

**Financial Reporting Council**  
**Report on Auditor Independence**  
**2005-06**

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23 October 2006

The Hon Peter Costello MP  
Treasurer  
Parliament House  
CANBERRA ACT 2600

Dear Treasurer

I have pleasure in presenting the report of the Financial Reporting Council (FRC) on the performance of its auditor independence functions for the year ended 30 June 2006.

This is the second report prepared by the FRC in accordance with section 235BA of the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

Subsection 235BA(1) of the ASIC Act requires the FRC, by 31 October each year, to prepare a report on its performance of its auditor independence functions, the findings and conclusions reached by the FRC in performing those functions, and the actions (if any) taken by the FRC in respect of those findings and conclusions.

Under subsection 235BA(3) of the ASIC Act, the report must be tabled in each House of the Parliament as soon as practicable.

Yours sincerely

A handwritten signature in black ink, appearing to read 'C Macek', followed by a vertical red line.

Charles Macek



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## ABBREVIATIONS

The following abbreviations are used throughout this report:

APRA	Australian Prudential Regulation Authority
AQRB	Audit Quality Review Board
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
ASX	Australian Stock Exchange Ltd
ASXMS	ASX Markets Supervision Pty Ltd
CALDB	Companies Auditors and Liquidators Disciplinary Board
CLERP 9 Act	<i>Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004</i>
Corporations Act	<i>Corporations Act 2001</i>
CPA	CPA Australia
CPE	Continuing Professional Education
CPP	Certificate of Public Practice
EU	European Union
FRC	Financial Reporting Council
ICAA	The Institute of Chartered Accountants in Australia
IFAC	International Federation of Accountants
MOU	Memorandum of Understanding
MOU bodies	APRA, ASIC, ASX, CPA, ICAA and NIA
NIA	National Institute of Accountants
PCAOB	Public Company Accounting Oversight Board (United States)
PPC	Public Practice Certificate
SEC	Securities and Exchange Commission (United States)
UK	United Kingdom
US	United States of America

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## EXECUTIVE SUMMARY

This, the Financial Reporting Council's (FRC) second auditor independence report, outlines the work undertaken by the FRC in 2005-06 in the performance of its auditor independence functions. The report also sets out the findings of the FRC as a result of that work and, where appropriate, the action taken by the FRC in respect of those findings.

In 2005-06, the FRC addressed each of the core issues that, together, make up its auditor independence functions: systems and processes of Australian auditors, quality review programmes and disciplinary procedures of the professional accounting bodies as related to auditor independence, the teaching of ethics by, or on behalf of, those bodies and compliance by companies with audit-related disclosure requirements. In addition, the FRC gave consideration to international developments in the area of auditor independence.

The overall conclusion that the FRC has reached during 2005-06 is that the auditor independence framework in Australia is operating effectively. No systemic issues were revealed as a result of the significant work undertaken by the various parties. Based upon this finding, stakeholders can have a high degree of comfort that the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9 Act) is operating as envisaged, and investors can have a high level of assurance in the audit process in Australia. While the FRC has concluded that the overall system is working effectively, it has also identified some areas that are worthy of further consideration for potential improvements.

In 2005-06, as in the previous year, the FRC's work on the systems and processes of Australian auditors relied heavily on the report of the audit inspection programme conducted by the Australian Securities and Investments Commission (ASIC), supplemented by information gathered at meetings between the FRC and the major accounting firms. In this respect, the FRC is mainly interested in ASIC's observations and findings regarding the independence of auditors. It is only interested in quality review issues to the extent that they impact on its responsibilities under CLERP 9.

ASIC noted in its inspection report that the accounting firms have generally responded positively to the new Australian legislative requirements for auditor independence and audit quality and that its observations and findings vary considerably between the Big Four firms and the other firms.

Although ASIC noted a small number of instances where individuals had failed to comply with the independence requirements of the *Corporations Act 2001* (Corporations Act), the firms concerned asserted that these were addressed promptly in accordance with the requirements of the Act. The FRC has concluded that there is no evidence of systemic problems in respect of compliance with those requirements.

The FRC's 2004-05 independence report foreshadowed that the FRC would examine issues associated with the quality review programmes and disciplinary procedures of

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the professional accounting bodies and the teaching of ethics by, or on behalf of, those bodies as part of its 2005-06 auditor independence function work programme. This work commenced during the year, with the engagement of a number of short-term consultants to examine each matter, and will be continued in 2006-07 as part of the work programme for that year.

The consultants have made a number of findings and recommendations, summarised at Appendices C to E. The FRC intends to examine these findings and recommendations as part of its 2006-07 work programme, including consultations with the professional accounting bodies and other stakeholders.

The examination of the quality review programmes of the professional accounting bodies concluded that the programmes for reviewing members and firms that undertake audits comply with International Federation of Accountants (IFAC) and Australian professional pronouncements, although the consultants qualified their findings because they did not review files and thus were unable to conclude that the processes and procedures had been followed. The consultants recommend that the files from the quality review programme of the Institute of Chartered Accountants in Australia (ICAA) should be available to the FRC so that it can sight evidence that the professional accounting bodies' quality review policies and procedures, as they relate to auditor independence, have been followed.

The consultants have also noted the absence of a requirement for auditors in Australia to belong to a professional accounting body as a pre-requisite for registration as a company auditor and for the continuation of that registration. The FRC has monitoring responsibilities over the quality review, teaching of ethics and disciplinary arrangements of the professional accounting bodies as related to auditor independence, but in view of accountants not being required to be members of a professional accounting body to be registered as an auditor, it cannot provide oversight through the professional bodies over a segment of the auditing industry.

The consultants have also highlighted the concentrated structure of the Australian audit industry around the Big Four accounting firms, and recommend further research on the structure of the industry.

The examination of the disciplinary procedures of the professional accounting bodies indicated that the procedures of each body are adequate. However, the consultant has identified a number of threshold issues concerning the purpose and role of the professional bodies in disciplining auditors, their relationship in this area with ASIC and the Companies Auditors and Liquidators Disciplinary Board (CALDB), and the CALDB's ability to initiate disciplinary actions in the public interest. These issues warrant further examination and consultation with the professional bodies and other stakeholders by the FRC, which the FRC intends to undertake as part of its 2006-07 work programme.

Pleasingly, the examination of the teaching of ethics by, or on behalf of, the professional accounting bodies has found that the depth of understanding of ethical issues by officers of the three bodies and by members of accounting firms, their

commitment to deal with these issues and steps being taken to do so, is well beyond anything observed in other disciplines, business or professions, including law. The consultant has also made a number of recommendations on ways to enhance the teaching of ethics in the profession. These recommendations will be subject to further examination and consultation with the professional bodies and other stakeholders by the FRC, which the FRC intends to undertake as part of its 2006-07 work programme.

The FRC's work on monitoring the overall compliance by companies, registered managed investment schemes and disclosing entities with audit-related disclosure requirements of the Corporations Act and accounting standards was based on information supplied by ASIC from their accounts surveillance programme and the Australian Stock Exchange Ltd (ASX). The results of ASIC's review (which did not cover the full range of disclosure requirements) showed that the majority of the financial reports examined complied with the requirements examined as part of the review. A similar conclusion was reached by the ASX.

As part of its 2006-07 work programme, the FRC plans to review the level of compliance with audit-related disclosure requirements by considering the information provided by the Memoranda of Understanding (MOU) bodies.

In its last report, the FRC indicated that during 2005-06 it intended researching Australia's requirements on auditor independence compared with those applicable in other major jurisdictions worldwide. The review, which was undertaken by the Treasury to provide assistance to the FRC, compared five core elements of the Australian auditor independence requirements with the equivalent requirements applying in Canada, the European Union (EU), the United Kingdom (UK) and the United States of America (US). The overall conclusion of the review is that, notwithstanding differences in terminology, institutional arrangements and legal frameworks, there is a substantial underlying equivalence between the Australian auditor independence requirements and 'best practice' standards adopted internationally.

The FRC has identified from the review the following areas in which some aspects of the Australian independence requirements differ from the requirements applicable in some or all of the other jurisdictions: employment and financial restrictions, employment restrictions applying to former audit partners and senior audit personnel, multiple former partners of an audit firm/audit company director restrictions and auditor rotation. The FRC will consider these issues as part of its work programme for 2006-07, with a view to submitting appropriate recommendations for consideration by the Government.

The FRC welcomes the Government initiatives aimed at the reduction of red tape affecting businesses. The FRC intends to give further consideration, as part of its 2006-07 work programme, as to whether any scope exists for reducing the overlap of auditor review responsibilities between the firms, professional accounting bodies and regulators. This is particularly important in view of the lesser depth and diversity of auditing resources in Australia compared with the US and Europe.



## **INTRODUCTION**

Since 1 July 2004, the FRC has been responsible for monitoring the effectiveness of auditor independence requirements in Australia and giving the Minister reports and advice about those requirements. In addition, the FRC's functions include giving the professional accounting bodies reports and advice about aspects of their quality review programmes and disciplinary procedures. (See Appendix A for a detailed summary of the FRC's auditor independence functions.)

### **2005-06 WORK PROGRAMME**

In 2005-06, the FRC performed its auditor independence functions in a manner broadly similar to the performance of its functions in 2004-05. During the year under review, this work addressed each of the core issues that comprise these functions: systems and processes of Australian auditors, quality review programmes and disciplinary procedures of the professional accounting bodies, the teaching of ethics by, or on behalf of, those bodies and compliance by companies with audit-related disclosure requirements. The FRC also gave consideration to international developments in the area of auditor independence.

The administrative arrangements which the FRC put in place last year to perform these functions were continued in 2005-06. These arrangements included:

- the Audit Independence Subcommittee, which dealt with day-to-day matters associated with the performance of the function with the assistance of the FRC's auditor independence consultant; and
- the programme of regular meetings, and the exchange of information, with the bodies with which the FRC had entered into an MOU and selected accounting firms.

Further information about these arrangements, including the membership of the Subcommittee and the names of the MOU bodies, is contained in Appendix B.

To facilitate an expansion of the FRC's work programme in the areas of quality review, disciplinary procedures and the teaching of ethics, the FRC arranged with the Treasury for the engagement of consultants to prepare reports to the FRC on various aspects of these matters. The names of these consultants also appear in Appendix B, while the key requirements of the Statements of Work for the consultancies appear in Appendices C to E.

The auditor independence work performed by the FRC during the period under review, including the findings and conclusions reached by the FRC in the performance of its functions and the actions (if any) that it took, are described in later sections of this report.

Appendix F lists the key matters arising from the 2004-05 independence report and the action that was taken by the FRC in respect of each of those matters during 2005-06.

## **2006-07 WORK PROGRAMME**

The FRC's 2006-07 audit independence function work programme builds on, and, where appropriate, refines, the 2005-06 programme.

Apart from ongoing work associated with monitoring and assessing the nature and overall adequacy of the systems and processes used by Australian auditors to ensure compliance with auditor independence requirements, key matters included in the FRC's auditor independence work programme for 2006-07 are:

- examining the consultants' reports on the quality review programmes and disciplinary procedures of the professional accounting bodies and the teaching of ethics by, or on behalf of, those bodies, including consultations with the bodies and other stakeholders;
- reviewing, and analysing, the level of compliance by entities with audit-related disclosure requirements, primarily by considering the information provided to the FRC by the MOU bodies;
- considering areas in which some aspects of Australian auditor independence requirements differ from the requirements applicable in other jurisdictions with a view to submitting appropriate recommendations for consideration by the Government; and
- considering, in the context of Government initiatives aimed at the reduction of red tape affecting business, whether any scope exists for reducing the overlap of audit review responsibilities between the firms, professional accounting bodies and regulators.

A detailed outline of the work programme for 2006-07 is contained in Appendix G of this report.

## AUDITOR INDEPENDENCE IN AUSTRALIA

Professional independence is a fundamental concept for the accounting profession and auditors are held accountable for their actions under an extensive framework of rules established under legislation and by the professional accounting bodies.

Users of audited financial information expect that the auditor has been objective and exercised professional judgment free from all economic, financial and other relationships. Independence is the absence of actual or perceived interests or threats that create an unacceptable risk of material bias with respect to the quality or content of information that is the subject of the audit/assurance engagement.

It has been argued that the greatest threat to auditor independence is the auditor's relationship with the directors and management of the audited entity. Following recent corporate collapses, both in Australia and overseas, prominence was given to independence issues in the corporate law reforms.

### LEGISLATIVE AND PROFESSIONAL REQUIREMENTS

Australia has comprehensive legislative and professional requirements concerning the independence of auditors:

- Division 3 of Part 2M.4 of the Corporations Act sets out the requirements that have to be satisfied by the auditors of those entities that are subject to the audit requirements of the Corporations Act.
- Professional Statement F1 *Professional Independence*<sup>1</sup> contains the independence requirements applicable to all members of the ICAA and CPA Australia (CPA). The National Institute of Accountants (NIA) has issued an equivalent statement which is applicable to all members of the NIA (NIA Pronouncements of the Board of Directors 1 Code of Ethics, Section 8).
- Professional Statement APS 5 *Quality control for firms*<sup>2</sup> establishes basic principles and essential procedures and provides guidance regarding a firm's responsibilities for its system of quality control. APS 5 is only applicable to members of ICAA and CPA. The NIA Statement on Quality Control is an equivalent statement.

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1 From 1 July 2006, Professional Statement F1 was replaced by Section 290 of APES 110 Code of Ethics for Professional Accountants, which was issued by the Australian Accounting Professional and Ethical Standards Board in June 2006. The equivalent NIA statement is Section 290 of NIA Pronouncement 1. Code of Ethics.

2 From 1 July 2006, Professional Statement APS 5 was replaced by APES 320 Quality control for firms, which was issued by the Australian Accounting Professional and Ethical Standards Board in May 2006.

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- Auditing Standard AUS 206 *Quality control for audits of historical financial information*.<sup>3</sup>

### Corporations Act requirements

Under the Corporations Act, all disclosing entities (which are primarily listed public companies), other public companies, large proprietary companies and registered managed investment schemes are required to have their financial reports audited. These audits have to be conducted by auditors or audit companies registered by ASIC for the purpose of conducting such audits.

ASIC may, in certain circumstances, relieve a large proprietary company of the obligation to have its financial report audited. On the other hand, the members of a small proprietary company that is not required by the legislation to prepare a financial report can require the company to prepare such a report and have it audited.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) amended the Corporations Act through the establishment of a comprehensive regime on auditor independence. The amendments implemented recommendations of the Ramsay report (*Independence of Australian Company Auditors*) and relevant recommendations of the HHH Royal Commission.

As a result of the CLERP 9 Act amendments, the Corporations Act now contains the following measures to promote auditor independence:

- a general requirement of auditor independence;
- a requirement that auditors provide directors with an annual independence declaration;
- a prohibition of a number of specific employment and financial relationships between auditors and their clients which are considered to compromise independence;
- a 'cooling off' period of two years for partners of an audit firm or directors of an audit company who are directly involved in the audit of an audit client before they can take up a directorship or senior management position with the audit client;
- consistent with the recommendations of the HHH Royal Commission, a restriction on more than one former audit firm partner becoming an officer of an audit client at any one time;

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<sup>3</sup> For financial reporting periods commencing on or after 1 July 2006, Auditing Standard AUS 206 has been replaced by ASA 220 *Quality control for audits of historical financial information*, which was issued by the Auditing and Assurance Standards Board in April 2006.

- a requirement for an auditor of a listed company to attend the company's annual general meeting, and for shareholders to be able to submit written questions to the auditor concerning the auditor's report, including the independence of the auditor;
- a requirement for audit partner rotation for auditors of listed companies after five consecutive years. In light of concerns surrounding the impact of this requirement on smaller audit firms and those operating in rural and regional areas, ASIC is able to extend the period after which rotation is required to up to seven consecutive years; and
- a requirement for listed companies to disclose in their annual directors' report the fees paid to the auditor for each non-audit service, together with a description of the service. In addition, the annual directors' report of each listed company must include a statement by directors that they are satisfied that the provision of non-audit services does not compromise the auditor's independence.

## **ENSURING COMPLIANCE WITH REQUIREMENTS**

To complement the legislative and professional requirements on independence of auditors, appropriate institutional arrangements have been put in place to monitor compliance with those requirements and, where necessary, take appropriate follow-up action. The principal organisations making up these institutional arrangements, and their respective roles, are outlined below.

### **Australian Securities and Investments Commission**

CLERP 9 strengthened ASIC's role in the surveillance, investigation, and enforcement of the responsibilities of companies and auditors on financial reporting, audit independence, and compliance with accounting, and auditing standards.

CLERP 9 requires auditors to provide a declaration of their compliance with both the Corporations Act and the professional standards for each audit.

ASIC conducts audit inspections of auditing firms to assess compliance with CLERP 9 audit reforms, including audit independence provisions.

ASIC is the body that registers company auditors in Australia. To become a registered company auditor, an applicant must satisfy ASIC as to their qualifications, experience and competency in auditing.

### **Australian Stock Exchange**

The ASX is required under the Corporations Act to ensure that the listed company markets are fair, orderly and transparent. From 1 July 2006 the key supervisory operations of the ASX have been undertaken by ASX Markets Supervision Pty Ltd

(ASXMS), a subsidiary company under a charter to undertake principles-based market supervision. ASXMS is responsible for monitoring the conduct of market users and compliance with ASX Operating Rules, enforcing the Operating Rules, and ensuring that sufficient resources are allocated to it to perform its supervisory functions.

The ASX Corporate Governance Council principles recommend that an audit committee should oversee the appointment of auditors and their independence of listed companies. ASX Principle 4: *Safeguard integrity in financial reporting* requires the company to have a structure that independently verifies and safeguards the integrity of the company's financial reporting. This would include, for example, a review and consideration of the accounts by the audit committee, and a process to ensure the independence and competence of the company's external auditors.

A declaration of compliance with the auditor independence requirements under Section 307C of the Corporations Act or of any applicable code of professional conduct in relation to the audit must be made by the auditor and be included in the directors' report. The ASX monitors compliance with auditor independence certificate requirements and advises ASIC of any breaches.

### **Professional accounting bodies**

The ICAA, CPA and NIA, being the professional accounting bodies, who are members of IFAC in Australia, undertake regular mandatory quality reviews of members who have a Certificate of Public Practice (CPP) or Public Practice Certificate (PPC). The reviews include ensuring their members are complying with the accounting, auditing and assurance standards and their respective code of ethics. The reviews take place on a rolling three-year programme for auditors of listed entities. Reviews of the Big Four firms are undertaken by the ICAA. The NIA only has a few members who audit public listed entities.

All the professional accounting bodies have updated their quality review programmes and manuals to reflect the new independence requirements under CLERP 9 and IFAC.

### **Accounting Professional and Ethical Standards Board**

During 2006, the Accounting Professional and Ethical Standards Board was established as an initiative of the ICAA and CPA as an independent body to set the code of ethics and the professional standards by which their members are required to abide.

### **Audit firms (systems and processes)**

The Audit Quality Review Board (AQRB) was established in February 2006 by the major audit firms. It is a not-for-profit company limited by guarantee, initiated and funded by the major audit firms to act as an independent review body with a board of members drawn from a broad range of disciplines. The majority of the AQRB's

directors (including the Chairman) are persons who have never been practicing accountants.

The AQRB's primary purpose is to monitor the processes by which Participating Monitored Audit Firms<sup>4</sup> seek to ensure their compliance with applicable professional standards and legal obligations in relation to independence and audit quality with respect to financial statement audits of publicly listed entities. In doing so, AQRB aims to enhance the credibility and integrity of the Australian auditing framework, to improve public confidence in that framework and to contribute to the continual improvement of the audit profession for the benefit of the Australian public.

AQRB has established a Constitution, Code of Conduct and Rules, which provide the framework for its operations. These Rules include a power to specify the monitoring process.

### **Companies Auditors and Liquidators Disciplinary Board**

The CALDB, which is established under the ASIC Act, may take disciplinary action on the application of ASIC or the Australian Prudential Regulation Authority (APRA) against an auditor or liquidator. CALDB has power to admonish or reprimand a person; require a person to give an undertaking to engage in, or to refrain from engaging in, specified conduct; require a person to give an undertaking to refrain from engaging in specified conduct except on specified conditions; suspend or cancel a person's registration. The CALDB does not have the power to initiate disciplinary actions on its own, even in cases of public interest.

### **Financial Reporting Council**

Since July 2004, the FRC has been responsible for monitoring the effectiveness of auditor independence requirements in Australia and giving the Minister reports and advice about those requirements. The FRC has been given information gathering powers to support its auditor independence monitoring role.

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4 The initial participating firms are PricewaterhouseCoopers, Ernst & Young, KPMG, and Deloitte.

## 1. SYSTEMS AND PROCESSES OF AUSTRALIAN AUDITORS

Subparagraph 225(2B)(a)(i) of the ASIC Act requires the FRC to monitor and assess the nature and overall adequacy of the systems and processes used by Australian auditors to ensure compliance with auditor independence requirements.

In 2005-06, the FRC performed this function by gathering information from ASIC under the terms of its MOU with that body and through meetings with the four largest accounting firms.

### REPORT FROM ASIC

The MOU that the FRC has entered into with ASIC provides for periodic consultations and information sharing between the two bodies to assist in undertaking their respective responsibilities under the law.

ASIC's second report to the FRC on the audit inspection programme describes ASIC's inspection process together with observations and findings in relation to independence systems and audit quality for the Big Four firms and selected offices of six other firms.<sup>5</sup> ASIC's report focuses on improvements since its first (2004-05) inspections, where relevant, together with weaknesses identified, rather than areas of strength requiring no action.

The review undertaken by ASIC has therefore constituted a key source of information for the FRC with respect to its responsibilities in this area during 2005-06.

In its report to the FRC, ASIC noted that:

- the firms have generally responded positively to the new Australian legislative requirements for auditor independence and audit quality; and
- its observations and findings vary considerably between the Big Four firms and the other firms, as the challenges faced by these respective firms and the resources available to them are significantly different.

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5 Collectively the Big Four firms (PricewaterhouseCoopers, Ernst & Young, KPMG, and Deloitte) audit 53 per cent of the listed entities in Australia, and approximately 88 per cent by composition and 96 per cent by market capitalisation of the 300 largest entities listed on the Australian Stock Exchange (S&P/ASX 300). In contrast, the other firms inspected by ASIC (BDO Sydney, Horwath Sydney Partnership, PKF Sydney, Grant Thornton Western Australian Partnership, Pitcher Partners Melbourne and RSM Bird Cameron and RSM Bird Cameron Partners) audit approximately 2 per cent by composition and 0.2 per cent by market capitalisation of the S&P/ASX 300.

ASIC's report contained the following comments concerning independence at the Big Four firms:

- all the firms have the resources and capability to undertake audits of the largest listed entities and the necessary resources to implement effective systems in response to changes to the regulatory framework;
- ASIC recognises that the firms have had limited time since the completion of the first year inspections to implement all of its observations and findings; and
- ASIC went on to comment that, while the necessary improvements could be characterised as further enhancements to an already fundamentally sound process, there is a need for further improvement in the quality of audit work being done on the financial statements of listed entities in Australia, with areas requiring continued emphasis from the leadership of the Big Four firms including:
  - compliance with their independence policies; and
  - documentation and approval of non-audit services.

The other firms, which were included in ASIC's audit inspection programme for the first time in 2005-06, were subject to a more comprehensive inspection than that received by the Big Four firms during their first inspection in 2004-05, which was focussed just on auditor independence. ASIC has noted that its observations and findings vary considerably between the firms. It acknowledges that there are significant differences in the other firms' size, structural complexity, extent of centralized resources and international reach. Accordingly, it states that its observations for the firms visited may not be indicative of this group of firms as a whole, or of other member firms of the associations to which they belong.

While ASIC was encouraged by the policies and systems developed by these firms in some areas of independence, it was concerned that its inspections identified that:

- four firms need to further develop independence policies and systems to ensure they fully comply with the requirements of CLERP 9;
- five firms do not have adequate documentation supporting decisions to provide non-audit services to audit clients;
- in all firms, partner performance reviews are either not conducted or not documented, and/or the remuneration of audit partners is linked purely to financial results without explicitly considering audit independence and audit quality; and
- two firms have conducted very limited testing of compliance with audit independence policies and systems and four have not commenced any testing programme.

ASIC also noted that most of its observations and findings in respect of the other firms are consistent with recent reviews conducted by other international regulators of non-Big Four firms within their own jurisdiction.

ASIC has noted that with respect to the Big Four firms, only limited progress has been made in testing compliance with the firms' own independence policies and systems and, in the case of the other firms, four have not commenced any testing programme. In the case of the Big Four firms, two firm's testing programmes identified breaches of the Corporations Act, but the firms concerned asserted that these were addressed promptly in accordance with the requirements of that Act.

The FRC acknowledges that, in certain instances, the firms' policies could be more stringent than the requirements of the Act and therefore breaches of the firms' policies do not necessarily equate to breaches of the Act, but also supports the observation by ASIC that failure to comply with the firm's own policies may increase the risk of breaches of the Corporations Act.

Other observations made in the ASIC report note that the provision of non-audit services are one of the main threats to auditor independence.

The FRC notes that the Treasury comparative review, which is referred to in a later section of this report, indicates that Australia, unlike the US, has not prohibited actuarial services, although APRA precludes auditors of banks and insurance companies from providing such services to the banks or insurance companies that they are auditing. The FRC has also noted from the Treasury comparative review that in Canada and the UK actuarial services may only be provided on condition that specified requirements are satisfied.

The FRC further notes that the Treasury comparative review identified that the UK considers that the provision of certain tax services poses potential threats to independence.

Because of the importance of perceptions on auditor independence, in addition to the quantum of work involved in the provision of these non-audit services, the FRC intends to do further research and analysis in this area as part of its 2006-07 work programme.

## **ISSUES RAISED BY ACCOUNTING FIRMS**

### **Big Four response to ASIC's report**

The major firms were generally pleased with ASIC's findings and accepting of the observations and findings in relation to auditor independence. The FRC is encouraged by ASIC's conclusions that improvements have been made since the first report and

that the firms have a strong commitment to independence and quality demonstrated by their leadership.

As noted previously, the detail of the report does refer to two firms internal testing which encountered breaches of the independence rules. The report makes a number of observations and findings regarding processes and procedures which should be improved at one or more of the firms. In terms of the FRC's goal of aiming for continuous improvement it is recommended that the firms involved consider implementing the improvements.

All of the firms raised the issue of the substantial additional cash and non-cash costs which they have incurred as part of their processes to implement the requirements of CLERP 9. Examples were given of the dedicated teams of partners and staff now in place whose sole purpose is to monitor the new corporate governance requirements. Additional costs of between \$5 million to \$10 million were mentioned as being incurred by each of the firms for 2005-06. The FRC acknowledges that firms have faced higher costs, but rather than they being attributable to CLERP 9 reforms only, they result from the cumulative impact of several concurrent changes and, in the case of some firms, from international requirements such as the US PCAOB requirements for the audits of US Securities and Exchange Commission (SEC) registrants.

The FRC acknowledges that 2005-06 has been a watershed year for the profession with the major firms being subject to reviews by ASIC/ICAA/FRC Quality Control Consultants and starting to gear up for the AQRB in 2006-07. The FRC recommends that the ICAA, as the professional body whose members do most audits of listed entities and who completed in 2005-06 triennial reviews of the Big Four firms, assists in planning for the 2006-07 year by arranging a roundtable of interested parties to streamline the processes dealing with the quality reviews by the firms, including the AQRB, and ASIC. It is the FRC's view that any inspections needed for monitoring compliance with the requirements of the US Public Company Accounting Oversight Board (PCAOB) should be considered in the context of their intended collaboration with ASIC's inspections.

### **Response of other accounting firms**

A meeting between the FRC and the accounting firms other than the Big Four firms was arranged by the ICAA to discuss ASIC's findings in relation to these firms. The meeting only dealt with the ASIC comments relevant to the FRC's auditor independence responsibilities in relation to CLERP 9. The comments in relation to audit methodologies and audit standards are outside the scope of this report.

The firms have noted that ASIC appears to apply a uniform model behind a number of its observations and findings as to how some of the firms could improve their processes and procedures in relation to audit independence. The firms at the meeting commented that to implement some of ASIC's observations and findings would lead, in the case of some firms, to high levels of documentation and add to the costs of the assignment with no benefit to the recipients of the assignment.

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Within the group of firms outside the Big Four there are significant differences in each of the firm's size, structural complexity, extent of international reach and centralised resources. The FRC wishes to see a strong and varied profession made up of different types of firms best geared to servicing the wide array of users. Since this is the first year of review of the firms other than the Big Four, the FRC recommends that for 2006-07, the ICAA takes a lead position in assisting the implementation of ASIC's observations and findings. The FRC understands that ASIC is willing to continue to work with individual firms, each of the three professional bodies, and through working committees to assist all firms understand how ASIC's observations and findings should lead to improved audit quality.

The ICAA may also choose to develop training programmes, with input from ASIC, aimed at the other accounting firms in relation to the CLERP 9 requirements and documentation.

## **2. QUALITY REVIEW PROGRAMMES OF THE PROFESSIONAL ACCOUNTING BODIES**

Under subparagraphs 225(2B)(a)(ii), (iii) and (iv) of the ASIC Act, the FRC is required to monitor and assess the nature and overall adequacy of:

- (a) the systems and processes used by professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors to the extent that those reviews relate to auditor independence requirements;
- (b) the action that Australian auditors who have been subject to such quality assurance reviews have taken in response to the reports prepared as a result of those reviews; and
- (c) the action taken by professional accounting bodies to ensure that Australian auditors who have been subject to such quality assurance reviews respond appropriately to the reports prepared as a result of those reviews.

In its 2004-05 independence report, the FRC indicated that in 2005-06 it would be both monitoring the amount of resources allocated to the professional bodies' quality review programmes to ensure a comprehensive review is conducted at the audit firms and reviewing the extent and quality of those reviews.

In April 2006, the Treasury, in consultation with the FRC, engaged Messrs Graeme MacMillan and Michael Cain of CiptaNet International Pty Ltd to examine the quality review programmes of the professional accounting bodies. The key requirements of the statement of work for this task are set out in Appendix C of this report.

The examination of the quality review programmes of the professional accounting bodies concluded that the programmes for reviewing members and firms that undertake audits comply with IFAC and Australian professional pronouncements, although the consultants qualified their findings because they did not review files and thus were unable to conclude that the processes and procedures had been followed.

The consultants have also noted the absence of a requirement for auditors in Australia to belong to a professional accounting body to be registered as a company auditor. The FRC has monitoring responsibilities over quality review, teaching of ethics and disciplinary arrangements of the professional bodies as related to independence, but in view of accountants not being required to be members of a professional accounting body to be registered as an auditor, it cannot provide oversight through the professional bodies over a segment of the auditing industry.

The consultants have also highlighted the concentrated structure of the Australian audit industry around the Big Four accounting firms, and recommend further research on the structure of the industry.

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The consultants made a number of findings and recommendations in respect of matters examined by them during the course of their consultancy and these are summarised in Appendix C.

The FRC intends to examine the findings and recommendations of the consultants as part of its 2006-07 work programme, including consultations with the professional accounting bodies and other stakeholders.

### **3. DISCIPLINARY PROCEDURES OF THE PROFESSIONAL ACCOUNTING BODIES**

Subparagraph 225(2B)(a)(v) of the ASIC Act requires the FRC to monitor and assess the nature and overall adequacy of the investigation and disciplinary procedures of the professional accounting bodies as those procedures apply to Australian auditors.

In its 2004-05 independence report, the FRC noted that there are many entities potentially involved in the disciplinary process, including the accounting bodies, ASIC and the CALDB, but because they all act independently there are situations of potential overlap and underlap. The FRC indicated that it is uncomfortable with the present disciplinary framework and that, in its opinion, there is significant room for improvement and strengthening of disciplinary procedures.

In these circumstances, the FRC indicated that it would be reviewing the disciplinary framework in detail in 2005-06.

In April 2006, the Treasury, in consultation with the FRC, engaged Mr William J Bartlett to examine the disciplinary procedures of the professional accounting bodies. The key requirements of the statement of work for this task, which Mr Bartlett undertook in association with Ms Anne Dalton of legal firm Sparke Helmore, are set out in Appendix D of this report.

The examination of the disciplinary procedures of the professional accounting bodies indicated that the procedures of each body are adequate. However, the consultant has identified a number of threshold issues concerning the purpose and role of the professional bodies in disciplining auditors, their relationship in this area with ASIC and the CALDB, and the CALDB's ability to initiate disciplinary actions in the public interest.

The consultant made a number of findings and recommendations in respect of the matters examined by him during the course of his consultancy and these are summarised in Appendix D.

The FRC intends to examine the findings and recommendations of the consultant as part of its 2006-07 work programme, including consultations with the professional accounting bodies and other stakeholders.

## **4. TEACHING OF ETHICS BY THE PROFESSIONAL ACCOUNTING BODIES**

Paragraph 225(2B)(f) of the ASIC Act requires the FRC to promote, and monitor the adequacy of, the teaching of professional and business ethics by, or on behalf of, the professional accounting bodies to the extent to which the teaching of those subjects relates to auditor independence.

In its 2004-05 independence report, the FRC indicated that the three professional accounting bodies had provided it with detailed information about their courses on business and professional ethics and that it planned to undertake an in-depth examination of this information during 2005-06.

In April 2006, the Treasury, in consultation with the FRC, engaged Ms Jane Walton of Henderson Walton Consulting Pty Ltd to examine the teaching of professional and business ethics by, and on behalf of, the professional accounting bodies. The key requirements of the statement of work for this task are set out in Appendix E of this report.

The examination of the teaching of ethics by, or on behalf of, the professional bodies has found that the depth of understanding of ethical issues of officers of the three professional accounting bodies and of members of accounting firms, their commitment to deal with these issues and steps being taken to do so, is well beyond anything observed in other disciplines, business or professions, including law.

The consultant has also made a number of recommendations on ways to enhance the teaching of ethics in the profession and these are summarised in Appendix E.

The FRC intends to examine the findings and recommendations of the consultant as part of its 2006-07 work programme, including consultations with the professional accounting bodies and other stakeholders.

## 5. COMPLIANCE WITH AUDIT-RELATED DISCLOSURE REQUIREMENTS

The FRC is required by paragraph 225(2B)(b) of the ASIC Act to monitor the overall compliance by companies, registered managed investment schemes and disclosing entities with audit-related disclosure requirements of the Corporations Act and the accounting standards.

The principal audit-related disclosure requirements of the Corporations Act and accounting standards are:

- paragraph 298(1)(c) of the Corporations Act, which requires a company, registered managed investment scheme or disclosing entity to include in its directors' report for each financial year a copy of the auditor's independence declaration under section 307C in relation to the audit for the financial year;
- section 300 of the Corporations Act, which requires the following information to be included in the directors' report of a listed company:
  - if a registered company auditor plays a significant role in the audit of a listed company for a financial year in reliance on a declaration made under section 342A<sup>6</sup>, subsection 300(11A) requires the report for the company to include details of the declaration;
  - in relation to each auditor:
    - : details of the amounts paid or payable to the auditor for non-audit services provided, during the year, by the auditor (or by another person or firm on the auditor's behalf);
    - : a statement whether the directors are satisfied that the provision of non-audit services, during the year, by the auditor (or by another person or firm on the auditor's behalf) is compatible with the general standard of independence for auditors imposed by the Corporations Act;
    - : a statement of the directors' reasons for being satisfied that the provision of those non-audit services, during the year, by the auditor (or by another person or firm on the auditor's behalf) did not compromise the auditor independence requirements of the Corporations Act;
- subsection 306(2) of the Corporations Act, which provides that the directors' report of a disclosing entity must include a copy of the auditor's independence declaration under section 307C in relation to the audit or review for the half-year; and

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<sup>6</sup> Section 342A of the Corporations Act outlines the circumstances, and manner, in which ASIC may modify the auditor rotation requirements contained in section 324DA of the Act.

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- paragraphs Aus 126.1 and Aus 126.2 of accounting standard AASB 101 *Presentation of Financial Statements*, which require an entity or economic entity to disclose in its financial report the remuneration of:
  - the auditor, showing separately amounts for audit and non-audit services (including, in the case of the latter, the nature and amount of each of the non-audit services provided by the auditor); and
  - a practice related to the auditor's firm for non-audit services provided in relation to the entity or economic entity (including the nature and amount of each category of non-audit service).

In its 2004-05 independence report, the FRC indicated that it planned to undertake a detailed examination of the audit-related disclosure requirements as part of its 2005-06 work programme. The FRC undertook this task with the assistance of information provided by ASIC and ASX.

The MOU that the FRC has entered into with ASIC provides for ASIC to give the FRC regular reports identifying matters arising from its financial reporting or auditor surveillance activities in relation to compliance by auditors and companies with the independence disclosure requirements in Part 2M.3 of the Corporations Act. The MOU with ASX also provides for that body and the FRC to exchange information.

ASIC has informed the FRC that, as part of its 2005-06 accounts surveillance programme, it reviewed 295 financial reports of listed entities for the year ended 30 June 2005. As part of that review, ASIC considered the following specific audit-related disclosure issues:

- Did the directors' report include (including by way of cross-reference to an attached document) an auditor's independence declaration?
- Where the directors' report includes details of non-audit services, did it include an unqualified statement that these services had not affected the auditor's independence?

The results of ASIC's review showed that the majority of financial reports complied with the auditor-related disclosure requirements examined as part of the review. There were, however, a small number of financial reports that failed to comply with these disclosure requirements. Nineteen entities failed to include an auditor's independence declaration and 20 entities failed to include an unqualified statement that non-audit services had not affected the auditor's independence.

In addition, ASX informed the FRC that it had reviewed financial reports filed by listed entities with ASX under the listing rules for the financial period ending on 31 December 2005. ASX's review included an examination of the form and location of the auditor independence declarations required under section 307C and disclosed by directors under sections 298(1) and 306(2) of the Corporations Act. The review

indicated that the preferred format was for the declaration to be presented as a separate attachment to the directors' report.

As part of its 2006-07 work programme, the FRC will review, and analyse, the level of compliance with audit-related disclosure requirements by considering the information provided by the MOU bodies.

## 6. OTHER INDEPENDENCE-RELATED ISSUES

### SPECIFIC ISSUES WITH CLERP 9

This section details issues raised by the MOU parties, accounting firms and other stakeholders with respect to the implementation of CLERP 9. The FRC will consider these issues as part of its work programme for 2006-07 with a view to submitting appropriate recommendations for consideration by the Government. These issues, which are covered in more detail in the following section dealing with 'International Developments in Auditor Independence', are:

- employment and financial restrictions, including adopting a covered person<sup>7</sup> test;
- amending the cooling off restrictions applying to former audit partners and senior audit personnel;
- reviewing the multiple former audit partner restrictions, which has already been announced by the Government; and
- amending audit rotation rules to relieve the burden which sometimes arises with smaller firms and also with all firms when the audit involves specialised industries.

### Unintended consequences

The 2004-05 report dealt with unintended consequences which arose during the first year of the implementation of CLERP 9.

There has been excellent cooperation between Treasury, ASIC, the accounting bodies and the accounting firms in resolving the unintended consequences. There are still a

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7 A 'covered person' is defined in the Securities and Exchange Commission (SEC) Rules to mean the following members of an accounting firm: (a) the engagement team; (b) the chain of command; (c) any other member of the firm who has provided ten 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 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 ten 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.

The 'chain of command' concept in the definition of a 'covered person' is defined in the SEC Rules as all persons who: (a) supervise or have direct management responsibility for the audit, including at all successively senior levels through the audit firm's chief executive; (b) evaluate the performance or recommend the compensation of the audit engagement partner; or (c) provide quality control or other oversight of the audit.

few minor issues outstanding and FRC encourages the various stakeholders to resolve them in due course.

### **Hiring issues**

The 2004-05 report referred to an issue raised by the accounting profession in terms of hiring of talented young people and lateral partners and senior executives. We have been advised that there is a major skill shortage of graduates entering the profession. The strict rules surrounding the holding of financial interests in audit clients of the audit firm may need to be examined further in this context. The FRC recommends that this issue be considered when deliberations are held concerning the possibility of amending the requirements in any consideration of a covered person test.

## **REDUCING THE REGULATORY BURDEN ON BUSINESS**

On 7 April 2006 the Government announced its interim response to the *Report of the Taskforce on Reducing Regulatory Burdens on Business – Rethinking Regulation* ('the Banks report'), which looked at ways to reduce the red tape affecting Australian businesses. In its interim response, the Government noted that over-regulation is a major concern to all businesses and especially small businesses. In its final response to the Banks report, issued on 15 August 2006, the Government addressed the report's 178 recommendations, which should significantly reduce the red tape on business. On 14 August 2006, the Parliamentary Secretary to the Treasurer, the Hon Chris Pearce, announced the most comprehensive package of corporate law reform proposals since the commencement of the Corporate Law Economic Reform Programme, which will be progressed through the *Simpler Regulatory System Bill*.

The FRC welcomes these initiatives and, with the aim of contributing to the reduction of the red tape affecting the auditing profession in Australia, intends to examine, as part of its 2006-07 work programme, whether any scope exists for reducing the overlap of auditor review responsibilities between the firms, professional accounting bodies and regulators. Any recommendations in this area will be submitted for the consideration of the Government. Consideration will be given on how to optimise the environment in Australia given the lesser depth and diversity of auditing resources compared with the US and Europe.

## **PROPOSED LEGISLATION INCREASING ASIC'S INSPECTION POWERS**

In its 2004-05 independence report, the FRC noted that ASIC's powers of inspection in relation to audit firms needed to be clarified. It also noted the release of a consultation paper by the Commonwealth Treasury containing proposals for law reform in this respect. The FRC understands that consultations on this topic are now completed and that the corresponding Bill will be introduced later in 2006 for consideration by Parliament.

## **AUDITORS WHO ARE NOT MEMBERS OF AN ACCOUNTING BODY**

The 2004-05 independence report included an observation that an issue that needs to be considered further is the case of registered company auditors who are not members of a professional accounting body and, therefore, are not subject to any of the professional development requirements, ethical requirements, or disciplinary procedures of those bodies.

The consultants reviewing issues associated with quality review programmes, disciplinary procedures and the teaching of ethics have each made recommendations concerning the need for auditors to be members of a professional accounting body.

The FRC, in consultation with ASIC and the professional accounting bodies, is currently reviewing the register of company auditors for the purpose of ascertaining the number of registered company auditors who are not members of a professional body. The FRC anticipates that this project will be completed during the first half of 2007.

## **INTERNATIONAL DEVELOPMENTS IN AUDITOR INDEPENDENCE**

Paragraph 225(2B)(e) of the ASIC Act provides that the FRC is to monitor international developments in auditor independence, assess the adequacy of the Australian auditor independence requirements provided for in the Corporations Act and the codes of professional conduct in light of those developments and give the Minister, and the professional accounting bodies, reports and advice on any additional measures needed to enhance the independence of Australian auditors.

### **MONITORING DEVELOPMENTS**

In 2005-06, the FRC continued the programme commenced in the previous year of monitoring international developments through examination of publicly-available inspection reports issued by overseas oversight bodies (such as the US Public Company Accounting Oversight Board, the Canadian Public Accountability Board and the Audit Inspection Unit of the UK Professional Oversight Board), other material placed on the internet websites of these oversight bodies and associated regulatory agencies and general media reports about audit independence issues.

The FRC Chairman also met with representatives of overseas oversight bodies during visits to Europe and North America in November 2005 and July 2006.

### **COMPARATIVE REVIEW OF AUSTRALIAN REQUIREMENTS**

In its last report, the FRC indicated that during 2005-06 it intended researching Australia's requirements on auditor independence compared with those applicable in other major jurisdictions worldwide. The review, which was undertaken by the Treasury to provide assistance to the FRC, compared the Australian auditor independence requirements with the equivalent requirements applying in Canada, the EU, the UK and the US.

The review focused on the following core elements of auditor independence:

- general standard of auditor independence;
- specific restrictions applying to employment, financial and business relationships;
- provision of non-audit services;
- employment restrictions applying to former audit partners and senior audit personnel; and

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- audit rotation.

The overall conclusion of the review is that, notwithstanding differences in terminology, institutional arrangements and legal frameworks, there is a substantial underlying equivalence between the Australian auditor independence requirements and 'best practice' standards adopted internationally.

The FRC has identified from the review the following areas in which some aspects of the Australian independence requirements differ from the requirements applicable in some or all of the other jurisdictions. Areas of difference include:

- employment and financial restrictions;
- employment restrictions applying to former audit partners and senior audit personnel ('cooling-off' periods);
- multiple former partners of an audit firm/audit company directors restriction; and
- auditor rotation.

The following paragraphs provide further information about these areas of difference and the FRC's views on what, if any, action should be taken.

### **Employment and financial relationships**

The review noted that the SEC independence rules in the US have applied a 'covered person' test in relation to a number of the specific employment and financial relationship restrictions in place of an 'all partner approach'. Canada has adopted an 'all partner' approach in relation to dual employment restrictions but has adopted a 'restricted person' regime in relation to financial relationship restrictions. The employment and financial relationship restrictions in the EU Recommendation apply to the statutory auditor and those persons in the firm in a position to influence the outcome of the audit, rather than an 'all partner' approach.

The 'covered person' concept has not been applied under the auditor independence requirements in Australia and the UK. Australia and the UK have adopted an 'all partner' approach in relation to dual employment restrictions and in relation to restrictions on financial investments. However, the restrictions in Australia and the UK relating to loans and guarantees have not adopted an 'all partner' approach.

- The FRC will consider this issue as part of its work programme for 2006-07, with a view to submitting appropriate recommendations for consideration by the Government.

## **Employment restrictions applying to former audit partners and senior audit personnel**

### **'Cooling-off periods'**

The two year 'cooling-off' period in Australia<sup>8</sup> is similar to the periods in the other jurisdictions although in Canada the period is only one year. The Sarbanes Oxley Act 2002 (US) also refers to one year but the way the provision is drafted, the period in fact is longer than one year but not more than two years.

The obligation under the Australian restriction is placed on the former partner while in other jurisdictions the burden falls on the audit firm as it is not regarded as being independent if the 'cooling-off' restriction is breached. (The Australian position is explained by the fact that breach of the restriction is a criminal offence and it would not be appropriate to prosecute the firm after the partner has resigned from the firm.)

The Australian two year 'cooling-off' period applies to a former partner of the firm who was a member of the audit team, regardless as to how far back the partner's participation on the audit team took place. Canada, the UK and the US place a limit on the time of participation in an audit prior to the partner's date of departure from the firm.

However, the scope of the Australian 'cooling-off' period only applies to a partner or director of an authorised audit company who has been a professional member of the audit team. The UK requirement includes other partners in the 'chain of command'. The US requirement is even more extensive and applies to any person who participated 'in any capacity' in the audit.

- The FRC will consider this issue as part of its work programme for 2006-07, with a view to submitting appropriate recommendations for consideration by the Government.

### **Multiple former partners of an audit firm/audit company directors restriction**

Section 324CK of the Corporations Act implements a recommendation of the HIIH Royal Commission that a prohibition be introduced preventing more than one former partner of an audit firm, or director of an audit company, at any time becoming an officer of the audit client. The restriction has been criticised by the accounting profession because of its potential negative impact on the employment market and recruiting practices of audit firms.

The report of the Taskforce on Reducing Regulatory Burdens on Business has recommended that the Australian Government review the multiple former audit partner restriction. While the Treasury comparative review did not identify an equivalent restriction in any of the relevant overseas jurisdictions, it notes that the existing restriction implements a recommendation of the HIIH Royal Commission

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8 The ASX Corporate Governance Guidelines recommend a three year 'cooling-off' period.

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which concluded that the cumulative effect of three former partners of HIIH's auditor, Andersen, being appointed to the board of HIIH, resulted in the perception that Andersen was not independent of HIIH.

The Australian Government has announced that it will review the multiple former audit partner restriction by the end of 2006.<sup>9</sup>

- The FRC will consider this issue as part of its work programme for 2006-07, with a view to submitting appropriate recommendations for consideration by the Government.

## Audit rotation

The review found that, while Australia and the relevant overseas jurisdictions have all adopted auditor rotation requirements for auditors of listed companies, there are subtle differences between the requirements adopted in each jurisdiction. None of the jurisdictions require audit firm rotation.

The auditor rotation requirements in each jurisdiction extend to the lead engagement auditor and the review auditor.

Australia, Canada, the UK and the SEC Rules in the US, require rotation after five successive years (although Australia has an additional requirement that a lead or review auditor may not audit a particular audit client for more than five out of seven successive years). The EU requires rotation after seven years.

Australia and the EU have adopted a two year time-out period before a 'rotated' auditor is allowed to resume involvement with the same audit client. Canada, the UK and the SEC have adopted a five year time-out period.

However, the SEC Rules provide an exemption from the rotation requirements for smaller audit firms (fewer than five audit clients and less than ten audit partners) provided the PCAOB conducts a review at least once every three years of each of the firm's audit client engagements.

- The FRC will consider this issue as part of its work programme for 2006-07, with a view to submitting appropriate recommendations for consideration by the Government.

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<sup>9</sup> Australian Government's Response to the Rethinking Regulation Task Force report: 15 August 2006.

## **APPENDIX A**

### **FRC'S AUDITOR INDEPENDENCE FUNCTIONS**

The FRC's functions include monitoring the effectiveness of auditor independence requirements in Australia and giving the Minister reports and advice about those requirements. These functions are conferred on the FRC under paragraphs 225(1)(c) and (d) and subsection 225(2B) of the ASIC Act.

Under subsection 225(1) of the ASIC Act, the FRC is required to monitor the effectiveness of auditor independence requirements in Australia and to give the Minister reports and advice about those requirements.

In addition, the FRC has the following specific auditor independence functions conferred on it under subsection 225(2B) of the ASIC Act:

- monitoring and assessing the nature and overall adequacy of:
  - the systems and processes used by Australian auditors to ensure compliance with auditor independence requirements;
  - the systems and processes used by professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors to the extent that those reviews relate to auditor independence requirements;
  - the action that Australian auditors who have been subject to such quality assurance reviews have taken in response to the reports prepared as a result of those reviews; and
  - the investigation and disciplinary procedures of professional accounting bodies as those procedures apply to Australian auditors;
- monitoring the overall compliance by companies, registered schemes and disclosing entities with the audit-related disclosures requirements of the Corporations Act and the accounting standards;
- giving the Minister reports and advice about the matters referred to in the above paragraphs;
- giving the professional accounting bodies reports and advice about matters related to their quality assurance reviews and disciplinary procedures as detailed in the above paragraphs;

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- monitoring international developments in auditor independence, assessing the adequacy of the Australian auditor independence requirements provided for in:
  - the Corporations Act; and
  - codes of professional conduct;

in the light of those developments and giving the Minister, and professional accounting bodies, reports and advice on any additional measures needed to enhance the independence of Australian auditors; and

- promoting, and monitoring the adequacy of, the teaching of professional and business ethics by, or on behalf of, professional accounting bodies to the extent to which the teaching of those subjects relates to auditor independence.

To facilitate the performance of the audit independence functions by the FRC, section 225A of the ASIC Act sets out powers that may be used by the FRC for gathering information from Australia's professional accounting bodies and Australian auditors.

## **APPENDIX B**

### **FRC'S PERFORMANCE OF ITS AUDITOR INDEPENDENCE FUNCTIONS**

To facilitate the performance of the auditor independence functions, the FRC has:

- established an Audit Independence Subcommittee to deal with day-to-day matters associated with the performance of the function;
- signed MOUs with the professional accounting bodies, ASIC, ASX and APRA (MOU bodies);
- met with the MOU bodies and selected accounting firms;
- appointed a consultant to provide guidance and advice to the FRC in the performance of the function; and
- engaged a number of short-term consultants to perform specific tasks associated with its auditor independence functions.

#### **AUDIT INDEPENDENCE SUBCOMMITTEE**

The Audit Independence Subcommittee held eight meetings during 2005-06.

Members of the Committee during the year were Ms Elizabeth Alexander AM (Chairman), Mr David Jackson, Mr Charles Macek, Mr Brian Scullin (until 10 June 2006) and Ms Catherine Walter AM.

The Subcommittee's Charter provides that the Subcommittee will assist the FRC by:

- making recommendations to the FRC concerning the engagement of a person, or persons, to assist the FRC in the performance of the functions conferred on it under subsection 225(2B) of the ASIC Act (the auditor independence consultant);
- performing, either alone or in-conjunction with the auditor independence consultant, the work and other activities needed to ensure the FRC meets the obligations imposed on it by subsection 225(2B) of the ASIC Act;

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- making recommendations to the FRC Chairman concerning the notices that should be given by the Chairman pursuant to section 225A of the ASIC Act; and
- preparing, for the consideration of the FRC, a draft of the report the FRC is required to prepare under section 235BA of the ASIC Act.

## MEMORANDA OF UNDERSTANDING

The FRC has MOUs with the three professional accounting bodies (CPA, ICAA and NIA), ASX, APRA and ASIC in order to facilitate the efficient exchange of information between the MOU bodies and the FRC.

In addition, the FRC has a letter of understanding with the CALDB concerning the exchange of information.

## MEETINGS WITH MOU BODIES AND ACCOUNTING FIRMS

During 2005-06, regular meetings were held with each of the MOU bodies and the CALDB.

Meetings were also held with the four major accounting firms (Deloitte Touche Tohmatsu, Ernst and Young, KPMG and PricewaterhouseCoopers).

## APPOINTMENT OF CONSULTANTS

Mr William Bartlett's contract to undertake the FRC's auditor independence consultancy continued throughout 2005-06. In May 2006, the Treasury, at the request of the FRC, exercised its option to extend Mr Bartlett's contract until December 2007.

The FRC's 2005-06 work programme included an examination of the following matters falling within the scope of the Council's auditor independence functions:

- quality review programmes of the professional accounting bodies;
- disciplinary procedures of the professional accounting bodies; and
- teaching of professional and business ethics by, or on behalf of, the professional accounting bodies.

## Appendix B: FRC's performance of its auditor independence functions

During April 2006, the Treasury, acting on behalf of the FRC, entered into contracts with the following people for the provision of short-term consultancy services on these matters:

- Quality review programmes – Messrs Graeme MacMillan and Michael Cain of CiptaNet International Pty Ltd (represented by the International Accounting and Auditing Institute) (see Appendix C for more information);
- Disciplinary procedures – Mr William Bartlett in association with Ms Anne Dalton of Sparke Helmore (see Appendix D for more information); and
- Teaching of ethics – Ms Jane Walton of Henderson Walton Consulting Pty Ltd (see Appendix E for more information).

## **APPENDIX C**

### **CONSULTANCY ON QUALITY REVIEW PROGRAMMES OF THE PROFESSIONAL ACCOUNTING BODIES**

#### **STATEMENT OF WORK**

The consultancy on the quality review programmes of the professional accounting bodies required the consultant to:

- (a) review the planning and performance of the quality assurance review programmes of the ICAA, CPA and NIA (to the extent that those reviews relate to auditor independence requirements) and the arrangements for monitoring the follow-up actions in respect of such reviews;
- (b) include, as part of the review referred to in (a) above, an examination of the activities of the AQRB, to the extent that they complement and support the quality assurance review programmes of the professional accounting bodies as related to auditor independence;
- (c) prepare a report for the FRC assessing the adequacy of the planning and performance of the quality assurance reviews (to the extent that those reviews relate to auditor independence requirements) and the adequacy of the follow-up actions taken in respect of such reviews;
- (d) make recommendations to the FRC concerning changes or other modifications that should be made in respect of the planning and performance of the quality assurance reviews and the monitoring of follow-up of actions taken in respect of such reviews; and
- (e) review whether auditors who are not members of a professional accounting body are subject to a quality review programme, establish in broad terms the quantum of auditors that fall under this category and make recommendations to the FRC on any changes that may be needed to address any gaps with respect to the quality assurance review programmes that should apply to those auditors.

## Appendix C: Consultancy on quality review programmes

The Statement of Work also provided that, without limiting the scope of the work to be performed, the consultant would:

- (a) consider the adequacy of the planning and performance of the professional bodies' quality assurance review programmes having regard to:
  - (i) the requirements (if any) of IFAC for planning and conducting quality reviews; and
  - (ii) the procedures used by professional accounting bodies in other jurisdictions for planning and conducting quality reviews;
- (b) consider the inter-relationship between the quality review programmes of the professional accounting bodies and the activities of the AQRB;
- (c) consider the inter-relationship between the quality review programmes of the professional accounting bodies and the audit inspection programme of ASIC;
- (d) have regard to international developments in accounting and other disciplines for planning and conducting quality reviews; and
- (e) review, and where appropriate have regard to, academic and other material concerning the planning and conduct of quality review programmes.

### **CONSULTANTS' REVIEW**

The ICAA, CPA and NIA each conduct quality reviews of the work of their members who are public practice certificate holders.

For those members who undertake audit and assurance work, the programmes test compliance with the requirements of the Corporations Act, auditing standards and professional pronouncements. The accounting bodies have well documented policies, procedures and guidelines to assist its members comply with the independence requirements. The reviewers utilize comprehensive checklists and work programmes to ensure key areas are assessed and supporting information is obtained to corroborate review conclusions.

### **The Institute of Chartered Accountants in Australia**

ICAA has a membership of about 43,900, of whom some 7,500 hold a CPP. A total of 4,100 CPP holders are registered company auditors. Under ICAA rules, members who undertake audits are required to hold a current CPP.

ICAA members who conduct listed audit engagements are required to undergo a full quality review, regardless of their level of fees, once every three years. Other practices

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are reviewed once every five years. Practices that have serious breaches noted are subject to a follow-up review within 12 months of the initial review.

The audit quality reviews are undertaken by cooperative arrangement with members holding a CPP.

Practitioners are selected for quality reviews on a random basis, unless they had previously been reviewed, in which case the next review will be based on the date from the practitioner's last review.

In order to maintain confidentiality, ICAA destroys all correspondence, questionnaires and work paper files relevant to the member's review on successful completion in accordance with the Quality Review programme policy. The only record retained with the Quality Review database is a memorandum note that the review has been completed and the outcome achieved.

## CPA Australia

CPA has approximately 108,000 members, of whom 5,284 hold a PPC. Some 873 holders of a PPC are registered company auditors. It is believed that the majority of these auditors are also members of ICAA.

From 2007, the review cycle will be based on a risk assessment of practitioners on a 12 months, three year or four year cycle for each practitioner depending on whether the practitioner conducts audits.

To maintain confidentiality of the Quality Review programme, all correspondence, questionnaires and work paper files relevant to the member's review are destroyed upon successful completion of the review. A record is maintained on the Quality Review database showing that the review has been completed, and the outcome achieved.

## National Institute of Accountants

The NIA has a membership at 30 June 2006 of approximately 14,352, of whom 2,316 hold a PPC. Fifty-three of the PPC holders are registered company auditors, with about half of them believed to be also members of either ICAA or CPA.

All NIA members who hold a PPC are normally subject to a quality assurance review every five years. However, if they audit a public listed company they are subject to a review every three years. The NIA retains all records and working papers created during a quality control review.

The practitioners are selected for quality reviews on a random basis.

## **Audit Quality Review Board**

As noted earlier, the AQRB, was established during February 2006 to monitor the processes by which participating firms seek to ensure their compliance with applicable professional standards and legal obligations in relation to independence and audit quality with respect to financial statement audits of publicly listed entities.

To obtain standardised information on the quality control processes of procedures adopted by the firms, the AQRB has developed a Quality Control Report format. The Quality Control Report contains sections for each element of quality control based on the topic headings from APS 5. For each sub-element of quality control, firms are required to submit a description of their relevant policies and practices.

It is understood that the AQRB will make public the information provided to it.

## **Other findings from the consultants' review**

The consultants' major findings in respect of the quality review programmes of the professional accounting bodies included that:

- The quality review programmes for reviewing members that undertake audits comply with IFAC and Australian professional pronouncements, although the consultants stated that they did not view samples of the review files as part of their engagement.
  - The consultants recommend that the review files from the quality review programmes of the ICAA should be available to the FRC so that it can sight evidence that the professional accounting bodies' quality review policies and procedures, as they relate to auditor independence, have been followed.
- A limitation of the professional accounting bodies' review of independence is that the review findings are largely based on quality review questionnaires completed by the reviewed practitioner which are then confirmed with the practitioner by subsequent interview. The reviewer undertakes testing of the files to confirm the appropriateness of the questionnaire answers.
  - The consultants recommend that the professional bodies quality reviews could further test check, where practicable, practitioner responses to questions on auditor independence against external confirmatory evidence.
- The quality review of the Big Four accounting firms by the ICAA conducted in 2005 consisted of one different person allocated to each firm for approximately 300 hours per firm at a cost of approximately \$50,000 each, and a further 100 hours spent by the ICAA reviewing the quality review files. The people conducting the reviews were former partners of major firms. This contrasts with the audit investigation resources of ASIC, which has approximately 25 qualified staff members for their programme. Each ASIC inspection has a team of four to six

members, and has allocated approximately 1,000 hours to complete each review. As the Big Four firms audit approximately 92 per cent of public listed companies by market capitalisation, it might be expected that more time and resources should have been devoted to the review of these practices by the ICAA. However, the planning of ICAA's reviews needs to be considered in the context of the results of their previous review programmes and other reviews conducted, or proposed to be conducted, on the Big Four firms as follows:

- the commencement of ASIC inspections in 2004-05;
- audit quality reviews being conducted by the newly formed AQRB from early 2006; and
- extensive internal quality assurance and independence checking procedures instituted by the firms to meet their professional membership obligations and local and international regulatory requirements.

Although not strictly related to the area of auditor independence, which is the FRC's oversight mandate, the consultants have also noted results from recent international audit research. This evidence shows that the mandatory peer review programmes of accounting bodies are effective in predicting audit quality. The consultants have recommended that the FRC's monitoring of the professional accounting bodies review programmes should be extended to cover audit quality as well as independence.

In other observations and findings by the consultants, they noted that emerging issues involving the auditing profession (arising from their review of quality review programmes as they related to auditor independence) included that:

- the overall structure of the Australian audit industry is complex with a number of regimes applying to different entities (such as corporates, superannuation funds, self-managed superannuation funds and the public sector, among others). This complexity is reflected in terms of different regulators in charge of approving and reviewing the work of auditors (see Figure 1 for a schematic summary of the regimes applying across the audit industry);
- there is no significant recognition of the audit specialisation by the professional accounting bodies other than through requiring auditors in practice to hold a CPP and the requirement to undertake at least 40 per cent of the minimum Continuing Professional Education (CPE) requirement in each of the appropriate speciality areas; and
- it is not necessary to be a member of the ICAA, CPA or NIA and to have a practicing certificate from those bodies to style oneself as an 'auditor' or to conduct an audit in Australia (although only a registered company auditor can conduct Corporations Act audits).

Recommendations made by the consultants in respect of these other findings included that:

- the Australian accounting profession consider introducing an individual audit practicing certificate requiring regular renewal as a means of ensuring quality in audit is maintained (which would imply reviewing ASIC's current role for the registration of auditors and the requirement for the lodgement of an annual statement);
- the government consider reserving the designation 'auditor' to persons who hold an audit practicing certificate, a move that would be consistent with government policy for other professions;
- only persons approved and registered by a professional accounting body should be able to use the designation 'auditor', applicable also for public sector audits;
- the accounting profession should extend the definition of an audit assignment requiring a member to hold an audit practicing certificate; and
- the FRC consider the UK model of auditor oversight whereby the responsible government body accredits and regularly reviews the professional accounting bodies in the exercise of their functions to qualify all practising auditors, based on those bodies' admission, continuing education, monitoring, quality review and disciplinary programmes.

Commenting on the structure of the Australian auditing industry, the consultants have noted that the major change on the supply side since 2001 has been the concentration of audit expertise among the Big Four firms. It is noted that the auditing of large corporations has become a complex international industry requiring substantial investment in technical expertise and training to compete on a global basis. The consultants have also highlighted the concentrated structure of the Australian auditing industry around the Big Four accounting firms, and recommend further research on the structure of the industry.

The FRC is aware that similar concerns are held in other jurisdictions and that the UK FRC is conducting research on means to promote competition and choice in the UK audit market. The FRC intends to monitor progress of these initiatives.

The FRC intends to examine the findings and recommendations of the consultants as part of its 2006-07 work programme, including consultations with the professional accounting bodies and other stakeholders.

## **APPENDIX D**

### **CONSULTANCY ON DISCIPLINARY PROCEDURES OF THE PROFESSIONAL ACCOUNTING BODIES**

#### **STATEMENT OF WORK**

The consultancy on the disciplinary procedures of the professional accounting bodies required the consultant to:

- (a) review the investigation and disciplinary procedures of the ICAA, CPA and NIA as those procedures apply to Australian auditors;
- (b) consider the inter-relationship between the investigation and disciplinary procedures of the professional accounting bodies and the disciplinary arrangements for auditors contained in the Corporations Act;
- (c) prepare a report for the FRC assessing the overall adequacy of the investigation and disciplinary procedures of the professional accounting bodies; and
- (d) make appropriate recommendations to the FRC concerning changes or other modifications that should be made to the present framework for taking disciplinary action against Australian auditors, including those that are not members of a professional accounting body, having particular regard to the procedures used by the professional accounting bodies, the arrangements contained in the Corporations Act (including the activities of the CALDB, ASIC and APRA) and the scope (if any) for rationalising that framework.

The Statement of Work also provided that, without limiting the scope of the work to be performed, the consultant would:

- (a) consider the adequacy of the investigation and disciplinary procedures of Australia's professional accounting bodies having regard to:
  - (i) the requirements (if any) of IFAC concerning the investigation and disciplinary procedures to be adopted by its member bodies;
  - (ii) the investigation and disciplinary procedures of:

## Appendix D: Consultancy on disciplinary procedures

- (A) Australian self-regulatory organisations in respect of disciplines other than accounting; and
  - (B) professional accounting bodies in other jurisdictions;
- (b) consider whether, and in what circumstances and manner, a professional accounting body should announce that it is investigating the conduct of one of its members;
  - (c) have regard to international developments concerning the investigation and disciplinary procedures of self-regulatory organisations;
  - (d) review, and where appropriate have regard to, academic and other material concerning the investigation and disciplinary procedures of self-regulatory organisations; and
  - (e) examine whether, and in what circumstances, investigation and disciplinary procedures could be initiated against a registered company auditor either by a professional accounting body or under the Corporations Act prior to the conclusion of any civil or criminal proceedings against the auditor.

### CONSULTANT'S REVIEW

In addition to considering the adequacy of the investigation and disciplinary procedures of Australia's professional accounting bodies, the consultant also considered the investigation and disciplinary procedures of Australian self regulatory organisations in respect of disciplines other than accounting, including medical practitioners in Victoria, legal practitioners in New South Wales and Victoria, and actuaries in Australia.

The consultant has reported that his examination revealed that the disciplinary procedures of each body could be described as adequate. The bodies do appear to handle most of the matters before them adequately. Each of the bodies displayed significant evidence of internal review and reform in recent years leading to improvements in their investigation and disciplinary procedures. As well, the relevant officers of the accounting bodies displayed a very professional attitude to investigation and disciplinary matters.

However despite these very positive aspects the consultant has also reported the following:

- The investigation and disciplinary procedures of each of the professional accounting bodies are compromised by a perceived lack of independence. Whilst there is an appearance of 'co-regulation' by the professional bodies and ASIC/APRA it is not correct to characterize them as 'self-regulating'. These bodies are not formally regulators, but membership bodies. In most cases this lack of

independence is not problematic, although it does lead to a confusion of responsibilities, duplication of effort and uncoordinated responses to events which have auditor involvement and are in the public interest;

- The procedures are not consistent with trends in the regulation of other professionals, both in Australia and internationally, toward the establishment of an independent statutory authority with legislative power to investigate and discipline professionals (for example medical practitioners in Victoria). These changes have come about largely as a result of public pressure to regulate professionals who have an impact on the social, physical or financial wellbeing of members of the public. The general theme running through at least some of the parliamentary speeches which introduced the legislation establishing the statutory authorities is the need to have robust, transparent and independent regulation of professional organisations;
- The effectiveness of the procedures is also compromised by a low level of communication between the professional accounting bodies and ASIC in the past. All parties have recently attempted to improve the level of communication;
- The most significant issue that exists in the current 'framework' is that there is in fact no 'framework' or system for there is no inter-relationship between the investigation and disciplinary procedures of the professional accounting bodies and the disciplinary arrangements for auditors contained in the Corporations Act. Each of the professional and regulatory bodies act independently of one another and may not be aware of the steps, if any, taken by the others in respect of the same person and the same conduct. Apart from some very informal meetings and ad hoc monitoring of websites, all these bodies co-exist with no framework for inter-relationship. The FRC notes, though, that the CALDB has a standard practice to notify a professional accounting body where one of its members is a respondent before the CALDB. This is done when a Notice of Decision is published; and
- The professional accounting bodies are currently dealing with the issues of the initiation of any processes against members whilst a legal proceeding is on foot, in different and inconsistent ways. This is unsatisfactory from a number of aspects, including that given that some auditors are members of more than one professional accounting body, the one individual can be subject to a different interpretation of the law relating to contempt and sub judice, and therefore different disciplinary responses. This will also lead to duplication of effort and additional costs. There is also the very real potential that for some conduct, no actions are taken, as the registered auditors do not belong to any professional body. Account should also be taken of the very real public interest in having a fully informed market, that is the public being informed of concerns in relation to a particular auditor's conduct. This needs to be balanced against an individual's right to a fair trial. The consultant recommends that the professional accounting bodies publicise that they are investigating such a member and reserve the right to themselves, in particular matters of high public interest, to suspend a member's membership rights until the matter is dealt with by the courts and the professional accounting body. He notes that some of these steps are currently taken by some of the professional bodies, but it is not consistent across the profession. Legal advice has been received by some

#### Appendix D: Consultancy on disciplinary procedures

professional bodies concerning suspension and natural justice obligations which makes it difficult to implement some of the steps.

As a result of the above, the consultant has concluded that the present framework in respect of disciplinary action against Australian auditors is sub-optimal. In particular, he has noted that:

- The functions and operation of the CALDB are potentially compromised by their funding and staff being provided by ASIC;
- Whilst ASIC could use the Annual Statement by an Auditor to ascertain, monitor and scrutinize the conduct of registered company auditors who are not members of any professional accounting body, it is not currently doing so; and ASIC and APRA have different powers in relation to disqualifying auditors; and
- ASIC refer very few cases to the CALDB preferring to deal with any auditor disciplinary matters via their own legislative powers (a view which is disputed by ASIC). APRA have referred no cases to the CALDB again preferring to use their own legislative powers.

Against the above findings, the consultant has recommended that consideration be given to the establishment of a new and independent body. The features of such a new body would be:

- Independence from ASIC and APRA;
- The ability to initiate actions, particularly in the public interest, not requiring referrals from ASIC or APRA; and
- Adequately resourced and funded from sources other than through ASIC.

The consultant has also noted that an alternative approach would be to change the mandate of the CALDB to incorporate the above features.

The FRC intends to examine the findings and recommendations of the consultant as part of its 2006-07 work programme, including consultations with the professional accounting bodies and other stakeholders.

## **APPENDIX E**

### **CONSULTANCY ON TEACHING OF ETHICS BY, OR ON BEHALF OF, THE PROFESSIONAL ACCOUNTING BODIES**

#### **STATEMENT OF WORK**

The consultancy on the teaching of professional and business ethics by, or on behalf of, the professional accounting bodies required the consultant to:

- (a) review the courses, or components of courses, on professional and business ethics offered by, or on behalf of, the ICAA, CPA and NIA;
- (b) review the work programme of the Accounting Professional and Ethical Standards Board and of any other body established by the professional accounting bodies for the setting, promoting or teaching of professional and business ethics;
- (c) prepare a report for the FRC on the adequacy of the courses (including the matters covered by the syllabus of each course or component of a course), and of any activities taken by the professional accounting bodies related to the setting, promoting and teaching of professional and business ethics;
- (d) make appropriate final recommendations to the FRC for any changes that might be needed to the content of the courses, the manner in which they are presented or both and on any activities that might be needed for further promoting the teaching of professional and business ethics; and
- (e) review whether auditors who are not members of a professional accounting body are subject to any mandatory ethical training and make recommendations to the FRC on any changes that might be needed to address any gap in this respect.

The Statement of Work also provided that, without limiting the scope of the work to be performed, the consultant would:

- (a) consider the adequacy of the accounting profession's courses on the teaching of professional and business ethics having regard to the content and presentation of equivalent courses conducted by:
  - (i) Australian professional organisations in respect of disciplines other than accounting;
  - (ii) Australian universities and other tertiary institutions; and
  - (iii) professional accounting bodies in other jurisdictions;
- (b) consider the inter-relationship between the profession's courses on the teaching of professional and business ethics and the staff training courses conducted by accounting firms and undertake a review of attendance at these staff training courses;
- (c) have regard to international developments and overseas trends in the teaching of professional and business ethics and in any mandatory ethical training for auditors;
- (d) review, and where appropriate have regard to, academic and other material concerning the teaching of professional and business ethics; and
- (e) consider (and make appropriate recommendations concerning) the action being taken by the FRC to promote the teaching of business and professional ethics.

## **CONSULTANT'S REVIEW**

The consultant's major observations and findings in respect of the teaching of ethics included that:

- the depth of understanding of ethical issues of officers of the three professional accounting bodies and of members of accounting firms, their commitment to deal with these issues and steps being taken to do so, is well beyond anything observed in other disciplines, business or professions, including law;
- ethics education should begin early, preferably at undergraduate level;
- at the professional level, in the absence of a compulsory undergraduate ethical course, there needs to be a separate professional and business ethics component plus integration of the ethical issues throughout other more technical subjects;

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- of most importance for the development of an ethical culture is the 'tone at the top' – the more committed, supportive and enthusiastic the leaders, the more successful the integration of professional values will be;
- the public practice programmes of the professional bodies appear to be excellent programmes in which ethics education could take a major part;
- all professional bodies mandate 120 hours of continuing professional education per triennium, but there is no requirement for ethics education at this level. ASIC mirrors this requirement for auditors registered with it who might not be members of a professional body, but does not verify its fulfilment;

Against the above findings the consultant has made the following recommendations:

- the professional bodies include ethics as a stand alone course and, in addition, integrate it throughout the technical curriculum with the issues, case studies and problems that students will encounter at every level of practice;
- all possible steps should be taken to develop and reinforce the profession's appreciation of the importance of culture in ethical standards within their firms and organisations;
- the public practice programmes of the professional accounting bodies should be utilised to develop and reinforce ethical leadership skills;
- ethics should be mandated as an additional component of continuing professional education requirements for the accountancy profession; and
- all auditors who are not members of a professional association should be subject to the same professional ethics educational requirements as those who are members.

Other recommendations made by the consultant included that:

- undergraduate ethical education requirements for entry into the accountancy profession should be reviewed;
- accountancy teaching methodologies and content, at undergraduate and graduate levels, should be reviewed to ensure that they enhance rather than impede ethical thinking skills and behaviours;
- accountancy teaching faculties should be reviewed to ensure that there is a high level of ethical understanding, skill and commitment to teach professional and business ethics in an effective way and to enhance a deep learning experience; and
- undergraduate faculties should, if possible, be influenced to ensure that they role model professional ethical cultures and behaviours for their students.

#### Appendix E: Consultancy on teaching of ethics

The FRC intends to examine the findings and recommendations of the consultant as part of its 2006-07 work programme, including consultations with the professional accounting bodies and other stakeholders.

## APPENDIX F

### MATTERS ARISING FROM 2004-05 INDEPENDENCE REPORT

The following tabulation lists the matters arising from the 2004-05 independence report and the action that has been taken in respect of each matter.

Page	Issue	Action
156-157	The report states that the implications of advice from AGS is that the FRC should extend the scope of its work beyond Corporations Act audits.	The Parliamentary Secretary to the Treasurer has advised the FRC Chairman that the FRC should remain focused on independence issues associated with Corporations Act audits for at least the next 12 months.
161	The FRC acknowledged ASIC comments about the differing policies of firms concerning the holding of a financial interest in audit clients and expressed the view that it would be appropriate for firms to further consider this issue.	Raised in 2006 meetings with stakeholders. Also being examined as part of the international comparisons project.
162	The FRC considered that it is appropriate for firms to take into account public perceptions in relation to auditor independence when deciding to offer non-audit services.	Raised in 2006 meetings with stakeholders. Also being examined as part of the international comparisons project.
162/169	The FRC acknowledged that there could be some anomalies reflecting unintended consequences from the CLERP 9 legislation.	The Treasury has informed that only a few minor matters remain outstanding.
162	The FRC is of the view that it would be unfortunate if the audit independence framework made it more difficult to hire appropriate personnel. This is an area the FRC will be focusing on in 2005-06 with a view to considering whether recommendations for any legislative changes might be considered appropriate.	Raised in 2006 meetings with stakeholders. FRC still has to consider its response. Might be a bit premature to suggest specific changes at this stage.
164	The report states that the FRC will be monitoring, in 2005-06, the amount of resources allocated to the quality review programmes to ensure a comprehensive review is conducted at the audit firms.	Covered as part of the terms of reference of the consultancy on the quality review programmes of the professional accounting bodies.
165	The report states that the FRC will be reviewing the extent and quality of the reviews of the big four accounting firms as part of its 2005-06 work programme.	FRC appointed a consultant to undertake work on the quality review programmes of the professional accounting bodies.
165	The report states that the FRC will be reviewing disciplinary procedures in detail in 2005-06. The report also indicates that in 2005-06 the FRC will investigate whether in some instances the reasons for resignation from a professional body should be made public.	FRC appointed a consultant to undertake work on the disciplinary procedures of the professional accounting bodies.

Appendix F: Matters arising from 2004-05 independence report

Page	Issue	Action
166	The report indicates that in 2005-06 the FRC will attempt to establish in broad terms the quantum of auditors who are not members of an accounting body.	This task will be finalised during the first half of 2007.
167	The report states that the FRC will be undertaking a detailed examination of the audit-related disclosure requirements as part of its 2005-06 work programme.	Information has been provided by ASIC and ASX to assist in this task.
167	The report states that the FRC plans to undertake an in-depth examination of information about the profession's courses on business and professional ethics during 2005-06.	FRC appointed a consultant to undertake work on the teaching of ethics by the professional accounting bodies.
168	The report states that, in 2005-06, the FRC intends to research Australia's requirements on auditor independence compared with those applicable in other major jurisdictions worldwide.	The Treasury has undertaken this work for the FRC.
170	The report states that in 2005-06 the FRC will investigate in more detail whether disciplinary action can be taken against an audit firm.	As noted in the 2004-05 report, the Australian legal system does not allow for action to be taken against a firm.
170	The report indicates that the FRC will be looking at the audits of self-managed superannuation funds in more detail in 2005-06.	The Parliamentary Secretary to the Treasurer has advised the FRC Chairman that the FRC should remain focused on independence issues associated with Corporations Act audits for at least the next 12 months.
171	The report states that the professional bodies are upgrading their quality control, independence monitoring, and disciplinary procedures and that the FRC will be paying special attention to these upgrades in 2006.	Addressed through meetings with stakeholders and consultancies.
171	The report indicates that, in 2005-06, the FRC while continuing to monitor the functions covered in 2004-05, an increased emphasis will be placed on monitoring the teaching of ethics, compliance by companies with audit-related disclosure requirements and research into best practice worldwide with respect to auditor independence requirements.	Teaching of ethics and auditor independence being considered by consultant and Treasury respectively. Work on disclosure requirements will be based on material from MOU bodies.

## APPENDIX G

### AUDITOR INDEPENDENCE FUNCTIONS: 2006-07 WORK PROGRAMME

Function	Approved work programme for 2006-07
<p>Monitoring and assessing the nature and overall adequacy of the systems and processes used by Australian auditors to ensure compliance with auditor independence requirements.</p>	<p>Information concerning the performance of this function should continue to be provided by ASIC (under the terms of the MOU with the FRC) following its inspections of those accounting firms targeted for inspection in 2006-07.</p> <p>However, there may be merit in the FRC expanding the scope of its involvement with the accounting firms. In addition to periodic meetings, it may be useful for the FRC to use its information gathering powers to obtain manuals and other documents from the firms to form its own assessment of the systems and processes adopted by the firms for the purpose of ensuring compliance with auditor independence requirements.</p> <p>The assessment of the information gathered by the FRC could be undertaken by a consultant and, depending on a preliminary review of the material, might be targeted at firms of a particular size or operating in a particular geographical area. This assessment could result in further work to determine whether individual firms are complying with their systems and processes.</p>
<p>Monitoring and assessing the nature and overall adequacy of:</p> <ul style="list-style-type: none"> <li>(a) the systems and processes used by professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors to the extent that those reviews relate to auditor independence requirements</li> <li>(b) the action that Australian auditors who have been subject to such quality assurance reviews have taken in response to the reports prepared as a result of those reviews; and</li> <li>(c) the action taken by professional accounting bodies to ensure that Australian auditors who have been subject to such quality assurance reviews respond appropriately to the reports prepared as a result of those reviews.</li> </ul>	<p>The FRC's work in respect of this function will flow from the report of the consultant and the recommendations contained in that report.</p> <p>The FRC will be consulting with the professional accounting bodies and other stakeholders concerning the recommendations of the consultants.</p> <p>There may be a need for further consultancies in 2006-07 or later years to consider issues that arise out of this consultative process.</p>

Appendix G: Auditor independence functions: 2006-07 work programme

Function	Approved work programme for 2006-07
<p>Monitoring and assessing the nature and overall adequacy of the investigation and disciplinary procedures of professional accounting bodies as those procedures apply to Australian auditors.</p>	<p>The FRC's work in respect of this function will flow from the report of the consultant and the recommendations contained in that report.</p> <p>The FRC will be consulting with the professional accounting bodies and other stakeholders concerning the recommendations of the consultants.</p> <p>There may be a need for further consultancies in 2006-07 or later years to consider issues that arise out of this consultative process.</p>
<p>Monitoring the overall compliance by companies, registered schemes and disclosing entities with the audit-related disclosure requirements of the Corporations Act and the accounting standards. The disclosure requirements include:</p> <ul style="list-style-type: none"> <li>(a) paragraph 298(1)(c) of the Corporations Act, which requires a company, registered managed investment scheme or disclosing entity to include in its directors report for each financial year a copy of the auditor's independence declaration under section 307C in relation to the audit for the financial year;</li> <li>(b) section 300 of the Corporations Act, which provides that the following information is to be included in the directors' report of a listed company: <ul style="list-style-type: none"> <li>(i) if a registered company auditor plays a significant role in the audit of a listed company for the financial year in reliance on a declaration made under section 324A, the report for the company must also include details of the declaration [s-sec.300(11A)];</li> <li>(ii) in relation to each auditor: <ul style="list-style-type: none"> <li>(A) details of the amounts paid or payable to the auditor for non-audit services provided, during the year, by the auditor (or by another person or firm on the auditor's behalf);</li> <li>(B) a statement whether the directors are satisfied that the provision of non-audit services, during the year, by the auditor (or by another person or firm on the auditor's behalf) is compatible with the general standard of independence for auditors imposed by the Act;</li> <li>(C) a statement of the directors' reasons for being satisfied that the provision of those non-audit services, during the year, by the auditor (or by another person or firm on the auditor's behalf) did not compromise the auditor independence requirements of the Act.</li> </ul> </li> </ul> </li> </ul>	<p>As part of its 2006-07 work programme, the FRC will review, and analyse, the level of compliance with audit related disclosure requirements by considering the information provided by the MOU bodies.</p>

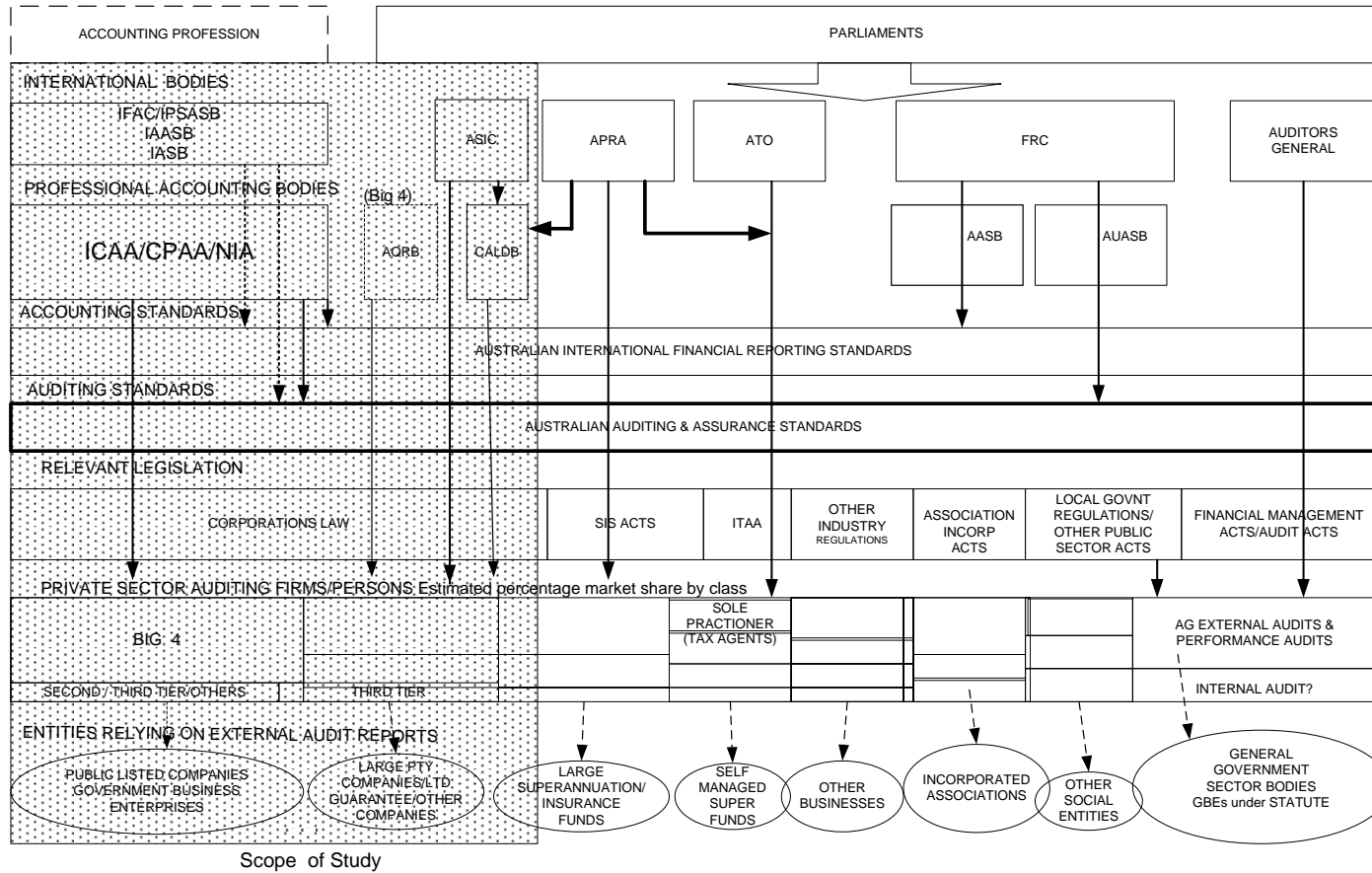
## Report on Auditor Independence 2005-06

Function	Approved work programme for 2006-07
<p>(c) subsection 306(2) of the Corporations Act, which provides that the directors' report of a disclosing entity must include a copy of the auditor's independence declaration under section 307C in relation to the audit or review for the half-year; and</p> <p>(d) paragraphs Aus 126.1 and Aus 126.2 of accounting standard AASB 101 <i>Presentation of Financial Statements</i>, which require an entity or economic entity to disclose in its financial report the remuneration of:</p> <p>(i) the auditor, showing separately amounts for audit and non-audit services (including, in the case of the latter, the nature and amount of each of the non-audit services provided by the auditor); and</p> <p>(ii) a practice related to the auditor's firm for non-audit services provided in relation to the entity or economic entity (including the nature and amount of each category of non-audit service).</p>	
<p>Giving the Minister reports and advice about the matters referred to above.</p>	<p>Monitor developments on an ongoing basis and provide reports and advice on an 'as required' basis.</p>
<p>Giving professional accounting bodies reports and advice about matters related to their quality assurance reviews and disciplinary procedures as detailed above.</p>	<p>Monitor developments on an ongoing basis and provide reports and advice on an 'as required' basis.</p>
<p>Monitoring international developments in auditor independence, assessing the adequacy of the Australian auditor independence requirements provided for in:</p> <p>(a) the Corporations Act; and</p> <p>(b) codes of professional conduct;</p> <p>in the light of those developments and giving the Minister, and professional accounting bodies, reports and advice on any additional measures needed to enhance the independence of Australian auditors</p>	<p>In 2006-07, the FRC should continue to perform this function by:</p> <p>(a) monitoring media reports and information on relevant web-sites (this information is provided to all FRC members on a monthly basis); and</p> <p>(b) meeting with appropriate bodies in other jurisdictions as part of overseas visits by the FRC chairman.</p> <p>Having regard to the Treasury's work comparing Australian independence requirements with the requirements of other major jurisdictions, the FRC will consider areas in which some aspects of Australian auditor independence requirements differ from the requirements applicable in other jurisdictions with a view to submitting appropriate recommendations for consideration by the Government.</p>
<p>Promoting, and monitoring the adequacy of, the teaching of professional and business ethics by, or on behalf of, professional accounting bodies to the extent to which the teaching of those subjects relates to auditor independence.</p>	<p>The FRC's work in respect of this function will flow from the report of the consultant and the recommendations contained in that report.</p> <p>The FRC will be consulting with the professional accounting bodies and other stakeholders concerning the recommendations of the consultants.</p> <p>There may be a need for further consultancies in 2006-07 or later years to consider issues that arise out of this consultative process.</p>

Appendix G: Auditor independence functions: 2006-07 work programme

<b>Function</b>	<b>Approved work programme for 2006-07</b>
<p>Other matters.</p> <p>(a) Non-Corporations Act audits (in particular, self managed superannuation funds).</p>	<p>The 2006-07 work programme does not envisage any direct action in respect of this matter.</p> <p>Nevertheless, given the terms of the Parliamentary Secretary to the Treasurer's letter of 22 February 2006, the FRC should monitor/consider any independence issues that arise in respect of non-Corporations Act audits so that it is able to provide appropriate advice to the Minister at the expiration of the 12 month period.</p> <p>The advice to the Minister could result in work in this area being programmed in 2007-08.</p>

Figure 1: Australian audit industry overview



\* The Accounting Professional and Ethical Standards Board (APESB) was formed in 2006.