF NON-AUDIT SERVICES

5.60 The expression 'non-audit services' is taken, for the purposes of this report, to cover all services not coming within the scope of the audit contract that an audit firm provides to an audit client.

Australian position

5.61 The Corporations Act is silent on the issue of an audit firm providing non-audit services to its audit clients. Australian accounting standard AASB 1034 does, however, require disclosure of amounts paid or payable to the auditor for 'audit services' and to the auditor and any related entity for 'non-audit services'.

5.62 The Audit Review Working Party proposed that disclosure requirements relating to non-audit services should be expanded to require a breakdown of the nature of those services and to include services provided by entities whose beneficial ownership is substantially the same as that of the auditor's firm. While recent amendments to AASB 1034 have addressed the beneficial ownership issue, the proposal that the nature of non-audit services be disclosed was not acted on, mainly on the grounds that this was not a requirement of international accounting standards with which the AASB was seeking to harmonise the relevant Australian standard.

5.63 Professional requirements about firms providing non-audit services to their audit clients are contained in Statement F1 and AUP 32. Statement F1 imposes a range of restrictions designed to ensure the independence of the auditor, including:

- (a) not providing valuation services to an audit client if the valuation is to be referred to as an 'independent' valuation in audited financial statements of the audit client;
- (b) not accepting appointment as liquidator, provisional liquidator, controller, scheme manager or administrator of a company if any person in the practice has, or in the two previous years has had, a continuing professional relationship with the company;
- (c) not participating in the executive function of an audit client when providing management consulting services; and
- (d) not participating in the preparation of books of a public company audit client (although an exception to this requirement is allowed in 'exceptional circumstances' provided the client accepts full responsibility for the books and the auditor does not become involved in the client's executive decision making function).

5.64 AUP 32, in addition to imposing similar restrictions to those contained in Statement F1, also identifies internal audit services as a matter that could affect the independence of the external auditor. However, the statement does not prohibit the provision of such services provided the auditor does not assume the role of management when providing the services and that any recommendations made by the auditor are for implementation by management.

5.65 The only existing proposals for amendments to legislative or professional requirements in respect of non-audit services are:

- (a) possible revision of Statement F1 in accordance with changes to section 8 of IFAC's Code of Ethics and withdrawal of AUP 32; and
- (b) a legislative amendment to implement the Audit Review Working Party's recommendation that disclosure requirements relating to non-audit services be expanded to require a breakdown of the nature of those services.

Overseas position

International Federation of Accountants

5.66 The IFAC exposure draft identifies nine categories of non-audit services as having the potential to pose a threat to an auditor's independence. The services are preparing accounting records and financial statements, valuation services, internal audit services, IT systems services, temporary staff assignments, acting for or assisting an assurance client in the resolution of a dispute or litigation, legal services, recruiting senior management for an assurance client, and corporate finance and similar activities.

5.67 Table 5.4 sets out the nature of the threats to independence that may be caused by each of these services and the measures that should be adopted to safeguard independence.

<i>Non-audit service</i>	<i>Possible threats to independence</i>	<i>Measures to protect independence</i>
Preparing accounting records and financial statements	A self-review threat may be created where a firm assists an audit client in matters such as preparing accounting records or financial statements and the statements are subsequently audited by the firm.	Services should not be provided to listed audit clients except in emergency situations.
Valuation services	A self-review threat may be created when a firm performs a valuation service that directly affects the subject matter of the assurance engagement.	Services should not be provided where they involve the valuation of matters that are material to the subject matter of the assurance engagement.

Internal audit services	A self-review threat may be created when a firm provides internal audit services to an audit client (see note a).	The audit client should be responsible for establishing, maintaining and monitoring the system of internal controls. An employee of the client should be responsible for internal audit activities, with the client approving the scope, risk and frequency of the internal audit work and which recommendations of the firm should be implemented.
IT systems services	A self-review threat may be created when a firm is involved in the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements.	The audit client must be responsible for establishing and monitoring a system of internal controls. The client or one of its employees should have responsibility for all management decisions concerning the design and implementation of the system, for evaluating the adequacy and results of the design and implementation, and for the operation of the system and the data used or generated by it.
Temporary staff assignments	A self-review threat may be created when a firm lends staff to an audit client, especially when the individual is in a position to influence the preparation of the client's accounts or financial statements.	Assistance may be given provided the client is responsible for directing and supervising the activities of the firm's staff and the firm's staff will not be required to make management decisions, approve or sign agreements or similar documents, or exercise discretionary authority to commit the client.

Acting for or assisting an assurance client in the resolution of a dispute or litigation	An advocacy threat may be created when a firm acts for an audit client in the resolution of a dispute or litigation while a self-review threat may be created when the assignment includes the estimation of the possible outcome.	Except where the amounts involved are immaterial or the threat is insignificant, a firm should not provide such services to an audit client.
Legal services	Self-review and advocacy threats may be created by the provision of legal services to an audit client.	Whether the service should be provided will depend on a range of factors, including the nature of the service and whether there would be a material impact on the financial statements.
Recruiting senior management for an assurance client	Self-interest, familiarity and intimidation threats may be created by the recruitment of senior management for an audit client.	While the firm might advertise for and interview prospective staff and produce a list of potential candidates, the decision about who should be hired is one for the client to make.
Corporate finance and similar activities	Advocacy and self review threats may be created by the provision of corporate finance services, advice or assistance to an audit client.	In the case of some corporate finance services (eg promoting, dealing in, or underwriting an audit client's shares), the threat to independence is so great that no adequate safeguards are available. In other cases, adequate safeguards may be available.
(a) Under the IFAC proposals, internal audit services do not include operational internal services unrelated to the internal accounting controls, financial systems or financial statements.		

Europe

5.68 The European Commission's existing requirements on audit independence do not specifically refer to the provision of non-audit services, although they do provide that 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.

5.69 Similarly, the UK Companies Act does not contain provisions dealing expressly with provision of non-audit services. While subsection 27(2) of the Act provides that the Secretary of State may make regulations specifying connections between an audit firm and its audit client that would make the firm ineligible for appointment, no such regulations appear to have been made.

Proposed changes

5.70 The consultative paper released by the European Commission in December 2000 proposes that Member States significantly strengthen independence requirements concerning the provision of non-audit services. Situations that have been identified as having the potential to affect an auditor's independence include preparing accounting records and financial statements, design and implementation of financial information systems, valuation services, internal audit, resolution of litigation, and recruiting senior management. The threats to independence identified in the European Commission's paper and the safeguards that could be adopted to protect independence are similar to those identified by IFAC.

United States of America

5.71 Paragraph c(4) of Part 210.2-01 of the SEC's rules provides that an accountant is not independent if, at any time during the audit and professional engagement period, the accountant provides specified non-audit services to an audit client. The specified services, the scope of the restrictions for each service, and whether any exemptions are permitted are listed in Table 5.5.

TABLE 5.5: NON-AUDIT SERVICES SUBJECT TO SEC RULE 210 RESTRICTIONS		
<i>Non-audit service</i>	<i>Scope of restriction</i>	<i>Exceptions</i>
Bookkeeping or other services related to the audit client's accounting records or financial statements.	Includes maintaining or preparing the audit client's accounting records; preparing the audit client's financial statements for filing with the SEC; and preparing or originating source data underlying the audit client's financial statements.	Exceptions are allowed in 'emergency or unusual situations' and, subject to strict conditions, for foreign divisions or subsidiaries of an audit client.
Financial information systems design and implementation	Includes: (1) directly or indirectly operating, or supervising the operation of, the audit client's information systems or managing the audit client's local area network; and (2) designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements.	Relief from (2) is available when the audit client's management makes all management decisions concerning the design implementation and is responsible for evaluating the adequacy and results of the system. Provided the auditor does not act as an employee or perform management functions, no limits are placed on services in connection with the assessment, design and implementation of internal accounting controls and risk management controls.
Appraisal or valuation services or fairness	Includes any service involving a fairness opinion where it is	Exemptions include where the accountant reviews the work of

opinions	reasonably likely that the results of these services would be material to the financial statements or where the results of these services will be audited by the accountant during an audit of the audit client's financial statements.	the audit client or a specialist employed by the audit client (provided the client or the specialist provides the primary support for the balances recorded in the client's financial statements) and where the valuation is for non-financial purposes and the results of the valuation do not affect the financial statements.
Actuarial services	Includes any actuarially-oriented advisory service involving the determination of insurance company policy reserves and related accounts for the audit client.	Exceptions are permitted where the audit client uses its own or third-part actuaries to provide management with the primary actuarial capabilities; management accepts responsibility for any significant actuarial methods and assumptions; and the accountant's involvement is not continuous. Subject to conditions, the rules also allow a number of other actuarial-type services (see paragraph (c)(4)(iv)(B) of the rules).
Internal audit services	Includes: (1) providing more than 40% of the total hours expended on the client's internal activities in any one year (unless the client has less than \$200 million in total assets); or (2) any internal audit services, or any operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements, for an audit client.	Some relief is available in respect of (2) when the audit client's management assumes responsibility for various aspects of the internal audit function and a number of other conditions are satisfied.
Management functions	Includes acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.	None permitted.
Human resources	Includes searching for or seeking out prospective	An accountant may interview candidates and advise the

	candidates for managerial, executive or director positions; engaging in psychological testing, or other formal testing or evaluation programs; undertaking reference checks of prospective candidates for an executive or director position; or recommending that the audit client hire a specific candidate for a specific job.	audit client on the candidate's competence for financial accounting, administrative, or control positions.
Broker-dealer services	Includes acting as a broker-dealer, promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.	None permitted.
Legal services	Includes providing any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction.	None permitted.

5.72 In addition, Part 240 of the SEC's rules requires registrants to disclose a range of information about fees billed for professional services.

Adequacy of Australian requirements

5.73 Given the various prohibitions and restrictions on employment and financial relationships between the members of an accounting firm and the firm's audit clients, the provision of a range of non-audit services to an audit client tends to be the principal area of involvement between an accounting firm and an audit client other than the audit itself.

5.74 The issue of whether accounting firms should provide non-audit services to their audit clients generates a wide range of views from stakeholder groups, ranging from calls for a total prohibition on the provision of such services to submissions that there is no evidence that providing the services impairs independence. Audit independence studies examined during the course of this review have reached different conclusions concerning whether the provision of non-audit services impairs audit independence (see Part 8 of this report).

5.75 The growth of non-audit services has tended to derive from requests by clients for additional services their auditors are capable of providing, as well as from the special skills needed to audit new and complex business transactions.²⁴ According to the Panel on Audit Effectiveness, today, effective audits depend more than ever on specialists. Specialists used in audits include:²⁵

- (a) technology and systems specialists;
- (b) actuaries, to help evaluate risk management controls, insurance companies' reserves, and pension and other benefit accruals;
- (c) treasury specialists, to help evaluate controls over cash management, financing, currency and derivatives;
- (d) tax specialists, to help evaluate tax liabilities and deferred tax assets; and
- (e) valuation specialists, to help evaluate the reasonableness of valuations of financial instruments, shares issued for assets or services, and allocations of the purchase price of acquired businesses.

5.76 The growth of non-audit services for the largest audit firms has been substantial. The Panel on Audit Effectiveness provides, in its report, the following statistics for the Big 5 audit firms in the United States, showing these firms' mix of practice as a percentage of gross fees.²⁶

	<u>1990</u>		<u>1999</u>	
	<u>All clients</u>	<u>SEC audit clients</u>	<u>All clients</u>	<u>SEC audit clients</u>
Accounting and auditing	53%	71%	34%	48%
Tax	27	17	22	20
Consulting	<u>20</u>	<u>12</u>	<u>44</u>	<u>32</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

According to the Panel on Audit Effectiveness, this indicates that, for SEC audit clients, the ratio of accounting and auditing revenues to consulting revenues dropped from approximately 6 to 1 in 1990 to 1.5 to 1 in 1999. For 1999, 75% of the big 5 firms' SEC audit clients received no consulting services from their auditors, down from 80% in 1990. Four per cent of those firms' SEC audit clients had consulting fees that exceeded audit fees, up from 1% in 1990.²⁷

5.77 The Australian Securities and Investments Commission has recently announced that it is conducting a survey of Australia's largest 100 listed companies to obtain evidence on the extent of non-audit services provided by the auditors of these companies.²⁸

²⁴ Panel on Audit Effectiveness, *Report and Recommendations* (2000) (chaired by Shaun F O'Malley).

²⁵ *Ibid*, para 5.10.

²⁶ *Ibid*, para 5.13.

²⁷ *Ibid*, para 5.14.

²⁸ ASIC Media Release 01/230, 29 June 2001, 'ASIC to Examine Accounting Standards and Auditing'.

5.78 The arguments supporting and opposing the provision of non-audit services by audit firms to their clients are outlined in a number of reports and other publications. The Panel on Audit Effectiveness is one of the reports that deals with the arguments. The following is a summary of a number of the arguments outlined in Chapter 5 of the report of the Panel on Audit Effectiveness.

Arguments opposing the provision of non-audit services by auditors to their clients

- 1 When an audit firm provides non-audit services to a client it is serving two different sets of clients: management in the case of non-audit services and the audit committee, the shareholders and all those who rely on the audited financial statements in the case of the audit. In serving these different clients the audit firm is subject to conflicts of interest.
- 2 A rule prohibiting audit firms from providing non-audit services to their clients would be relatively easy to administer and would not preclude an audit firm from providing non-audit services, as long as those services are not provided to audit clients.
- 3 Systems of compensation within audit firms may not give adequate weight to performing the audit function and may in fact adversely impact audit effectiveness. Success in marketing an audit firm's consulting services is often a significant factor in firms' compensation systems. The skills that make one successful in marketing non-audit services to management are not generally consistent with the professional demands on an auditor to be persistently sceptical, cautious and questioning in regard to management's financial representations, thereby creating a tension counter-productive to audit excellence.

Arguments supporting the provision of non-audit services by auditors to their clients

- 1 There is no solid evidence of any specific link between audit failures and the provision of non-audit services, and non-audit services have been provided by audit firms to their clients for many years. A ban should not be imposed in the absence of compelling evidence of a problem.
- 2 Many non-audit services are both in the public interest and beneficial to audit effectiveness. For example, 'a company may seek the assistance of its auditors to correct control weaknesses identified during the audit. The public interest is served by the controls (and the company's financial reporting process) having been strengthened through the auditors' knowledge of the company and its operations, and audit effectiveness is enhanced through the auditors' increased understanding of the company's systems'.
- 3 Companies that most need to improve their controls may decide not to do so because of the potential added costs and efforts of identifying and using firms other than their auditors.
- 4 It is not correct to assert that an audit firm has divided loyalties when it provides non-audit services to a client because it serves different clients (ie, management in the case of non-audit services and shareholders, the audit committee and those who rely on audited financial statements in the case of audits). To make this argument is to assert that the interests of management must necessarily be inimical to good financial reporting.
- 5 Audit firms increasingly need specialists such as information technology specialists to provide critical audit support. Attracting and retaining these specialists, and motivating them to provide direct audit support, may be hampered if they were to be prohibited from providing non-audit services to clients. These specialists generally are not accountants and

their primary professional interest is not auditing. Yet they maintain and build their skills by providing non-audit services. Therefore, an unintended consequence of a prohibition on auditors providing non-audit services to their clients could be to reduce audit effectiveness.

5.79 A blanket prohibition on auditors providing non-audit services to their clients would be entirely inconsistent with international practice. Different countries may have different degrees of regulation of non-audit services but a blanket prohibition on the provision of such services has not been adopted in any major capital market.

5.80 It is important to note that regulators, professional accounting bodies, and others who have considered the issue of non-audit services, all agree that there are some services which an audit firm cannot provide to its client. For example, the IFAC proposals state that an audit firm cannot:

- (a) authorise, execute or consummate a transaction, or otherwise exercise authority on behalf of the client, or have authority to do so;
- (b) prepare source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders);
- (c) determine which recommendations of the audit firm should be implemented; or
- (d) report, in a management role, to those charged with governance in the client.

5.81 The IFAC proposals also identify other non-audit services that an audit firm cannot provide to its client. These include:

- (a) valuation services involving the valuation of matters that are material to the subject-matter of the audit and the valuation involves a significant degree of subjectivity; and
- (b) promoting, dealing in, or underwriting a client's shares.

5.82 To date, legislators have generally tended to rely on the requirements of professional accounting bodies to ensure the independence of auditors is not impaired through the provision of non-audit services. Legislators have tended to either remain silent on the issue of non-audit services (for example, Australia and the United Kingdom) or address the issue through the inclusion of a general requirement for auditors to be independent (for example, Canada and New Zealand). The SEC rules represent the only example of which we are aware of a regulator developing very detailed rules in this area.

5.83 The new SEC rules and the IFAC and European Commission proposals seek to safeguard independence by ensuring that auditors are independent in fact and appearance. The rules and proposals seek to achieve this by ensuring the auditor does not:

- (a) have a mutual or conflicting interest with the audit client;
- (b) audit his or her own work;
- (c) function as management of the audit client; or
- (d) act as an advocate for the audit client.

5.84 In keeping with these objectives, prohibitions or restrictions are placed on the provision of a range of non-audit services, including bookkeeping and other services related to the audit client's accounting records or financial statements, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit services, human resources and legal services.

5.85 In addition, as noted above, the SEC's rules require registrants to disclose a range of information about fees billed for professional services.

5.86 As noted above, the Australian legislative requirements are silent on the issue of non-audit services. However, Australian accounting standard AASB 1034 requires disclosure of amounts paid or payable to the auditor of a company for the provision of audit and non-audit services. Proposals exist for the disclosure requirements to be enhanced to include a breakdown of the nature of the non-audit services.

5.87 The only Australian requirements about the provision of non-audit services are contained in Statement F1 and AUP 32 issued by the Australian accounting profession. The professional requirements specifically identify a number of non-audit services which could impair audit independence, including bookkeeping services, valuation services, participating in the executive function of a client when providing management consulting services, and internal audit. The ethical rules of the bodies provide guidance on whether such services should be provided to audit clients.

5.88 Australia's existing requirements on provision of non-audit services could be updated through:

- (a) use of a co-regulation model, in which both the Corporations Act and the ethical rules of the professional bodies contain requirements dealing with audit independence;
- (b) exclusive reliance on independence requirements in the ethical rules of the professional bodies; or
- (c) exclusive reliance on independence requirements in the Corporations Act.

5.89 Exclusive reliance on amending the Corporations Act to deal with non-audit services is inappropriate given the lack of precedent for this in Australia and elsewhere. More fundamentally, the review has not uncovered any evidence to suggest there are systemic failures within the accounting profession in complying with the ethical rules for providing non-audit services to audit clients. In these circumstances, there would appear to be an argument for retaining the professional ethical rules, suitably updated in accordance with the IFAC proposals, as the basic guidance on maintaining audit independence when providing non-audit services to audit clients.

5.90 A further point to note is that of all three key areas examined in Part 5 of the report (employment relationships, financial relationships, and provision of non-audit services) it is in the area of non-audit services that rapid changes in the financial markets and business development make it impossible to draft a list of all circumstances when providing non-audit services to a client threatens the independence of the auditor. The rapidly changing nature of this area, including developments such as some accounting firms deciding to sell their management consulting businesses, means there are very real practical limits to legislating to define what non-audit services can or cannot be provided to audit clients.

5.91 An issue the review has considered is whether it is appropriate to adopt in this country the list of nine non-audit services identified in the SEC's rules which are subject to prohibition or restriction. We are of the view that this is not appropriate. It is clear that a number of the SEC restrictions arose from intense debate and discussion and therefore represent compromises which, to an external observer, may lack principle. An example is the limit on the external auditor providing no more than 40% of the total hours expended on the client's internal audit activities in any one year unless the client has less than \$200 million in total assets. It has been made clear to us that the figure of 40% represents a compromise between the SEC and stakeholders with which it was negotiating as to what would be acceptable. We believe it inappropriate to rely on these types of political compromises, typically reflecting particular US circumstances, as precedents for Australia.

5.92 There is one of the SEC non-audit service prohibitions which could not be adopted in Australia in any practical way. The SEC rules prohibit an auditor providing legal services to a client. This rule reflects particular US circumstances. Australian audit firms have had legal arms for a number of years. This is also the case in many other countries. This reinforces our belief that to adopt the SEC rules on non-audit services is inappropriate.

5.93 There is an important issue concerning disclosure of non-audit services. Australian requirements now lag best practice by not requiring disclosure of amounts spent on non-audit services divided by category of service. Requirements for the disclosure of information about fees paid by a company to its auditors for the provision of non-audit services should be improved.

Recommendations

5.94 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 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 Part 6 of this report regarding audit committees and the establishment of the Auditors Independence Supervisory Board as these recommendations affect non-audit services.