

PART 6

OTHER MEASURES THAT ENHANCE AUDIT INDEPENDENCE

6.01 Part 5 of this report outlined a series of measures that can be used for keeping accounting firms independent of their audit clients. In addition, a number of other measures are available to legislators, regulators and professional bodies for enhancing - and, where necessary, enforcing - the measures outlined earlier.

6.02 This part of the report examines the following issues:

- (a) oversight of auditors;
- (b) audit committees;
- (c) appointment and removal of auditors;
- (d) disciplinary procedures; and
- (e) attendance of auditors at annual general meetings of companies (AGMs).

OVERSIGHT OF AUDITORS

6.03 Traditionally, the accounting profession in most countries has operated on a self-regulatory basis. Government intrusion into the regulation of the profession has usually been limited to supervising specific activities, such as auditing and insolvency services, although in some places the regulatory requirements extend to all accountants providing services to the public.

6.04 As part of their self-regulatory activities, the professional accounting bodies, at both an international and national level, have developed ethical and procedural rules dealing with appropriate standards of behaviour for their members and the manner in which accountancy practices are to be conducted. Rules developed by the professional bodies address a wide range of issues, including the qualifications (education and experience) needed for membership, continuing obligations for membership (for example, professional development), disciplinary procedures and, in the case of members in public practice, the need to have periodic quality reviews of the work they are undertaking.

6.05 For many years professional bodies in most countries have also been actively involved in setting accounting and auditing standards. The original rationale for such involvement was to provide authoritative guidance to members involved in the preparation and audit of financial statements.

6.06 Over time there has been a growing recognition that, while the self-regulatory nature of the profession is to be encouraged, the impact, or potential impact, of the profession on industry and commerce is so great that some supervision of the profession is needed to ensure its self-regulatory mechanisms are both adequate and appropriate.

6.07 This section of the report briefly examines existing and proposed Australian arrangements for the self-regulation of the accounting profession, the oversight arrangements in place in the United States of America, and arrangements currently being introduced in the United Kingdom.

Australian position

6.08 Australia's three largest accounting bodies, CPA Australia (CPAA), The Institute of Chartered Accountants in Australia (ICAA) and the National Institute of Accountants (NIA) all have in place rules and other ethical requirements which must be satisfied to initially obtain, and then retain, membership of the respective bodies.

6.09 The Audit Review Working Party's report contained a series of recommendations which addressed the need for supervision of individual company auditors and touched on the wider issue of supervising the professional accounting bodies. In the case of individual company auditors, the Working Party recommended changes to the post-registration reporting arrangements (including replacing the triennial statement with an annual statement) and the introduction of mandatory requirements for continuing education and quality reviews.

6.10 Supervision of the professional bodies was also considered by the Audit Review Working Party in the context of the corporate regulator being given authority to delegate its powers for the registration and regulation of company auditors to the professional bodies. The Working Party recommended that, before any functions could be delegated to an accounting body, the corporate regulator had to be satisfied that, among other things, each accounting body has and will continue to maintain:

- (a) a comprehensive and mandatory code of ethics and other rules dealing with the conduct of members who provide auditing services;
- (b) mandatory requirements for the continuing professional education of its members and for professional indemnity insurance for those members in public practice;
- (c) a comprehensive program for the periodic review of the work of members who provide auditing services; and
- (d) appropriate disciplinary procedures for dealing with complaints and other matters concerning members who provide auditing services.

Overseas requirements

International Federation of Accountants

6.11 During August 2001, IFAC released a proposal for the establishment of a Public Oversight Board (POB) to oversee the public interest activities of IFAC, including:

- (a) the setting of auditing, ethical, public sector and educational standards;
- (b) the obligations of membership and compliance processes applicable to its member bodies; and
- (c) the quality assurance, compliance and other self-regulatory processes applicable to membership of the Forum of Firms.

6.12 It is proposed that, in performing its role, the POB will focus on whether the interests of users of financial statements are being appropriately reflected in the processes and outputs of IFAC and its committees and on those activities of the Forum which impact financial reporting.

6.13 The Forum of Firms is another new body which IFAC proposes establishing. The objective of the Forum is to promote consistently high standards of financial reporting and auditing worldwide. Its membership will be open to any firm that has or is interested in accepting transnational audit appointments, provided the firm:

- (a) agrees to conform to the Forum's Global Quality Standard; and
- (b) agrees to subject its assurance work to periodic external quality assurance reviews.

6.14 The deadline for commenting on the IFAC proposals is 22 October 2001.

United Kingdom

6.15 The United Kingdom is currently implementing a system of non-statutory independent regulation for its accountancy profession. The key feature of the system is its independence from control or undue influence by the accountancy profession. Its aim is to ensure that the public interest in the way the profession operates is fully met and thus to secure public confidence in the impartiality and effectiveness of the profession's systems of regulation and discipline.

6.16 The new system of regulation involves the establishment of five new bodies: the Accountancy Foundation, the Review Board, the Ethics Standards Board (ESB), the new Auditing Practices Board (APB) and the Investigation and Discipline Board (IDB). All five bodies are constituted as companies limited by guarantee.

6.17 Funding for the new system is being provided by the CCAB bodies.²⁹

6.18 The **Accountancy Foundation**, which is the peak body in the new structure, has three main functions: appointing the members of the Boards of each of the bodies, acting as the channel for finance and ensuring that the new system is adequately funded, and having overall responsibility for the success of the new system.

6.19 The **Review Board**, which is regarded as the pivot on which the whole new structure turns, is responsible for monitoring the operation of the new system to ensure that it is fully meeting the public interest. In carrying out this function the Review Board's responsibilities extend beyond the work of the three operational bodies in the new structure (ESB, APB and IDB) to cover the continuing responsibilities of the accountancy bodies for monitoring the work, training, qualification and registration of accountants and auditors, for handling complaints and for the conduct of investigation and discipline cases falling outside the remit of the IDB.

6.20 The Review Board will have the power to carry out such investigations and enquiries of the operational bodies and the accountancy bodies as it believes necessary. The operational bodies and the accountancy bodies will enter into agreements with the Review Board to provide such access to people and papers as reasonably lie within their powers. In relation to discipline cases the Review

²⁹ The members of the CCAB - short for Consultative Committee of Accounting Bodies - are The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland, The Institute of Chartered Accountants in Ireland, The Association of Chartered Certified Accountants, The Chartered Institute of Management Accountants and The Chartered Institute of Public Finance and Accountancy.

Board will have access to people and papers only for the purpose of reviewing the process of investigation and discipline. A key presumption underlying the new system is that the operational bodies and the accountancy bodies will normally accept and implement the Review Board's recommendations.

6.21 Under its constitution, the Review Board may have up to eight part-time members. However, in keeping with the new system's objective that the Review Board should, as far as possible, be independent of the accountancy profession, the Board's constitution rules out membership by those involved in any other Board in the system, by practising accountants, and by accountants involved in any way in the governance of any accountancy body.

6.22 The new **Auditing Practices Board** will take over the functions at present performed by the current Auditing Practices Board, which operates under the aegis of the accountancy bodies. The new APB will have about 15 members, no more than 40% of whom will be accountants who are eligible for appointment as company auditors.

6.23 The **Ethics Standards Board** will have the role of securing the development, on a profession-wide basis, of ethical standards for all accountants, whether in practice, industry and commerce, or the public sector. The ESB will not draft standards but will, instead, specify what standards are needed and the issues that need to be covered in them. It will then be for the CCAB bodies, acting collectively, to prepare an appropriate standard for the ESB's approval.

6.24 The **Investigation and Discipline Board** will take over the function of the Joint Disciplinary Scheme (JDS) operated by The Institute of Chartered Accountants in England and Wales and The Institute of Chartered Accountants of Scotland. However, its role will be extended to cover all the CCAB bodies. The focus of the IDB will, as with the JDS, be on cases of public concern. Other cases will continue to be dealt with by the individual accountancy body of the member concerned.

United States of America

6.25 In the United States of America an independent private sector body, the Public Oversight Board (POB), was established in 1977 for the purpose of overseeing and reporting on the self-regulatory programs of the Securities and Exchange Commission (SEC) Practice Section of the American Institute of Certified Public Accountants (SECPS). The POB exists to help assure regulators, investors and the public at large that the audited financial statements of public companies can be relied upon to provide an accurate picture of the financial health of those companies.

6.26 The SECPS is composed of accounting firms that audit the financial statements of some 17,000 public companies that file reports with the SEC. The SECPS establishes quality control requirements for member firms. For example, it requires each member firm to undergo peer review every three years. It also reviews allegations of audit failure to determine if there is any breakdown in a firm's quality control system.

6.27 Funded by dues paid by SECPS members, the POB's independence is assured by its power to set its own budget, establish its own operating procedures, and appoint its own members, chairperson, and staff. The POB has five members representing a broad spectrum of business, professional, regulatory, and legislative experience.

6.28 In February 2001, the POB announced agreement on a Charter aimed at strengthening and broadening its oversight of the auditing profession's self-regulatory programs and standard setting

processes. The provisions of the new POB Charter are consistent with the recommendations included in the Panel on Audit Effectiveness' Report and Recommendations dated 31 August 2000.

6.29 Key features of the POB's new Charter include:

- (a) expanded oversight over groups in the self-regulatory process, such as the Auditing Standards Board;
- (b) expanded responsibility for improving communication among the various bodies that make up the self-regulatory system of the accounting profession by creating a new coordinating task force; and
- (c) an expanded role to conduct oversight reviews and to undertake other projects and actions that are deemed to be appropriate to protect the public interest.

6.30 To enable the POB to perform the additional functions contained in its new Charter, it will have increased resources, both in staffing and budget.

Adequacy of Australian requirements

6.31 A number of stakeholders consulted during this review noted that the establishment of an independent oversight body would be a means of strengthening compliance with standards on audit independence. Having such a body would also ensure that the public interest in the way the profession operates is fully met.

6.32 A submission by the Big 5 accounting firms recommended that an oversight body be established to oversee the application of the independence standards applicable to the audits of public entities. In the view of the Big 5, this would serve the public interest and protect and promote investors' confidence in Australia's capital markets. The ICAA's submission also recommended the establishment of an oversight board.

6.33 In considering the establishment of an oversight board, consideration also needs to be given to a range of issues, including its membership, functions, method of establishment, and funding. These are discussed below. A key consideration when appointing members would be to ensure that the oversight board is, and is seen to be, independent of the accounting profession.

Recommendations

6.34 The following recommendations deal with the establishment of the Auditor Independence Supervisory Board, its composition, its funding, and its functions.

1 Establishment of the Auditor Independence Supervisory Board

An independent supervisory board is an essential instrument in addressing the challenge of implementing new auditor independence requirements in Australia. The new board, which will be known as the Auditor Independence Supervisory Board (AISB), will play a vital role in ensuring public confidence in the independence of auditors by monitoring implementation of the new regime, compliance with it, and important international developments in the area of auditor independence. Transforming the system governing auditor independence goes beyond regulatory change and strengthening professional requirements. The proposed changes contained in this report are not the end of the process of continuing to ensure auditor independence. Continued supervision and monitoring of auditor independence is required.

Insight for elements of the AISB structure has been drawn from the supervisory bodies established in the United Kingdom to independently govern the accountancy profession. As noted above, the UK system comprises five bodies constituted as companies limited by guarantee, all housed together in premises separate from the profession. Funding for the UK system is provided by the Consultative Committee of Accountancy Bodies (CCAB).

2 Composition of the AISB

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

The legal structure for the oversight board could be either a statutory body or a company limited by guarantee. While each structure has its merits, establishing the oversight body as a statutory body could result in greater formality (for example, compliance with government appointment procedures, accounting and reporting requirements) than is justified. On the other hand, establishing the oversight body as a statutory body could result in it having greater scope for seeing its recommendations implemented than if it were a company limited by guarantee.

2.1 AISB members

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

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

2.2 AISB employees

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

2.3 Process for appointment of initial and future members

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

3 Funding for the AISB

3.1 *Financial support*

It is crucial that the AISB operate as an independent and autonomous body. However, funding for the AISB should not be a drain on scarce public resources. The profession has a large stake in the issue of auditor independence, and accordingly, the profession should be responsible for the financial support of the AISB. This method of funding is in line with the UK model, and represents the only realistic source of funds. The method of funding could either be direct funding by the professional accounting bodies or a small increase in the registration fee for auditors. Appropriate mechanisms, such as the balanced nature of the board, majority non-professional membership, and provision of a fixed sum, will ensure that the funding cannot compromise the independence of the AISB. If the funding is provided by the professional accounting bodies, it must be locked in for a predetermined period and provided on a 'no strings attached' basis.

3.2 *Physical premises*

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

4 Functions of the AISB

4.1 *Obligation to prepare an annual report*

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

4.2 *Monitoring of international developments in auditor independence*

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

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

4.3 *Advising professional bodies on issues of auditor independence*

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

4.4 *Monitoring of audit firms*

The AISB will monitor the nature and adequacy of systems and processes used by Australian audit firms to deal with issues of auditor independence and advise on the adequacy of these systems and

practices. The accountancy bodies should be prepared to enter into an agreement with the AISB to provide reasonable access to people and papers to help the AISB with this monitoring process. The objective is to ensure that the internal systems and processes of audit firms accord with best practice. We note that the SEC rules (Rule 2.10.2-01(d)) provide for what is termed ‘quality controls’ in relation to accounting firms that annually provide audit, review, or attest services to more than 500 companies with a class of securities registered with the SEC. The SEC rules provide that an accounting firm’s independence will not be impaired solely because a relevant person in the firm is not independent of an audit client provided, among other things, the accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm’s practice, that the firm and its employees do not lack independence. For an accounting firm that annually provides audit, review or attest services to more than 500 companies with a class of securities registered with the SEC, the SEC rules provide that a quality control system will not provide such reasonable assurance unless it has at least the following features:

- written independence policies and procedures;
- with respect to partners and managerial employees, an automated system to identify their investments in securities that might impair the accountant’s independence;
- with respect to all professionals, a system that provides timely information about entities from which the accountant is required to maintain independence;
- an annual or ongoing firm-wide training program about auditor independence;
- an annual internal inspection and testing program to monitor adherence to independence requirements;
- notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence policies;
- written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from the audit client’s engagement and to review promptly all work the professional performed related to that audit client’s engagement; and
- a disciplinary mechanism to ensure compliance with the SEC rules.

It would be appropriate for the AISB to use these quality control systems and procedures, as well as any other systems and procedures the AISB thinks appropriate, as a benchmark for determining the adequacy of the internal systems and processes of Australia’s largest audit firms.

4.5 Monitoring of corporations

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

4.6 Monitoring of teaching of professional and business ethics

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

4.7 *No role in conducting disciplinary proceedings*

It is not appropriate for the AISB to conduct disciplinary proceedings given that disciplinary mechanisms are already in existence. However, as a part of its overall monitoring responsibilities, the AISB should monitor and assess the adequacy of the existing investigation and disciplinary processes and, if it forms the view that improvements are required, this should be communicated to the Government.

5 **Review of the AISB**

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

AUDIT COMMITTEES

6.35 There can be no doubt that a well structured and well functioning audit committee can play a very important role in ensuring that the auditor is independent of the company. The case for the establishment of audit committees is best summarised by the following quotation from *Audit Committees: Best Practice Guide*:

‘The audit committee can play a key role in assisting the board of directors to fulfil its corporate governance and overseeing responsibilities in relation to an entity’s financial reporting, internal control structure, risk management systems, and the internal and external audit functions.’³⁰

6.36 The Guide also lists, among the main objectives and potential benefits of having an appropriately established and effective audit committee, ‘facilitating the maintenance of the independence of the external auditor’.³¹

6.37 This section of the report provides an overview of the requirements in Australia and in some other countries concerning audit committees.

Australian position

6.38 The Corporations Act does not require Australian companies to establish audit committees.

6.39 The listing rules of the Australian Stock Exchange also lack a mandatory requirement for companies listed on the Exchange to establish an audit committee. Rule 4.10.2 of the Exchange’s listing rules does, however, require a company to include in its annual report information whether the entity had an audit committee at the date of the directors’ report and, if it did not, it must explain why.

6.40 In addition, rule 4.10.3 of the Exchange’s listing rules provides that the annual report is to contain a statement of the main corporate governance practices that the entity had in place during the reporting period. Among the matters that must be addressed is one requiring an outline of the procedures the entity had in place for the nomination of external auditors, and for reviewing the

³⁰ The Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors – Australia, *Audit Committees: Best Practice Guide* (2nd edition, 2001) 2.

³¹ *Ibid*, 4.

adequacy of existing external audit arrangements. Where these procedures involve an audit committee, directors are required to set out or summarise the committee's main responsibilities and rights and the names of committee members.

6.41 For those companies that have established an audit committee, guidance on the operation of the committee is provided in *Audit Committees: Best Practice Guide*. The Guide sets out best practice requirements on the following topics:

- (a) terms of reference for an audit committee;
- (b) committee membership;
- (c) induction of new members;
- (d) meetings;
- (e) systems of reporting to the board;
- (f) the audit committee's responsibilities, including its responsibilities on external reporting, related party transactions, internal control and risk management and co-ordination of external and internal audit;
- (g) external auditor's responsibilities;
- (h) internal auditor's responsibilities; and
- (i) assessing the audit committee's performance.

Overseas position

United Kingdom

6.42 There are no requirements in the UK Companies Act which require companies to establish an audit committee.

6.43 In relation to companies listed on the London Stock Exchange, the Listing Rules of the Financial Services Authority require listed companies incorporated in the UK to include in their annual reports a statement whether they have complied with the Principles of Good Governance and Code of Best Practice (the Combined Code) and to give reasons for any non-compliance. The Combined Code states that the board should establish an audit committee of a least three non-executive directors, the majority of whom should be independent.

United States

6.44 In the United States, the principal requirements for audit committees are contained in the listing rules of the New York Stock Exchange (NYSE). Under the NYSE's rules, each company listed on the exchange must have a qualified audit committee. The requirements for a qualified committee include:

- (a) having a formal written charter that has been adopted and approved by the board of directors; and

- (b) having at least three independent directors, each of whom is financially literate and at least one of whom has accounting or financial management expertise.

6.45 The rules also place a number of restrictions on audit committee membership for the purpose of ensuring each member's independence. Two examples of these restrictions are:

- (a) a director who has a business relationship with the company may only serve on the audit committee if the company's board of directors determines that the relationship does not interfere with the director's exercise of independent judgment; and
- (b) a director who is an immediate family member of an individual who is an executive officer of the company or one of its affiliates cannot serve on the audit committee until three years following the termination of such employment relationship.

6.46 The NYSE's rules were last amended in December 1999, with the amendments implementing a series of recommendations made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees aimed at strengthening the independence of audit committees and making committees more effective.

6.47 The Listing Rules of the NASDAQ also mandate audit committees and the requirements, in terms of independence and financial competence of members, are almost identical to the NYSE requirements.

Canada

6.48 Canada also has a mandatory requirement for companies to establish audit committees. Under subsection 171(1) of the Canada Business Corporations Act, a corporation, any of the issued securities of which are or were part of a distribution to the public and remain outstanding and are held by more than one person, must have an audit committee composed of not less than three directors of the corporation, a majority of whom are not officers or employees of the corporation or any of its affiliates.

6.49 The function of an audit committee established in accordance with section 171 is to review the financial statements of the corporation before such financial statements are approved under section 158. The auditor of a corporation is entitled to receive notice of every meeting of the audit committee and, at the expense of the corporation, to attend and be heard thereat; and, if so requested by a member of the audit committee, shall attend every meeting of the committee held during the term of office of the auditor.

6.50 The Act allows the regulatory authority to make an order, with or without conditions, permitting the corporation to dispense with an audit committee if it is satisfied that the shareholders will not be prejudiced by such an order.

Adequacy of Australian requirements

6.51 A number of bodies have recommended that audit committees be mandatory for companies listed on the Australian Stock Exchange. Two key Parliamentary Committees have made this recommendation:

- (a) Senate Standing Committee on Legal and Constitutional Affairs, *Report on Company Directors' Duties*, 1989, chapter 18; and

- (b) House of Representatives Standing Committee on Legal and Constitutional Affairs, *Report on Corporate Practices and the Rights of Shareholders*, 1991, chapter 5.

In addition, the Working Party of the Ministerial Council for Corporations recommended in its *Report on Review of Requirements for the Registration and Regulation of Company Auditors*, 1997, that the ASX Listing Rules or the Corporations legislation be amended to require listed companies to have an audit committee (recommendation 7.1).

6.52 The matter was raised again in 1998, when amendments were moved by the Australian Democrats during the Senate debate on the Company Law Review Bill 1997, but not passed, to require listed companies to establish an audit committee. Subsequently, the Treasurer asked the Parliamentary Joint Statutory Committee on Corporations and Securities to consider whether listed companies should be required by law to establish an audit committee. The Committee's report, which was tabled in October 1999, recommended that there should not be a requirement for listed companies to establish an audit committee.

6.53 Most stakeholders consulted during the review of audit independence were of the view that requiring listed companies to have an appropriately constituted audit committee would be a most effective way of enhancing the independence of auditors of such companies.

6.54 Recent high profile corporate failures and significant international developments have prompted a re-examination of the nature and role of audit committees. In a world where Australia is increasingly linked into international developments, it is necessary that Australian standards meet the protective oversight requirements of the international investing public. Audit committees play a vital role in investor protection and this is reflected in international requirements to either mandate or recommend audit committees for listed companies. This section considers the need to mandate audit committees for Australian listed companies.

Role of audit committees in ensuring financial market integrity

'An audit committee consisting of independent directors is the primary vehicle that the board of directors uses to discharge its responsibility with respect to the company's financial reporting.'³²

6.55 The importance of audit committees in effective corporate governance is widely acknowledged. There are an increasing number of international reports, best practice guides and standards which endorse the use of audit committees. These include:

- (a) Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors- Australia, *Audit Committees: Best Practice Guide* (2001);
- (b) Blue Ribbon Committee, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (1999);
- (c) Cadbury Commission, *Report on the Financial Aspects of Corporate Governance* (1992);

³² National Commission on Fraudulent Financial Reporting (Treadway Commission), *Report of the National Commission on Fraudulent Financial Reporting* (1987), 183.

- (d) Independence Standards Board, *Standard No 1: Independence Discussions with Audit Committees* (1999);
- (e) National Commission on Fraudulent Financial Reporting (Treadway Commission), *Report of the National Commission on Fraudulent Financial Reporting* (1987); and
- (f) Panel on Audit Effectiveness, *Panel on Audit Effectiveness Report and Recommendations* (2000).

6.56 Audit committees ‘can enhance, if not assure, the credibility and integrity of corporate financial reporting.’³³ ‘[Q]ualified, committed, independent and tough-minded committees represent true guardians of the public interest.’³⁴ Further, a study by Pincus, Rusbarsky and Wong³⁵ concluded that audit committees ‘enhance the quality of information flows between principal [shareholders] and agent [management].’

6.57 The United States Securities and Exchange Commission (SEC) advocated audit committee establishment as early as 1940.³⁶ An ex-chairman of the SEC contends that the audit committee ‘may well be the most important development in corporate structure and control in decades.’³⁷ The National Commission on Fraudulent Financial Reporting (Treadway Commission)³⁸ and the Kirk Panel³⁹ both recognised the role of the audit committee as a mechanism for ensuring financial market integrity through improving the quality of financial reporting. The chair of the Treadway Commission stated that the audit committee ‘represents the single most potentially effective influence for minimizing fraudulent reporting.’⁴⁰

6.58 In addition, the Committee on the Financial Aspects of Corporate Governance (Cadbury Committee)⁴¹ emphasised the role of the audit committee in corporate accountability. More recently, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) co-sponsored the Blue Ribbon Committee report on the effectiveness of audit committees which strongly endorsed their use.⁴²

³³ H M Williams, ‘Audit Committees - The Public Sector’s View’ (1977) *Journal of Accountancy* 71, 72.

³⁴ Arthur Levitt, ‘Now is the Time to Do What’s Right by Investors’ (1999) 13(15) *Accounting Today* 52, 52.

³⁵ K Pincus, M Rusbarsky and J Wong, ‘Voluntary Formation of Corporate Audit Committees Among NASDAQ Firms’ (1989) 8 *Journal of Accounting and Public Policy* 239, 265.

³⁶ Brenda Birkett, ‘The Recent History of Corporate Audit Committees’ (1986) 13(2) *Accounting Historians Journal* 109, 109.

³⁷ Above n 33.

³⁸ National Commission on Fraudulent Financial Reporting, above n 32,

³⁹ Kirk Panel, *Strengthening the Professionalism of the Independent Auditor* (1994).

⁴⁰ James Treadway, ‘Initial Conclusions of the National Commission on Fraudulent Financial Reporting’. Address to American Institute of Certified Practising Accountants, 99th Annual Meeting (1986) quoted in John Wild, ‘The Audit Committee and Earnings Quality’ (1996) 11(2) *Journal of Accounting, Auditing and Finance* 247, 249.

⁴¹ Cadbury Commission, *Report on the Financial Aspects of Corporate Governance* (1992).

⁴² Blue Ribbon Committee, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (1999).

6.59 Surveys of those concerned with the integrity of financial reporting and the independence of auditors consistently emphasise the importance of audit committees. A recent survey in the United States of chief executive officers of SEC registrant companies, chief financial officers of SEC registrant companies, chairs of audit committees of these companies, investment analysts, and partners of audit firms, found that a strengthened oversight role for audit committees is important to ensuring the independence of auditors.⁴³

Inadequate incentives to voluntarily form audit committees

6.60 Studies have investigated the incentives for companies to voluntarily form audit committees. Although US studies have observed an increase in voluntary audit committee formation,⁴⁴ Bradbury contends that this ‘can be interpreted as a means of forestalling regulation and quieting the press.’⁴⁵ Summarily, these studies indicate firstly that there may not be sufficient incentives for companies to form audit committees on a voluntary basis, and, secondly, that even where these committees are voluntarily formed, this might not be enough to achieve the ends sought. Voluntarily formed committees may not be formed for the right reasons, and in the absence of specific requirements, may suffer through a lack of consistency and standardisation.⁴⁶ Moreover, as discussed below, having an audit committee *per se* is not enough; it is essential that the audit committee have the necessary attributes to render it an effective corporate governance mechanism.

Need for more than mere existence of audit committees

‘While these committees routinely recommend the engagement of the auditors, listen to the outside auditors review their audit program and cursorily discuss internal controls with appropriate corporate personnel, they do not appear to be asking the hard questions or fulfilling the full range of expectations.’⁴⁷

6.61 ‘[A] corporation having an audit committee as part of its governance structure and having an effective audit committee are, of course, two different matters.’⁴⁸ It is not enough that companies form audit committees. The committee must be composed such that the board can and does rely on it to ‘enhance its monitoring ability.’⁴⁹ Concerns exist about audit committees lacking financial expertise ‘as well as the mandate to ask probing questions,’⁵⁰ and these weaknesses can have deleterious effects on their value. Menon and Williams⁵¹ maintain that an effective audit committee must not only exist and be independent, but must also be active.

⁴³ Earncliffe Research and Communications, *Report to the United States Independence Standards Board – Research into Perceptions of Auditor Independence and Objectivity*, Phase 1 Report, November 1999, Phase 2 Report, July 2000.

⁴⁴ See, eg, Pincus, Rusbarsky and Wong, above n 35.

⁴⁵ Michael Bradbury, ‘The Incentives for Voluntary Audit Committee Formation’ (1990) 9 *Journal of Accounting and Public Policy* 19.

⁴⁶ Birkett, above n 36.

⁴⁷ A A Sommer, Jr, ‘Auditing Audit Committees: An Education Opportunity for Auditors’ (1992) 173(6) *Journal of Accountancy* 112, 112.

⁴⁸ *Ibid.*

⁴⁹ Krishnagopal Menon and Joanne Deahl Williams, ‘The Use of Audit Committees for Monitoring’ (1994) 13 *Journal of Accounting and Public Policy* 121.

⁵⁰ Levitt, above n 34, 52.

⁵¹ Above n 49.

Relationship between audit committee composition and effectiveness

Independence of audit committee members

6.62 According to the Blue Ribbon Committee, ‘several recent studies have produced a correlation between audit committee independence and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud’.⁵²

6.63 Evidence on the relationship between earnings quality and the audit committee is presented by Wild.⁵³ Using market reaction to the earnings report as a proxy for its informativeness, the author finds a significant increase in market reaction subsequent to audit committee formation. This result is consistent with audit committees increasing earnings quality. Notwithstanding that the establishment of an audit committee alone has been shown to improve earnings quality, the composition of the audit committee has been demonstrated to have a further effect on the incentives and actions of members in performing their oversight role.

6.64 Deli and Gillan⁵⁴ find that the demand for independent and active audit committees is positively related to the demand for accounting certification. They investigate the relevance of factors that might impact the demand for certification, such as corporate growth opportunities, company size, managerial ownership and leverage. The authors consider that the only independent committees are those entirely composed of independent directors. Further, they emphasise the importance of regular meetings for an audit committee to be effective.

6.65 Independent and active audit committee members, it is argued, demand a higher level of audit quality.⁵⁵ Abbott and Parker⁵⁶ contend that independent directors have a greater investment in their reputation as financial monitors. They test whether independent and active audit committees demand higher quality through the choice of a specialist auditor. Consistent with their hypothesis, the authors find that audit committees that meet at least twice per year and do not contain employees of the company are more likely to engage a specialist auditor. According to their reasoning, this implies that independent and active audit committees are more likely to demand a higher quality audit. A criticism of the work of some audit committees is their potential allegiance to management.

6.66 Knapp⁵⁷ investigates when audit committees are likely to ‘side with’ management rather than the external auditor. The author finds that factors such as the background of the committee member, along with the objectivity of accounting standards and the financial condition of the audited company could be relevant. The study broadly finds that independent audit committees generally support auditors over management in a dispute, which highlights the importance of the

⁵² Blue Ribbon Committee, above n 42, 22.

⁵³ Above n 40.

⁵⁴ Daniel Deli and Stuart Gillan, ‘On the Demand for Independent and Active Audit Committees’ (2000) 6 *Journal of Corporate Finance* 427.

⁵⁵ Lawrence Abbott and Susan Parker, ‘Auditor Selection and Audit Committee Characteristics’ (2000) 19(2) *Auditing: A Journal of Practice and Theory* 47.

⁵⁶ *Ibid* 48.

⁵⁷ Michael Knapp, ‘An Empirical Study of Audit Committee Support for Auditors Involved in Technical Disputes with Client Management’ (1987) 62(3) *Accounting Review* 578.

existence of an independent audit committee as a governance mechanism. This conclusion underscores the importance of looking beyond the mere existence of an audit committee, to its composition and workings, in determining effectiveness.

6.67 Further evidence on the actions of audit committees in the event of a dispute between management and auditors is furnished by DeZoort and Salterio.⁵⁸ Audit committee members with greater independent director experience and audit knowledge were more likely to back an auditor promoting a ‘substance over form’ approach in a client dispute. Directors serving in senior management were more likely to support management. These results emphasise the importance of audit committees being independent.

6.68 Looking at a sample of financially distressed firms, Carcello and Neal⁵⁹ provide evidence on the relationship between audit committee membership and reports issued by the auditor. In particular, the authors examine whether financially distressed companies with more independent audit committees have a greater likelihood of receiving a going-concern report from their auditor. Consistent with calls for strengthening the independence requirements for audit committee members, they find that as the percentage of affiliated (or non-independent) directors on the audit committee increases, the likelihood of receipt of a going-concern report decreases.

6.69 There is also evidence that the proportion of independent directors on the audit committee is negatively associated with the probability of litigation against the external auditor,⁶⁰ and negatively associated with the probability of SEC enforcement action.⁶¹ Another study has found that having an audit committee composed of only independent directors who meet more than twice a year is negatively associated with earnings management.⁶²

6.70 Prior to the recent strengthening of the NYSE rules on audit committee independence, Vicknair, Hickman and Carnes⁶³ found that the inclusion of ‘grey’ area directors⁶⁴ was pervasive on the exchange across companies and time. The demonstrated potential for audit committee members lacking independence to compromise the effectiveness of the audit committee, along with evidence that absent regulation, such directors are systematically included, furthers the argument that independence requirements for audit committee members are essential.

⁵⁸ Todd DeZoort and Steven Salterio, ‘The Effects of Corporate Governance Experience and Financial Reporting and Audit Knowledge on Audit Committee Members’ Judgments’ (2001) *Auditing: A Journal of Practice and Theory* (forthcoming).

⁵⁹ Joseph Carcello and Terry Neal, ‘Audit Committee Composition and Auditor Reporting’ (2000) 75(4) *Accounting Review* 453.

⁶⁰ Y Park, ‘Corporate Governance, Audit Committees, and Auditor Litigation’ (Working Paper, University of Illinois at Chicago, 1999), cited in Sonda Marrakchi Chtourou, Jean Bedard and Lucie Courteau, ‘Corporate Governance and Earnings Management’ (Working Paper, Social Science Research Network Electronic Library, 2001).

⁶¹ D W Wright, ‘Evidence on the Relation Between Corporate Governance Characteristics and the Quality of Financial Reporting’ (Working Paper, University of Michigan, 1996), cited in Chtourou, Bedard and Courteau, above n 60.

⁶² Chtourou, Bedard and Courteau, above n 60.

⁶³ David Vicknair, Kent Hickman and Kay Carnes, ‘A Note on Audit Committee Independence: Evidence from the NYSE on “Grey” Area Directors’ (1993) 7(1) *Accounting Horizons* 53.

⁶⁴ ‘Grey’ area directors are defined as those who are not in the employment of the company, but are otherwise affiliated with management, suggesting some direct or indirect financial interest.

6.71 Few arguments have been advanced against the introduction of audit committees. Some have argued that an audit committee can become overburdened if too much emphasis is placed on its role. However, having a clear charter defining its duties and responsibilities can remedy this concern.⁶⁵ Further, others have questioned whether audit committees can be a ‘one size fits all’ solution, particularly in relation to smaller companies.⁶⁶ This point can be addressed through having different requirements for smaller capitalisation companies, as is evident by international best practice.⁶⁷

6.72 In concluding a study on the relevance of audit committee power as a factor in determining effectiveness, Kalbers and Fogarty⁶⁸ stress that ‘audit committees need a strong organizational mandate, both through an adequate written charter and sufficient informal recognition by its constituents...This includes timely, relevant reports from and interactions with management and auditors...Expertise of committee members is also important.’⁶⁹

6.73 The arguments above highlight the need not only for mandatory audit committee formation for listed companies, but also for this committee to be subject to standards aimed at enhancing its effectiveness. This is in line with best practice in Canada, the United States and some other countries and would provide Australian investors important oversight protection.

Expertise of audit committee members

6.74 As noted above, there is a trend by United States stock exchanges to mandate financial competency of members of the audit committee. There is empirical evidence to support these requirements. For example, it has been found that companies subject to SEC enforcement actions or companies restating their quarterly reports are less likely to have CPAs on their audit committee.⁷⁰ Another study found that the accounting experience of audit committee members as well as their knowledge of auditing are positively associated with the likelihood that they will support the auditor in an auditor-corporate management dispute.⁷¹ It has also been found that having at least one member of the audit committee with financial expertise is negatively associated with earnings management.⁷²

Recommendations

6.75 The following recommendations deal with mandating qualified audit committees for listed companies. Further details of the recommendations are contained in Appendix D of this report.

⁶⁵ See, eg, Anonymous, ‘Don’t Overburden Audit Committees, Expert Advises’ (2000) 59(2) *Directors & Trustees Digest* 3.

⁶⁶ See, eg, Peter Baxter and John Pragasan, ‘Audit Committees: One Size Fits All?’ (1999) 69(3) *Australian CPA* 42.

⁶⁷ See, eg, Blue Ribbon Committee, above n 42.

⁶⁸ Lawrence Kalbers and Timothy Fogarty, ‘Audit Committee Effectiveness: An Empirical Investigation of the Contribution of Power’ (1993) 12(1) *Auditing: A Journal of Practice and Theory* 24.

⁶⁹ *Ibid.*

⁷⁰ D A McMullen and K Raghundan, ‘Enhancing Audit Committee Effectiveness’ (1996) 182 *Journal of Accountancy* 79, cited in Chtourou, Bedard and Courteau, above n 60.

⁷¹ DeZoort and Salterio, above n 58.

⁷² Chtourou, Bedard and Courteau, above n 60.

- (a) It is recommended that the ASX Listing Rules be amended to require all listed companies to have an audit committee. The new Listing Rule would be accompanied by an ASX Guidance Note. The Listing Rule and associated Guidance Note should govern the structure of this committee, and should reflect international best practice in audit committees as outlined in Appendix D.⁷³
- (b) The Listing Rule should:
- mandate the existence of a qualified audit committee;
 - specify the composition of the audit committee as contained in section 3 of Appendix D; and
 - require the board of directors to adopt a written charter to govern the audit committee.
- (c) The Guidance Note should:
- specify the general requirements, and duties and responsibilities, of a qualified audit committee as contained in sections 4 and 5 of Appendix D; and
 - contain such other matters as are considered appropriate by ASX.

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

6.77 Appendix D specifies the composition of the audit committee and its general duties and responsibilities. In relation to the composition of the audit committee:

- (a) The audit committee of a listed company, where market capitalisation of that company exceeds a specified threshold, must consist of at least three directors, and all members of the audit committee must be independent. Where the market capitalisation of the listed company is below the specified threshold, the audit committee must contain at least one director who is independent, instead of all directors of the audit committee being required to be independent.
- (b) Each member of the audit committee should be financially literate or made financially literate within a reasonable period of time of appointment. At least one member of the audit committee must have accounting and/or related financial expertise. It is appropriate that members of the audit committee have a range of different backgrounds, skills and experiences. However, financial literacy is an essential skill for audit committee members.

6.78 In relation to the responsibilities of the audit committee, as noted in Appendix D, the audit committee should:

⁷³ These principles have been developed from international reports, best practice guides and standards. Particular reliance has been placed upon the Blue Ribbon Committee, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (1999); the New York Stock Exchange, *NYSE Listed Company Manual: 303.01 Audit Committee*; and the Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors - Australia, *Audit Committees: Best Practice Guide* (2nd edition, 2001).

- state in the annual report whether or not it believes the level of non-audit service provision by the auditor is compatible with maintaining auditor independence, and should include reasons where appropriate;
- make recommendations to the board on the appointment, reappointment or replacement, remuneration, monitoring of the effectiveness, and independence of the auditor;
- review and agree on the terms of engagement for the auditor at the start of each audit;
- review the scope of the external audit with the auditor including identified risk areas and any additional agreed upon procedures;
- review the auditor's audit fee, and be satisfied that an effective, comprehensive and complete audit can be conducted for that fee (this includes reviewing and assessing fees paid for non-audit service provisions);
- review with the auditor any significant disagreements between the auditor and management, irrespective of whether they have been resolved;
- monitor the number of former employees of the audit firm currently employed in senior positions in the company and assess whether this impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether taken as a whole, the various relationships between the company and the auditor impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether the compensation of the individuals employed by the auditor who are performing the audit of the company is tied to the provision of non-audit services and, if so, consider whether this impairs or appears to impair the auditor's judgment or independence in respect of the company;
- review the economic importance of the company (in terms of fees paid to the auditor for the audit as well as fees paid to the auditor for the provision of non-audit services) to the auditor, and assess whether the economic importance of the company to the auditor impairs or appears to impair the auditor's judgment or independence in respect of the company; and
- at least annually, meet with the auditor without the presence of management.

6.79 It might be argued that requiring an audit committee for smaller listed companies imposes unnecessary costs on these companies. We are not convinced by this argument. As documented earlier in this section, there are powerful advantages which result from a well functioning and well structured audit committee. In reply to the argument that there is a cost to obtaining independent directors, we note that under our recommendation for the composition of audit committees, for smaller capitalisation companies there is only a requirement for one independent director. This is a modest requirement. In relation to the requirement for each member of the audit committee to be financially literate, we do not believe there are any credible arguments opposing this. Financial literacy is an essential part of audit committee membership competence. We note that under our recommendations, it is possible for a member of the audit committee to be made financially literate within a reasonable period of time of appointment.

APPOINTMENT AND REMOVAL OF AUDITORS

6.80 Following the corporate failures that occurred during the first half of 2001, a number of commentators⁷⁴ have called for a radically different approach to the appointment of company auditors. Instead of auditors being appointed by company members, as currently occurs, the Australian Securities and Investments Commission would be responsible for their appointment.

⁷⁴ For example: Mr Tony Harris, former Auditor-General of New South Wales, and Senator Andrew Murray, the Australian Democrat's spokesperson on corporate law.

6.81 This section of the report outlines the existing procedures for appointment of auditors in Australia and a number of overseas jurisdictions before considering alternative methods of appointment.

Australian position

6.82 Australian requirements for the appointment and removal of company auditors are contained in Part 2M.4 of the Corporations Act. Under the Act, the directors of those companies required to appoint an auditor are required to appoint an auditor within one month after the incorporation of the company (subsection 327(1)) and within one month of any subsequent vacancy in the office of auditor, unless the company in general meeting has appointed a new auditor (subsection 327(5)). Where the directors appoint an auditor under either of these requirements, the auditor so appointed holds office until the next annual general meeting of the company.

6.83 At the first annual general meeting of the company, and at each subsequent annual general meeting where there is a vacancy in the office of auditor of the company, the company must appoint an auditor. An auditor appointed at an annual general meeting holds office until death or removal or resignation from office in accordance with section 329 or until ceasing to be capable of acting as auditor because of subsection 324(1) or (2).

6.84 Section 329 deals with the removal and resignation of auditors. Of particular note in this provision is the need for an auditor who is seeking to resign his or her office to obtain the prior approval of ASIC (subsection 329(5)).

6.85 Provision is made section 327 for ASIC to appoint an auditor in circumstances where the company has not appointed an auditor. Advice from ASIC indicates that it has never been required to appoint an auditor pursuant to section 327.

Overseas position

6.86 Overseas requirements for the appointment of company auditors are generally similar to those in Australia, with an appointment usually being made by the shareholders at each annual general meeting (or equivalent) at which there is a vacancy in the office of auditor. Where there is a casual vacancy in the office of auditor, an appointment is made by directors and a person so appointed holds office until the next annual general meeting.

6.87 Provisions dealing with the resignation or removal of auditors are also similar to those in Australia, although overseas jurisdictions do not appear to have a requirement equivalent to the Australian requirement in which an auditor must obtain the prior approval of ASIC before resigning.

Adequacy of Australian requirements

6.88 Chapter 7 of the Audit Review Working Party's report addressed a range of issues associated with the appointment, tenure, removal and resignation of company auditors. An outline of these issues and the Working Party's conclusions, which still appear relevant, are provided below.

Appointment

6.89 The options identified by the Working Party for appointing auditors include:

- (a) retaining the existing requirements with or without the provision of a period of fixed tenure for the appointment;
- (b) restricting voting at AGMs on resolutions to appoint auditors to those shareholders:
 - (i) who are not directors; or
 - (ii) who have not exercised a right (whether written or otherwise), based on the size of their share holdings, to have a nominee appointed to the board of directors;
- (c) having the auditor appointed according to existing requirements but on the recommendation of an audit committee or a committee of non-executive directors; and
- (d) having the auditor appointed by a completely independent body such as ASIC, the Court or an independently established tribunal.

6.90 Australia's regulations relating to audit appointment are broadly in line with those of other developed countries. The Working Party noted that there was no precedent for appointment by an independent body (option d) and, on the evidence before, it concluded that a move in this direction would create more problems than it would solve. The Working Party also believed that options (b) and (c) had merit, particularly option (c) which would complement the increasing emphasis on independent directors and audit committees in the overall context of corporate governance. These options were in line with the (then) recent recommendations of the Auditing Practice Board in Great Britain.

6.91 The Working Party considered that auditors of listed companies should be appointed on a recommendation of the audit committee or, where there is no audit committee, on a recommendation of an appropriate committee of non-executive directors. In the case of unlisted companies, the Working Party recommended that the auditor should be appointed on the recommendation of the audit committee where such a committee exists.

6.92 To facilitate the implementation of this proposal, the Working Party considered that either the ASX listing rules or the Corporations legislation should be amended to make it mandatory for listed companies to have an audit committee.

6.93 The Working Party was also of the view that changes to the auditors of a disclosing entity should be made a continuous disclosure matter.

Tenure

6.94 There are divergent views on whether company auditors should be appointed until 'death or removal or resignation' as provided for in section 327 of the Corporations Act, or for some fixed period.

6.95 Under section 327 of the Corporations Act, a person or firm appointed as auditor of a company holds office until death or removal or resignation. Section 329 of the Corporations Act provides that:

- (a) an auditor may be removed from office by resolution of the company at a general meeting of which special notice has been given; and

- (b) an auditor of a public company may resign if ASIC has consented to the resignation (the auditor of a proprietary company does not need ASIC's consent to resign).

6.96 Options available in respect of the tenure of auditors include:

- (a) retaining the existing requirements;
- (b) retaining existing requirements but with a fixed minimum term of appointment;
- (c) termination of the audit appointment after a specific period of time, with or without the opportunity to reappoint the existing auditor;
- (d) requiring, where the auditor is a firm, the rotation of the responsible partner after a specified period of time;
- (e) placing, in the case of a sole practitioner or a firm, a restriction on the period for which the sole practitioner or firm may hold office; and
- (f) requiring the appointment of a second or review partner within the auditor's firm or, in the case of a sole practitioner, from another firm.

6.97 Following consideration of these options, the Working Party concluded that there should be mandatory rotation of audit partners in accordance with the principles laid down in AUP 32 for all listed companies.

6.98 We endorse the principle that there be mandatory rotation of audit partners. However, we also believe that AUP 32 is not adequate in this respect. AUP 32 only requires 'the periodic rotation of audit staff between audit engagements'. Some firms may interpret this as only requiring rotation after many years. We have been advised that under rules in the United States and the United Kingdom, audit partners are required to rotate after a period of 7 years. We believe this is an appropriate precedent and therefore recommend that there be mandatory rotation of the audit partners responsible for the audit of listed companies and that the rotation is to occur after a maximum of 7 years. This leaves open the possibility that rotation may occur sooner if considered appropriate by those involved in the audit. We have also been advised that in both the United States and the United Kingdom, partners can be reassigned to the audit client following a 2 year period. Again, we believe this is an appropriate precedent and therefore recommend that there is to be a period of at least 2 years before the partner can again be involved in the audit of the client.

6.99 An issue considered by the Audit Review Working Party, and an issue which also arose for consideration as part of the current review, was whether or not it is appropriate to mandate rotation of the audit firm, as an alternative to rotating the audit partner. The Audit Review Working Party noted in its Report (paragraph 7.26) that only in Spain and Italy is there a requirement to rotate the audit firm after a specified period of time (9 years). We investigated this issue as part of the current review. We have been advised that Spain has now withdrawn the requirement to rotate audit firms and that the requirement is therefore limited to Italy.

6.100 We do not believe it appropriate to mandate rotation of audit firms. The Audit Review Working Party, in also reaching this conclusion, stated that 'the anticipated cost, disruption and loss of experience to companies is considered unacceptably high, as is the unwarranted restriction on the freedom of companies to choose their own auditors' (paragraph 7.27). We agree with these comments.

Resignation and removal

6.101 The Working Party received submissions suggesting that consideration be given to circumstances when it may be appropriate for a change of auditors to take place other than at an AGM or without the requirement to obtain ASIC approval. As noted below, the Working Party was concerned at the potential in these circumstances for the independence of the auditor to be compromised.

6.102 There was concern that executive management may be in a position to exert undue influence on the role of the auditor in reaching an independent professional opinion. The position for the auditor is unique, in that the appointment is officially made by shareholders as an independent group, but in practice the day to day dealings and payment of fees to the auditor are made by executive management. It would be very much in the public interest if the existing power and influence of executive management over the auditor could be minimised in the interest of auditor independence.

6.103 Any proposal to remove the auditor from office should be the subject of a continuous disclosure notice to be filed with ASX, on the basis that it is 'material' information. The notice should also indicate reasons. Similarly any resignation by an auditor should be the subject of a continuous disclosure notice which contains a statement of the auditor's reasons for resigning.

6.104 Any appointment of a new auditor of a public company or disclosing entity must, at present, be approved by shareholders at the next AGM. Existing requirements established by the ASIC restricting voting on the change of auditor upon resignation largely to the AGM and to dates not near the financial year end should be retained. There should also be a requirement that any proposal for appointment of auditors should contain information on proposed fees.

Recommendations

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

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

- (e) The Corporations Act should provide that any proposal for appointment of auditors of a disclosing entity must contain information on the proposed fees. (Recommendation 7.15)

DISCIPLINARY PROCEDURES

6.106 The report of the Audit Review Working Party contains a series of recommendations for streamlining the institutional arrangements for taking any disciplinary action against registered company auditors and the procedures for dealing with the disciplinary matters themselves.

6.107 This section of the report provides an overview of the Working Party's proposals and examines whether it would be appropriate to implement those recommendations.

Australian position

6.108 Disciplinary matters are dealt with by the Companies Auditors and Liquidators Disciplinary Board (CALDB), a statutory board established by section 202 of the Australian Securities and Investments Commission Act 1989 and continued in existence by section 261 of the Australian Securities and Investments Commission Act 2001 (ASIC Act). Sections 203 and 209 of the ASIC Act provide for the Board's membership to consist of:

- (a) a Chairperson who must be enrolled as a barrister, solicitor or legal practitioner of the High Court, any federal court or of the Supreme Court of a State or Territory and has been so enrolled for a period of at least five years;
- (b) a member and a deputy selected by the Minister from a panel of five persons nominated by the National Council of the ICAA; and
- (c) a member and a deputy selected by the Minister from a panel of five persons nominated by the National Council of CPA Australia.⁷⁵

6.109 A deputy of a member is entitled to attend meetings of the Board at which the member is not present and while attending is deemed to be a member. No deputy is appointed to the Chairperson, but a person may be appointed to act during a vacancy in the office or during any period when the Chairman is absent from office.

6.110 The powers of the CALDB, in terms of subsections 1292(1) and (7) of the Corporations Act are, in summary, to receive and review applications by ASIC in respect of the conduct of either registered company auditors or liquidators. In respect of auditors, the specific matters that may be referred to the CALDB by ASIC include:

- (a) the failure of an auditor to lodge a triennial statement;
- (b) the failure of an auditor to carry out or perform adequately and properly the duties of an auditor;
- (c) the failure of an auditor to carry out or perform adequately and properly any duties or functions required by an Australian law to be carried out or performed by a registered company auditor;

⁷⁵ The legislation still refers to the body by its former name, Australian Society of Certified Practising Accountants.

- (d) that an auditor is disqualified from managing corporations under Part 2D.6 of the Corporations Act;
- (e) that the auditor is incapable, because of mental infirmity, of managing his or her own affairs; and
- (f) that (in the opinion of ASIC) a person is not a fit and proper to remain registered as an auditor.

6.111 Section 218 of the ASIC Act provides that the proceedings of the CALDB are to be conducted with as little formality and technicality, and with as much expedition, as the requirements of the Act and a proper consideration of the matters before the Board permit. The section also provides that the Board is not bound by the rules of evidence. However, the CALDB is required to observe the rules of natural justice.

6.112 Penalties that may be imposed by the CALDB are the cancellation of an auditor's registration or the suspension of that registration for a specified period of time. The CALDB may also deal with a person by:

- (a) admonishing or reprimanding the person;
- (b) requiring the person to give an undertaking that he or she will not engage in specified conduct; or
- (c) requiring the person to give an undertaking that he or she will not engage in specified conduct except under certain conditions.

Overseas position

6.113 In the overseas jurisdictions examined by the Audit Review Working Party, there are two basic ways of dealing with disciplinary matters:

- (a) by the professional bodies, as in the United Kingdom, New Zealand and the United States;⁷⁶ and
- (b) by public accountants registration boards, as in Canada (Ontario) and South Africa.

6.114 In the United Kingdom, cases of public concern are currently dealt with under the Joint Disciplinary Scheme arrangements operated by The Institute of Chartered Accountants in England and Wales and The Institute of Chartered Accountants of Scotland. Responsibility for dealing with such cases is being transferred to the Investigation and Discipline Board, one of five bodies being established in conjunction with the implementation of a system of non-statutory independent regulation for the UK accountancy profession.

Adequacy of Australian requirements

6.115 As part of the review of audit independence, the Audit Review Working Party's proposals for revising the disciplinary arrangements were re-examined.

⁷⁶ The Working Party noted its understanding that in the United States discipline is done by the professional bodies under a regime that is overseen by the regulatory bodies.

6.116 The Audit Review Working Party examined the following aspects of the requirements for disciplining auditors as part of its review:

- (a) whether the existing institutional arrangements for dealing with disciplinary matters operate in an efficient and effective manner;
- (b) whether the matters that may be dealt with by the CALDB are appropriate;
- (c) whether the penalties that may be imposed by the CALDB are appropriate; and
- (d) whether the CALDB and/or ASIC should be authorised to exchange information with the accounting bodies for the purpose of disciplinary proceedings.

6.117 The Working Party, following consultation with stakeholders, put forward a total of 17 recommendations (these recommendations are reproduced in Appendix C of this report, recommendations 8.1-8.17) designed to achieve three basic objectives:

- (a) relieving the CALDB of the task of dealing with disciplinary matters of an administrative nature,⁷⁷ thus enabling it to devote its resources to dealing with the more substantive conduct matters;
- (b) broadening the membership base of the CALDB in order to increase the perception that it is independent of the accounting profession; and
- (c) increasing publicity associated with disciplinary matters for the purpose of acting as a deterrent to others.

6.118 At the time the Working Party's report was released there was general support for most of its recommendations, the principal exception being the proposal that the Chair of the Board need not be a legal practitioner (recommendation 8.6). The recommendation of the Working Party that the CALDB be relieved of the task of dealing with disciplinary matters of an administrative nature was not supported by either the CALDB or by ASIC on a number of grounds including that it is desirable that disciplinary action which affects the right of an auditor or liquidator to practise should be centralised in one body. In addition, one other recommendation, that the CALDB should have the ability to impose fines (recommendation 8.15), is no longer possible because the corporate regulation scheme is now based on Commonwealth Constitutional powers, rather than State and Territory powers as was the case when the recommendations were formulated, and there are constitutional limitations on Commonwealth bodies imposing fines.

6.119 Consultation with the CALDB as part of the current review indicates that there is still a high level of support for the Working Party's recommendations, other than those referred to above in paragraph 6.118. The Board's principal concerns are with proposed changes to its composition. In this regard, the Board has formed the view that, in light of the very technical issues coming before it, the composition of the Board should not be expanded by the inclusion of nominees from outside the legal and accounting professions.

6.120 Nevertheless, as a result of difficulties recently experienced by the Board in forming a quorum for an important hearing,⁷⁸ it is apparent that some changes are needed to the Board's

⁷⁷ Matters of an administrative nature are the failure of an auditor to lodge a triennial statement (para 1292(1)(a)); when an auditor is bankrupt (para 1292(7)(a) and when an auditor is disqualified from managing corporations under Part 2D.6 of the Corporations Act.

membership structure. The Board, for its part, has proposed that its membership be expanded through the appointment of reserve members for both the ICAA and CPAA. The Board envisages that reserve members would be used when neither the member nor deputy for a particular body is available for a hearing. It has also proposed that, when making future appointments, an effort should be made to include in the appointments some members, deputies or reserves who are current or former insolvency practitioners.

6.121 It is our view that it would be appropriate to proceed with the Working Party's recommendations, subject to the retention of the existing requirement that the chair have legal qualifications; omitting the proposals opposed by the Board and ASIC; and giving effect to the Board's proposal for the appointment of additional accounting and insolvency members in place of the Working Party's proposal for the appointment of people with other experience.

Recommendations

6.122 It is recommended that:

- (a) The ASIC Act be amended to:
 - (i) provide for the appointment of a deputy chairperson for the CALDB;
 - (ii) allow the CALDB to sit in more than one Division simultaneously;
 - (iii) provide that a Division of the CALDB be constituted by:
 - (A) the chairperson or deputy chairperson;
 - (B) a member, deputy of the member or a reserve member nominated by the ICAA; and
 - (C) a member, deputy of the member or a reserve member nominated by CPA Australia; and
 - (iv) provide for the ICAA and CPA Australia to each submit a panel of not less than seven and not more than ten names from which the Minister will appoint:
 - (A) one ICAA member, a deputy of the ICAA member, and up to two ICAA reserve members; and
 - (B) one CPA Australia member, a deputy of the CPA Australia member, and up to two CPA Australia reserve members.
- (b) In making the appointments, the Minister should have regard to the need to ensure that included in the appointments are some members, deputies or reserves who are current or former insolvency practitioners.
- (c) The ASIC Act or the Corporations Act, as appropriate, be amended to:
 - (i) enable the CALDB to enforce orders made during the pre-hearing period;

⁷⁸ The ICAA member and his deputy both excluded themselves from a hearing because of a conflict of interest.

- (ii) provide that, in respect of each disciplinary proceeding, the nature of the matter, the decision and the reasons for the decision should be published; and
- (iii) enable the CALDB to provide information obtained by it during the course of a disciplinary proceeding to the investigation and disciplinary committees of the ICAA, CPA Australia and NIA, to facilitate the disciplinary procedures of those bodies.

ATTENDANCE OF AUDITOR AT AGM

6.123 Section 249K of the Corporations Act provides that a company must give its auditor:

- (a) notice of a general meeting in the same way that a member of the company is entitled to receive notice; and
- (b) any other communications relating to the general meeting that a member of the company is entitled to receive.

Section 249V further provides that a company's auditor is entitled to attend any general meeting of the company and is entitled to be heard at the meeting on any part of the business of the meeting that concerns the auditor in their capacity as auditor.

6.124 Section 250T of the Corporations Act was introduced by the Company Law Review Act 1998 and deals with questions by members of auditors at the AGM of a public company. It provides that if the company's auditor or their representative is at the AGM, the chair of the AGM must allow a reasonable opportunity for members as a whole at the meeting to ask the auditor or their representative questions relevant to the conduct of the audit and the preparation and content of the auditor's report.

6.125 The Audit Review Working Party recommended in its 1997 Report that there should be a requirement in the law for an auditor to attend the AGM at which the audit report is tabled, either in person or by way of a representative, except in exceptional circumstances (Recommendation 7.16). The Working Party stated that this recommendation would appropriately complement what was then the draft provision to require the chairperson of the AGM to allow a reasonable opportunity for members to ask questions of the auditor. The Working Party further stated that it received submissions suggesting the role of the external auditor at a company's AGM should be strengthened as this is the only forum where the auditor and the persons to whom the auditor is accountable can meet on a face to face basis. The Working Party also noted that subsection 1289(1)(a) of the Corporations Act provides that an auditor has qualified privilege in respect of any statement that he or she makes, orally or in writing, in the course of duties as auditor.

6.126 We see considerable merit in the views of the Working Party concerning attendance of the auditor at the AGM. The recommendation operates to both strengthen the role of the auditor and also strengthen the accountability of the auditor to shareholders. We note that section 250T which requires the chair of an AGM to allow a reasonable opportunity for members to ask questions of the auditor applies only to AGMs of public companies. It would be appropriate for a recommendation which requires auditors to attend AGMs to apply only to listed public companies. There are many small public companies (including many public companies limited by guarantee) where attendance by the company's auditor is not usually expected or required.

Recommendation

6.127 It is recommended that the Corporations Act be amended to require an auditor, or a representative of the auditor, to attend the AGM at which the auditor's report is tabled unless reasonable circumstances preclude the auditor's attendance. This requirement for auditors to attend AGMs should apply only to AGMs of listed public companies.