

Financial Reporting Council
Report on Auditor Independence
2007-08

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ISBN 978-0-642-74480-7

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8 October 2008

Senator the Hon Nick Sherry
Minister for Superannuation and Corporate Law
Parliament House
CANBERRA ACT 2600

Dear Minister

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 2008.

Subsection 235BA(1) of the *Australian Securities and Investments Commission Act 2001* (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 'J Lucy'.

Jeffrey Lucy AM

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ABBREVIATIONS

The following abbreviations are used throughout this report:

APESB	Accounting Professional and Ethical Standards Board
APES	Accounting Professional and Ethical Standard
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 Securities Exchange Ltd
ASXMS	Australian Securities Exchange Markets Supervision Pty Ltd
ATO	Australian Taxation Office
CALDB	Companies Auditors and Liquidators Disciplinary Board
CLERP	Corporate Law Economic Reform Program
CLERP 9 Act	<i>Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004</i>
Corporations Act	<i>Corporations Act 2001</i>
FRC	Financial Reporting Council
IAESB	International Accounting Education Standards Board
ICAA	The Institute of Chartered Accountants in Australia
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFIAR	International Forum of Independent Audit Regulators

Abbreviations (continued)

IOSCO	International Organization of Securities Commissions
MOU	Memorandum of Understanding
MOU bodies	APRA, ASIC, ASX, CPA Australia, ICAA and NIA
NIA	National Institute of Accountants
PCAOB	Public Company Accounting Oversight Board (United States)
RCAs	Registered company auditors
SEC	Securities and Exchange Commission (United States)
SMSF	Self-Managed Superannuation Fund
SRS Act	<i>Corporations Legislation Amendment (Simpler Regulatory System) Act 2007</i>
Treasury	Australian Treasury
UK	United Kingdom
US	United States of America

AUSTRALIAN AUDITORS, AUDITORS, INDIVIDUAL AUDITORS, AUDIT FIRMS AND AUDIT COMPANIES

The ASIC and Corporations Acts use a number of terms to describe the individuals, firms and companies that may be appointed as auditor for a company or a registered scheme under Part 2M.4 of the Corporations Act.

The expression 'Australian auditor', which is used in Part 12 of the ASIC Act for setting the scope of the FRC's auditor independence function, is defined in section 5 of that Act to mean an individual auditor, an audit firm or an audit company.

In the Corporations Act, the terms 'individual auditor', 'audit firm' and 'audit company' are used to describe the manner in which the requirements of the Act apply to the different structures under which an audit practice may be conducted: sole trader, partnership and company.

For purposes of consistency and to simplify drafting, this report uses the expression **audit firm** to refer to all three structures.

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1 EXECUTIVE SUMMARY

This report outlines the work undertaken by the Financial Reporting Council (FRC) during 2007-08 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.

During the year, the FRC addressed each of the core issues that, together, make up its auditor independence functions.

The overall conclusion reached by the FRC as a result of its 2007-08 work on auditor independence is that the independence framework continues to operate effectively. No systemic issues were identified as a result of the work undertaken by the various parties. This outcome is consistent with the conclusions reached in the period since 1 July 2004 when the FRC first became responsible for monitoring auditor independence requirements.

Systems and processes of Australian auditors

- In 2007-08, the FRC undertook its work on monitoring the systems and processes used by audit firms to ensure compliance with auditor independence requirements by gathering information from the Australian Securities and Investments Commission (ASIC), reviewing reports published by the Audit Quality Review Board (AQRB) and The Institute of Chartered Accountants in Australia (ICAA), requesting relevant information from the professional accounting bodies and through meetings with the four largest audit firms (the 'Big Four') and three other firms. In reaching the overall conclusion referred to above, the FRC noted:
 - ASIC's 2007-08 audit inspection program report in which ASIC indicated that, overall, firms have shown commitment towards meeting their independence obligations. In relation to issues raised in prior year inspections, ASIC notes that all major issues have been addressed and good progress has been noted in most areas;
 - the AQRB's 2007 report which concluded that all of the Big Four firms have established policies and procedures that are designed to enable them to complete effective audits within the framework of current Australian legal and professional requirements;
 - that during the course of its meetings with audit firms the FRC did not become aware of any systemic issues in relation to the effectiveness of the

systems and processes used by firms to ensure compliance with the audit independence requirements; and

- that the quality assurance reviews conducted by the professional accounting bodies did not reveal any serious breaches of the audit independence requirements.
- As a result of the inspections by ASIC¹ and reviews by the AQRB² and the professional accounting bodies³ the FRC formed the view that the systems and processes used by audit firms to ensure compliance with independence requirements are working effectively. However, the FRC notes that the work by ASIC has revealed that a number of the smaller firms need to make improvements to their systems to ensure that the systems are robust and comply with all the legislative requirements.

Activities of professional accounting bodies

- During 2007-08, the FRC continued its work on monitoring and assessing the nature and overall adequacy of:
 - the systems and processes used by the professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by audit firms; and
 - the investigation and disciplinary procedures of the professional accounting bodies as those procedures apply to audit firms.

-
- 1 An ASIC inspection seeks to enhance public confidence in capital markets through raising the standard of audit quality independence in the profession. It is designed to focus on audit quality and independence by promoting compliance with the requirements of the *Corporations Act 2001*, (the Act) Australian auditing standards, and professional and ethical standards. [ASIC *Audit Inspection program public report for 2006-07*, p 4]. An inspection includes reviews of documentation, interviews with partners and staff, limited testing and verification of systems and processes, and reviews of aspects of a sample of individual audit and review engagements for compliance with the firm's stated audit methodology and applicable auditing standards as at the date of each audit or review.
 - 2 The AQRB's role (as an independent body funded by audit firms) is to monitor the processes by which audit firms seek to ensure their compliance with audit standards and legal obligations relating to independence and audit quality. AQRB's overarching commitment in examining, assessing and reporting on audit firms' quality assurance processes is to contribute to the improvement in audit quality. [AQRB *Report on 2007 reviews*, p 4].
 - 3 The ICAA, for example, as part of its quality review program assesses the quality control policies and procedures that are implemented in an accounting practice. The reviewer considers the quality control procedures that the practice has established by covering the elements of quality control set out in APES 320 *Quality Control for Firms*. [ICAA *Annual Report on the Quality Review Program for the year ended 30 June 2008*, p 7].

- Based on the information provided by the professional accounting bodies, the FRC did not become aware of any deficiencies in either the systems and processes used by the bodies for planning and performing quality reviews of audit work, or in the overall adequacy of the professional accounting bodies investigation and disciplinary procedures.
- The FRC also continued to monitor the adequacy of the teaching of ethics by the professional accounting bodies.
- The FRC based its observations on information supplied by the professional accounting bodies in response to a request from the FRC and through information gained at periodic meetings with those bodies. Based on its examination of this information, the FRC is satisfied that the teaching of ethics by each of the professional accounting bodies is adequate. That said, as part of its work program going forward, the FRC will continue to encourage the professional bodies and other stakeholders to participate in the debate on ethical behaviour within the profession, particularly on the issue of ethics as it relates to auditor independence.
- As a result of its work, the FRC did not become aware of any matters that would cause it to be concerned about the adequacy of the activities of the professional accounting bodies during 2007-08.

Consultants

- In 2006 and 2007, the FRC engaged a total of five consultants to examine and make recommendations to the FRC in the areas of disciplinary procedures, the teaching of professional and business ethics, the practical application of professional and business ethics by audit firms and quality review programs.
- During 2007-08, the FRC considered these recommendations, and considered the adoption (if not already adopted) of these recommendations into the FRC's current and future work programs. In doing so, the FRC also considered the need for it to make any recommendations to the Minister and the professional accounting bodies about issues arising out of the consultants' reports. To facilitate this process, the FRC sought feedback on the recommendations from stakeholders and other interested parties.

Other matters

- Information provided to the FRC by ASIC and the Australian Securities Exchange Ltd (ASX) shows that the majority of financial reports complied with the audit-related disclosure requirements examined as part of their reviews. There were, however, a small number of financial reports that failed to comply

with these disclosure requirements: the directors' reports of 11 entities did not include an unqualified statement that non-audit services had not affected the auditor's independence. As part of its 2008-09 work program, the FRC will continue to review, and analyse the level of compliance with audit-related disclosure requirements by considering the information provided by the bodies with which the FRC has signed a Memorandum of Understanding (MOU bodies).

- As part of its 2007-08 work program, the FRC undertook further analysis of the quantum of fees for audit and non-audit services that were received by audit firms from their clients⁴. This work carries on from the preliminary work undertaken in 2006-07. The FRC considers that the 2007-08 data does not suggest any problematic trends for auditor independence.

⁴ This information was provided by CGI Glass Lewis Pty Ltd. Any observations about, or conclusions drawn from, this information reflects the views of the FRC and not CGI Glass Lewis.

2 INTRODUCTION

Under section 225 of the *Australian Securities and Investments Commission Act 2001* (ASIC Act), the FRC is responsible for monitoring the effectiveness of auditor independence requirements in Australia and giving the Minister reports and advice about those requirements. The FRC's functions also include monitoring overall compliance with the audit-related disclosure requirements and giving the professional accounting bodies reports and advice about aspects of their quality review programs and disciplinary procedures. A summary of the FRC's auditor independence functions appears in Appendix A of this report.

The FRC has put in place a number of administrative arrangements designed to facilitate its performance of the auditor independence functions. These arrangements include:

- the establishment of an Audit Independence Committee, which monitors the work program associated with the performance of the function; and
- a program of regular meetings, and the exchange of information, with the bodies with which the FRC has entered into MOUs and with selected audit firms.

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

During 2007-08, the FRC addressed each of the core issues that comprise its auditor independence functions: systems and processes of audit firms, quality review programs 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 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, is described in later sections of this report. Appendix C lists the key matters arising from the 2006-07 independence report and the action that was taken by the FRC in respect of each of those matters during 2007-08.

For the year ahead it is envisaged that the FRC's auditor independence function work program will continue the work undertaken by the FRC in previous years. In addition to undertaking the 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, the FRC also plans to continue to monitor trends in fees received by auditors for audit and non-audit services and liaise with the accounting bodies with a view to increasing professional awareness of ethics and training opportunities.

A detailed outline of the work program for 2008-09 is contained in Appendix D of this report.

3 AUDITOR INDEPENDENCE IN AUSTRALIA

Australia has comprehensive legislative and professional requirements concerning the independence of auditors. The principal requirements are:

- Division 3 and 5 of Part 2M.4 of the Corporations Act which sets out the requirements that have to be satisfied by the auditors of those entities that are subject to the audit requirements of the Act;
- Auditing Standard ASA 220 *Quality control for audits of historical financial information*, which was issued by the Auditing and Assurance Standards Board in April 2006;
- Section 290 of the *Code of Ethics for Professional Accountants* (APES 110), which was issued by the Australian Accounting Professional and Ethical Standards Board (APESB) in June 2006; and
- APES 320 *Quality control for firms*, which was issued by the APESB in May 2006.

Under the Corporations Act, all disclosing entities, public companies, large proprietary companies and registered schemes are required to prepare financial reports and have them audited. These audits must be conducted by auditors or audit companies registered by ASIC for that purpose.

In 2004, Australia's audit independence framework was significantly strengthened with a number of measures contained in the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act). During 2006-07, the Government made further refinements to the auditor independence requirements as part of the package of reforms contained in the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* (SRS Act). A guide to Australia's auditor independence requirements prepared by the Treasury is at Appendix E.

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 are ASIC, ASX, the professional accounting bodies (the ICAA, CPA Australia and the National Institute of Accountants (NIA)), the APESB, the AQRB, the Companies Auditors and Liquidators Disciplinary Board (CALDB) and the FRC. The respective roles of these organisations are outlined at Appendix F.

3.1 SYSTEMS AND PROCESSES OF AUSTRALIAN AUDITORS

The ASIC Act requires the FRC to monitor and assess the nature and overall adequacy of the systems and processes used by audit firms to ensure compliance with auditor independence requirements.

In 2007-08, the FRC performed this function by gathering information from ASIC under the terms of its MOU with that body, by reviewing reports published by the AQRB and the ICAA, requesting information from the professional accounting bodies and through meetings with seven audit firms, including Australia's largest four firms.

As a result of this work, the FRC formed the view that the systems and processes used by audit firms to ensure compliance with independence requirements are working effectively. However, the FRC notes that the inspections by ASIC have revealed that a number of the firms reviewed need to make improvements in their systems to ensure that the systems are robust and comply with all the legislative requirements.

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 2007-08 report to the FRC summarises ASIC's observations and findings in relation to the independence systems and processes of selected firms where inspections commenced around 1 July 2007 and were substantially completed prior to 30 June 2008. As in past years, the review undertaken by ASIC has constituted a key source of information for the FRC with respect to its responsibilities in this area during 2007-08.

In addition to its report to the FRC for 1 July 2007 to 30 June 2008, ASIC also released a public report summarising the results of its audit regulation activities for the period 1 July 2006 to 31 December 2007. The findings of ASIC's report to the FRC differ to some extent, the public report relates to the period 1 July 2006 to 30 June 2007 and examines 19 firms whereas the report to the FRC relates to the inspections of 12 firms, two of which were not included in the public report and covers the 2007-08 financial year.

The scope of the public report covers audit quality as well as independence, whereas the report to the FRC relates only to the independence systems and processes used by Australian auditors, in accordance with the terms of ASIC's MOU.

ASIC's inspection process for the year ended 30 June 2008 covered 12 selected firms. Of these firms:

- five were inspected for the first time (Group A);
- three were inspected for the second time (Group B); and
- four were inspected for the third time (Group C).

Two of the inspections were conducted jointly with the Public Company Accounting Oversight Board of the United States (PCAOB). These were undertaken under an agreement entered into by ASIC to assist the PCAOB ascertain compliance by Australian auditors with the *Sarbanes Oxley Act of 2002*.

Collectively, the 12 firms inspected by ASIC audit approximately 95 per cent by composition and 99 per cent by market capitalisation of the 300 largest entities listed on the Australian Securities Exchange (S&P/ASX 300).

The FRC is pleased to note ASIC's overall finding that firms have shown commitment towards meeting their independence obligations.

ASIC observed that, in contrast to its 2006-07 report, more of the firms that were inspected for the first time in 2007-08 had implemented independence policies, systems and processes than the firms visited by ASIC for the first time in 2006-07. However, ASIC also noted that a number of the firms reviewed for a first and second time need to make improvements in their systems to ensure that the systems are robust and comply with all the legislative requirements. The areas where these firms need to make improvements include:

- *Independence policies, systems and processes.* ASIC reports that two Group A firms need to take action to ensure their documented policies meet all the legislative requirements of the professional and ethical standards and the Corporations Act.
- *Testing of the annual independence confirmations.* The professional and ethical standards require firms to annually confirm, in writing, their compliance with their independence policies. ASIC notes that the majority of firms in Group A and B have not commenced testing of the annual independence confirmations to ensure that processes are operating satisfactorily.
- *Acceptance and continuance policies.* While all Group B firms have developed and implemented policies and processes for the acceptance and continuance of client relationships and specific engagements as required by the professional and ethical standards, the acceptance and continuance processes of two Group A firms were not fully developed or appropriately documented.

- *Non-audit services policies and processes.* Notwithstanding that all firms have established policies and processes to approve the provision of non-audit services to existing audit clients, ASIC found deficiencies in the quality and existence of documentation to evidence the application of firm policies. In particular, ASIC observed that documentation of the consideration of threats and safeguards by many of the firms before agreeing to provide non-audit services to an audit client could be improved.
- *Human resources and tone at the top.* ASIC reports that approximately half of the Group A and Group B firms need to give appropriate recognition to the commitment to independence in the firm's staff evaluation, compensation and promotion processes. Most of the firms in Group A and Group B need to improve their processes so that it is clear that independence has been explicitly considered in partner performance evaluations. While all firms agree independence is 'a given', few firms assess partners or staff against defined criteria. ASIC also reports a high incidence of staff not being aware of the consequences of non-compliance with independence policies.

ASIC reports that firms inspected for a second and third time have continued to make good progress in addressing the observations and findings raised with them in prior year inspections. All major issues have been addressed and good progress has been noted in most areas.

With respect to Group C firms, which have responsibility for the audit of 90 per cent by composition and 95 per cent by market capitalisation of the S&P/ASX 300, ASIC reports that:

- All Group C firms are testing the annual independence confirmation processes and the data and systems supporting those confirmation processes. This testing has not revealed any breaches of the Corporations Act although it continues to show levels of non-compliance with the policies of the Group C firms. However, ASIC notes that policies of Group C firms include specific requirements that go further than the requirements of the Act.
- All but one of the Group C firms has adopted a process that extends beyond the mandatory obligations in relation to requiring staff to confirm in writing that they have no independence conflicts with each specific audit client on which they are working.
- All Group C firms have developed and implemented policies and processes for the acceptance and continuance of client relationships and specific engagements as required by the professional and ethical standards.
- All Group C firms have established and are testing their policies and processes for provision of non-audit services to ensure that they are being complied with. The results of testing revealed some non-compliance with the firms' policy

requirements to document the approval to provide these services. That said, the testing did not identify any instances of independence impairing services being provided.

- As was the case for Group A and B firms, there was also a high incidence of staff in Group C firms not being aware of the consequences of non-compliance with independence policies.

In its 2006-07 report to the FRC, ASIC noted that two firms needed to address rotation requirements as a matter of urgency. Both firms took action to avoid breaching the requirements of the Corporations Act by either resigning as auditor where relief could not be provided by ASIC under section 234A of the Act, or appointing external consultants to act as engagement quality control reviewer enabling rotation to be facilitated within the firm.

During 2007-08, ASIC received one application for relief from auditor rotation requirements, which was outside the scope of the Act and subsequently withdrawn by the firm.

ASIC's inspections did not highlight any significant issues with the rotation processes of firms. However, ASIC reports that their consultations with firms on rotation requirements highlighted two areas of ambiguity within the Act:

- When the rotation requirements begin to take effect if a company lists on a prescribed financial market in Australia.
- Whether the interpretation of 'significant role' as defined in section 9 of the Corporations Act applies to partners who provide assistance on an audit outside of the lead auditor and the review auditor roles.

As part of its 2008-09 work program, the FRC proposes to liaise further with ASIC on the issue of auditor rotation.

Reviews by the AQRB

The AQRB reviewed each of the Big Four accounting firms during 2007 and published a public version of the report summarising the results of its 2007 reviews in May 2008. The report considered issues associated with audit quality as well as auditor independence.

The AQRB concludes that, as a result of its reviews, all of the Big Four firms have established policies and procedures that are designed to enable them to complete effective audits within the framework of current Australian legal and professional requirements.

As a result of its 2007 review, the AQRB found no reason to believe that the firms' Quality Control Reports⁵ do not reflect, in all material aspects, practice within the firms.

In its report, the AQRB made the following observations about the commitment of the firms to the present auditing environment:

- All firms had leaders that continued to emphasise, through internal communications to partners and staff, the paramount importance of audit quality.
- Evidence suggests that leaders of all the firms were prepared to take decisive and strong disciplinary action whenever there is evidence of quality shortcomings.
- All firms have committed substantial resources and senior staff to dedicated roles in the areas of quality, risk and legal regulation. These functions are also supported by significant staff resources below partner level.
- In its 2006 report, the AQRB had noted that all firms had invested heavily to establish policies, systems and procedures to ensure compliance with new legislation and audit standards but that at some firms these new tools and systems suffered from a lack of integration resulting in some lack of utility. In 2007, the AQRB reports that the upgrading of existing systems, and functional testing of new online systems, is ongoing, as is the process of obtaining optimum benefit from the information the systems are capable of providing. The AQRB observes that it is likely the firms will continue upgrading existing systems to meet the evolution of new standards and legislation.
- In its 2006 report, the AQRB observed that the processes for ensuring that auditors remain duly independent of their audit clients in compliance with the law and auditing standards were perhaps the most focussed upon areas in both the firms' internal monitoring programs and regulators' reviews. In 2007, the AQRB remain satisfied with the firms' proactive approach towards independence and threats to independence.
- Although some firms had a disappointingly high number of breaches in 2007, the AQRB notes that these were generally minor in nature, and only entailed a breach of the firm's own (more stringent) internal policies rather than legislative requirements. The AQRB also observed that firms were responding appropriately to these breaches.
- All firms take into account compliance with independence rules in performance assessments for senior levels. Serious breaches can attract financial penalties.

5 Reports can be viewed at www.aqrb.org.au.

- Three of the four firms require all staff on a particular audit engagement to make a comprehensive independence declaration in respect of that client, normally at the commencement of the engagement. The fourth firm relies on its systems, continual staff independence reporting requirements and annual independence declarations to provide it with assurance on the required independence of staff on each engagement.
- All firms maintain comprehensive, normally global, client databases so as to enable monitoring processes both in respect of permissible investments and non-audit services.
- All firms have extensive human resource and professional development policies and procedures. Firms dedicate substantial investment in the area of training and developing staff.
- All firms have effective policies dealing with the procedures which must be followed prior to acceptance or continuance of client relationships and specific audit engagements and the documentation of conclusions reached in this regard. Each firm has a process to categorise its engagements across the spectrum of perceived risk and its policies determine what additional resources and processes shall be applied to 'higher' risk engagements. The AQRB believes that the firms' policies are comprehensive and provide an excellent basis for risk evaluation and employment of resources and, where needed, additional resources and processes. However, the AQRB noted that at some firms the policies are not always well applied and the reasoning behind the policies may not always be well understood. Documentation of acceptance and continuance processes, particularly on the audit files of clients classified as higher risk, is not in some cases, in the AQRB's view, adequate. That said, enquiry by the AQRB of the audit team members normally showed that they fully appreciated the heightened risk and had reacted appropriately.
- Each firm has its own program to test compliance with its quality control systems and processes. The AQRB observed that the firms make a large time and financial investment in their annual monitoring programs.

Overall, the AQRB's findings reflect positively on the auditor independence systems and processes used by the Big Four accounting firms. The findings support those of ASIC and the professional accounting bodies (referred to in section 3.2).

Meetings with audit firms

During 2007-08 the FRC met with the Big Four accounting firms and three other firms with auditing practices. During the course of these meetings, the FRC did not become aware of any systemic issues in respect of the adequacy of Australia's auditor

independence framework. However, a number of issues were raised that will continue to be monitored by the FRC. The issues discussed at these meetings included:

- *Auditor rotation.* A number of stakeholders voiced their concern about the inconvenience and costliness of auditor rotation and its potential to put audit quality at risk. The FRC Chairman invited stakeholders to make submissions in support of their claims that auditor rotation was having a negative impact. Most stakeholders responded positively to this suggestion and agreed to provide the FRC with supporting evidence.
- *Material financial fraud.* Undetected material financial fraud is one of the greatest risks to an organisation's viability and corporate reputation. Material financial fraud is one of the key factors evident in corporate collapse and preventing such fraud is a key challenge. The Chairman discussed with stakeholders whether there is a need for an optional standard on material financial fraud which might include features adopted in the United States regarding internal controls. The FRC notes that whilst this is an issue relevant to audit quality, it will nevertheless continue to monitor this matter.
- *Graduated auditor designations and registrations.* There was general consensus among stakeholders that the audit market consists of different tiers, and with this, comes different levels of audit skills and audit performance across the profession. In light of these different skill levels, a number of stakeholders raised the option of introducing graduated designations and registrations for auditors. This would require differential qualification of audit engagements.
- *Ethical behaviour and perception.* Stakeholders were keen to engage the FRC on the issue of ethical behaviour in the profession and market perception of this. It was suggested that part of the evaluation of an audit might include an analysis of ethical behaviour.
- *Professional ethics.* With a view to increase professional awareness of ethics and training opportunities, the proposal of a joint effort to develop an 'ethics education campaign' was raised at the meetings. All stakeholders responded positively to the suggestion and expressed willingness to participate in any such project.
- *Outsourcing and off-shoring of financial services and the impact on audit independence.* Some stakeholders expressed concern about the impact of the outsourcing of financial services on auditor independence. It was suggested that the audit value chain would unavoidably become longer with the off-shoring of financial services work, and the obvious complexities arising from this growing practice requires attention. The FRC will explore whether this is an issue that requires further consideration.

3.2 QUALITY REVIEW PROGRAMS AND DISCIPLINARY PROCEDURES OF THE PROFESSIONAL ACCOUNTING BODIES

Under the ASIC Act, the FRC is required to monitor and assess the nature and overall adequacy of: the systems and processes used by the 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 responsive action taken by auditors who have been subject to such reviews; and the action taken by the professional accounting bodies to ensure that auditors are responding appropriately. In addition, the FRC is required 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.

During 2007-08 the FRC met these requirements by requesting relevant information from the professional accounting bodies, obtaining information at periodic meetings with the professional accounting bodies and reviewing publicly available material issued by those bodies.

CPA Australia advised that during 2008, approximately 1,200 public practice certificate holders will be subject to its quality review process. In the year to 30 June 2008, these reviews did not reveal any breaches of the audit independence requirements.

The NIA noted that, in the vast majority of cases, their quality reviews did not identify any issues of concern. During 2008, quality reviews identified only two cases where members had prepared and audited the financial reports of a self managed superannuation fund (SMSF). In one case, the NIA has obtained an assurance that this type of conflict has ceased. The other instance has yet to be concluded.

The ICAA's annual report on its quality review program for the year ended 30 June 2008 summarises the results of 480 reviews, of these 29 per cent were practices that conduct audits which are subject to the Corporations Act. The practices reviewed by the ICAA ranged in size from national partnerships with multiple offices to sole individual offices with a sole practitioner. As at 30 June 2008, a further 510 practices were under review. Independence compliance formed only a part of the ICAA reviews.

The ICAA found that the vast majority of reviewed practices are meeting independence requirements. The ICAA report identifies three areas where a small proportion of firms need to take action. Specifically:

- fourteen per cent of those reviewed either had no documentation or inadequate documentation when considering possible threats to independence;

- thirteen per cent of reviewed firms had not adequately applied appropriate safeguards when carrying out audit and accounting functions for a client; and
- five per cent of firms reviewed were auditing the SMSF of a partner in their practice.

In each of these instances, the ICAA requires non-compliant practices to confirm in writing that these issues have been addressed.

In response to the non-compliance issues identified in their report, the ICAA introduced a range of measures in 2007-08, and are developing a number of others, to assist members in complying with regulatory and legal requirements as well as professional standards. Initiatives of the ICAA have included:

- amending their retention policy to allow the ICAA to retain the results letter that is issued to practices so that it can be considered when the practice is next reviewed. Where required the FRC will have access to review files. The aim of this is to increase the transparency of the ICAA's review program;
- publishing, in conjunction with the NIA and CPA Australia, a competency framework for the audit of SMSFs. The framework provides a structured and formal set of criteria that auditors of SMSFs should meet; and
- continuing to promote guidance and run a range of training and development events in respect of business and professional ethics and auditor independence for members.

The professional accounting bodies also plan to launch a revised and updated *Co-regulatory Guide to Independence* in 2008-09. This will be via an on-line resource aimed at providing consistency and support in the practical application of independence requirements outlined under the Corporations Act and independence principles under section 290 of APES 110 *Code of Ethics for Professional Accountants*.

In its 2006-07 report, the FRC encouraged the ICAA to assess and, if appropriate, place reliance on reviews by other bodies, such as the AQRB, to avoid duplication and minimise disruptions and costs to practices. The FRC is pleased to note that during 2007-08 the ICAA introduced changes to their procedures to help avoid duplicating the work of other bodies. Quality reviews now assess and, if appropriate, place reliance on reviews by other bodies.

The FRC has also considered information supplied by the professional accounting bodies in relation to their disciplinary procedures. Each of the professional bodies has confirmed that there were no disciplinary actions taken against their members in respect of auditor independence.

Based on the information provided by the professional accounting bodies, the FRC did not become aware of any deficiencies in either the systems and processes used by the bodies for planning and performing quality reviews of audit work, or in the overall adequacy of the professional accounting bodies investigation and disciplinary procedures.

Consideration of consultants' reports

During 2005-2006, the Treasury, in consultation with the FRC, engaged consultants to review the quality review programs and disciplinary procedures of the professional accounting bodies. Messrs Graeme MacMillan and Michael Cain of CiptaNet International Pty Ltd examined the bodies' quality review programs while Mr William J Bartlett examined their disciplinary procedures. A summary of the findings and recommendations made by each of the consultants was published in the FRC's *Report on Auditor Independence 2005-06*.

In its 2006-07 report, the FRC indicated that prior to considering the findings and recommendations of the consultants, it had decided that the recommendations should be reviewed to ensure they:

- clearly identify the need for a change to current policies, procedures or regulations by the professional accounting bodies, the Government or other stakeholders in order to better meet stated policy objectives in an efficient and effective manner;
- establish, when government intervention is recommended, a policy rationale for the proposed intervention which is consistent with the Government's legislative and policy frameworks; and
- include consideration and assessment of alternative means to meet the stated policy objectives.

To undertake this project for the FRC, the Treasury engaged The Allen Consulting Group Pty Ltd who presented their report to the FRC in May 2007. The recommendations made by Allen Consulting were considered by the FRC during 2007-08.

The Allen review recommended that the FRC further examine the nature and extent of the risks to compliance with current regulatory approaches to audit independence presented by the increasing concentration of firms in audit services, including alternative approaches to regulating auditor independence which mitigate identified risks and provide for market confidence in a robust way into the future.

The FRC notes recent reforms to the auditor regulation framework which have enhanced the robustness of the regulatory requirements. For example, ASIC's audit

inspection powers were significantly enhanced by the *ASIC Amendment (Audit Inspection) Act 2007*. The robust legislative framework in the Corporations Act is also supplemented by the professional conduct rules applying to members of the professional accounting bodies. In addition, the bodies have established an independent ethical standards board, APESB, which is responsible for the professional conduct rules applicable to their members.

Nevertheless, this recommendation raises other issues to consider, including those in the areas of competition policy and international developments. However, as these are policy matters which fall outside the FRC's area of responsibility they have been referred to Treasury. As part of the FRC's audit independence work program, the FRC will continue to consider the level of non-audit service fees and rotation of audit partners. The FRC will consult with relevant stakeholders on these matters.

The Allen review also recommended that the FRC provide an information program to improve the understanding of the current regulatory framework with a focus on improving the understanding within the profession of the roles of ASIC and CALDB and their statutory requirements in fulfilling those roles. The FRC has included this recommendation as part of its future work program. In a meeting between CALDB and the Chairman of the FRC, an invitation was extended to CALDB to participate in an education campaign through which the demarcation and clarification of respective roles could be emphasised. CALDB advised of its willingness to engage in such a program. CALDB also advised that a recent information program on their role and function had received a positive response from the profession.

In an effort to further enhance overall market understanding of the regulatory framework, the FRC has included the 'Short Guide to the Auditor Independence Requirements in the Corporations Act' (prepared by the Treasury) at Appendix E and, as part of its 2008-09 work program, will continue to consult relevant stakeholders to canvass ideas on how to improve market understanding.

3.3 TEACHING OF ETHICS BY THE PROFESSIONAL ACCOUNTING BODIES

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 2007-08, the FRC continued to monitor the adequacy of the teaching of ethics by requesting relevant information from the professional accounting bodies and through its periodic meetings with these bodies. Having examined the information supplied by the three professional bodies, the FRC is satisfied that the teaching of ethics by each of the bodies is adequate.

Consideration of consultants' reports

During 2007-08 the FRC considered the recommendations of two consultants engaged in previous years to examine the teaching of professional and business ethics.

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. In its 2006-07 report, the FRC indicated that prior to considering the findings made by Henderson Walton (Walton report) it had decided that a more detailed evaluation should be undertaken of how professional and business ethics are applied in practice by accounting firms.

To undertake this project for the FRC, the Treasury engaged Mr Richard Boele of The Banarra Trust. Banarra provided its final report (Banarra report) to the FRC in September 2007.

Walton report

Walton's examination of the teaching of professional and business ethics found that the depth of understanding of ethical issues by officers of the three professional accounting bodies and members of accounting firms, their commitment to deal with these issues and steps being taken to do so, are well beyond anything observed in other disciplines, businesses or professions, including law. A summary of the findings and recommendations made in the Walton report was published in the FRC's *Report on Auditor Independence 2005-06*.

The FRC has noted that most of the recommendations made in the Walton report are matters outside of the FRC's mandate. The majority of recommendations relate to the teaching of ethics as part of university and professional association programs. The FRC considers this to be an area for the professional accounting bodies which already have

a direct role in setting university teaching curricula and professional association programs. The FRC will however further engage with the professional accounting bodies and relevant stakeholders on certain elements of the recommendations made by the Walton report. As part of its work program, the FRC will also encourage the professional accounting bodies to further engage with academia and those parties that assist in the development of university teaching curricula.

The Walton report recommended that the FRC ensure that professional associations include ethics as a stand alone course and integrate it throughout the technical curriculum with issues, case studies and problems that students will encounter at every level of practice. The FRC notes comments from the professional accounting bodies suggesting that their programs already incorporate ethics as a substantial stand alone component, and that there is integration of ethical considerations throughout the technical materials. The FRC's future work program will consider this issue through consultations with the professional accounting bodies and other key stakeholders.

The FRC will encourage and support the professional accounting bodies in promoting the development and reinforcement of the profession's appreciation of the importance of culture in ethical standards within their respective firms and organisations. The FRC notes comments from the professional accounting bodies confirming that they have already undertaken various activities in this regard. Examples of such activity include: the ICAA's seminar and subsequent white paper on values, codes of ethics and the law; CPA Australia's regular ethical dilemma columns; and the NIA's regular ethical issues section appearing in their journals. The professional accounting bodies also direct their members to newsletters that provide regular updates on ethical and professional standards and changes therein.

The Walton report also recommended that the FRC utilise public practice programs to develop and reinforce ethical leadership skills. This is a matter for the professional accounting bodies and firms. The FRC notes, however, comments from the professional accounting bodies confirming that their public practice programs already address this. With respect to this recommendation, the FRC identifies its role as providing encouragement to the professional accounting bodies and firms to utilise public practice programs to develop and reinforce ethical leadership skills. The FRC will continue to do this as part of its future work programs.

Overall, the FRC has already included elements of the Walton recommendations in its work program, and is consulting with relevant stakeholders to encourage development in these matters. The FRC has also raised the possibility of combining efforts with various stakeholders – including the professional accounting bodies, the APESB, CALDB, and the Big Four firms – to develop and implement an education campaign on ethics and fraud. All stakeholders have responded positively to the proposal. The FRC will continue to gauge interest and seek input from relevant stakeholders, with a view to developing a more substantive plan in its future work program.

Banarra report

In its report, Banarra found that ethical practices are highly valued within the profession and that the profession has leading ethical practices. Banarra also found that while it could not arrive at any clear conclusions in terms of ethics practice between the Big Four and the significant other firms, there were clear differences in practice between individual firms.

The FRC considers that the scope of its responsibilities with respect to ethics is limited by the operation of the ASIC Act to ethics as it relates to auditor independence. Accordingly, the FRC considers that much of the Banarra report's recommendations are not directly relevant to the FRC. The FRC does, however, recognise the usefulness of the observations made and encourages the professional accounting bodies and APESB to consider the recommendations and encouragements made in the report.

The Banarra report recommended the professional accounting bodies and the APESB be encouraged to establish a mechanism that facilitates the sharing, reviewing and critiquing of leading ethical practices. The FRC has received advice from the APESB noting that the APESB has commenced dialogue with the professional accounting bodies (in particular, the education and continuing professional development departments of those bodies), to explore opportunities to achieve an outcome that will contribute to the highest ethical behaviour across the whole profession. The FRC encourages any initiatives that promote the commitment of the profession to ensuring it is driving the highest ethical standards. The FRC, therefore, will continue to encourage both the APESB and the professional accounting bodies to maintain their engagement with each other in order to develop ways to facilitate this.

The Banarra report suggests that widespread belief exists amongst firms to the effect that the FRC has a 'supervisory role' in relation to independence compliance. In order to overcome market misinterpretation of the FRC's role in ethics as it relates to auditor independence, the FRC will endeavour to further clarify its role in this area, as well as to make it clear that it is not considering an expansion of its role in ethics beyond auditor independence. As an initial step, the FRC recently refreshed its MOU with ASIC in order to highlight ASIC's responsibility for compliance and audit quality.

The Banarra report recommends that the FRC show greater leadership in both facilitating and participating in the debate on the dynamic and evolving tensions between the principles-based and rules-based approaches to encouraging ethical behaviour within the profession. As part of its work program going forward, the FRC will continue to encourage relevant stakeholders to participate in the debate on ethical behaviour within the profession, particularly through its engagement with stakeholders on the issue of ethics as it relates to audit independence.

3.4 COMPLIANCE WITH AUDIT-RELATED DISCLOSURE REQUIREMENTS

The FRC is required by 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. A summary of these requirements is provided at Appendix G.

Level of compliance

The FRC assesses the level of compliance with audit-related disclosure requirements by reviewing and analysing the information provided by the MOU bodies.

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 its 2007-08 financial reporting surveillance program included consideration of certain audit-related disclosures. ASIC reviewed 151 directors' reports as part of the review of the 325 financial reports of listed entities with financial years ending between 30 June 2007 and 31 May 2008. As part of that review, ASIC considered the following audit related disclosure issues:

- Did the directors' report include (including by way of cross reference to an attached document) an auditor's independence declaration?
- Did the auditor's independence declaration contain any exceptions?
- Did the directors' report include details of non-audit services where there was an indication that such services were provided?
- Did the directors' report include details of non-audit services where it appeared that such services were provided and, where there were details of non-audit services, did the directors' report 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: the directors' reports of 11 entities did not 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 during the financial year ending on 31 December 2007. 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, as in previous years, the preferred format for almost all entities was for the declaration to be presented as a separate attachment to the directors' report on the auditors' letter head with a reference to the attachment in the directors' report.

As part of its 2008-09 work program, the FRC will continue to review, and analyse, the level of compliance with audit-related disclosure requirements by considering the information provided by the MOU bodies.

Provision of non-audit services

In the 2006-07 audit independence report, the FRC provided a preliminary assessment of data regarding audit and non-audit services fees for 84 public companies. The majority of these companies were included in the ASX's top 100 companies for 2005-2006. During 2007-08 the Audit Independence Committee considered further analysis of the 2006-07 data and concluded that there was no indication of trends that raised concerns in relation to auditor independence. The FRC Secretariat also analysed 2007-08 data on audit and non-audit fees paid or payable to the auditors of 406 entities.

The data provides figures for four categories of auditor services. These are audit services, audit-related services, other services, and taxation advice services. Having regard to the categorisation of the fees presented in the data, the FRC notes that:

- fees for audit and audit-related services represented more than 75 per cent of the total fees of the auditors of 236, or nearly 60 per cent of entities, while the fees for these services for a further 25 per cent of entities were between 50 and 75 per cent of the total fees;
- fees for other services represented more than 25 per cent of the total fees of the auditors of 65, or 16 per cent of entities. Of these, 19, or nearly 5 per cent of entities received fees for other services which represented more than 50 per cent of their total fees; and
- fees for taxation services represented more than 25 per cent of the total fees of the auditors of 83, or 20 per cent of entities. Of these, 25, or 6 per cent received fees for taxation services greater than 50 per cent of total fees.

The FRC considers that the above data does not suggest any problematic trends for auditor independence. In 2008-09, the FRC proposes to continue monitoring trends in fees received by auditors of audited entities for audit and non-audit services provided to those entities.

4 INTERNATIONAL DEVELOPMENTS IN AUDITOR INDEPENDENCE

Subsection 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

During 2007-08, the FRC monitored international developments through the monitoring and consideration of general media reports about audit independence issues as well as material placed on the internet websites of key overseas oversight and standard setting bodies and other regulatory agencies (such as the International Ethics Standards Board for Accountants (IESBA), the International Accounting Education Standards Board (IAESB), the Financial Stability Forum, the UK Professional Oversight Board and the US PCAOB).

In addition, Mr Macek and Mr Lucy, Chairmen of the FRC for, respectively, the period to December 2007 and from December 2007 to date, met with representatives of overseas oversight bodies during international visits in October 2007 and March 2008. The Chairmen were accompanied by a representative from the FRC Secretariat.

One key development during the year was the release by the International Federation of Accountants (IFAC) of a report entitled 'The Financial Reporting Supply Chain: Current Perspectives and Directions'. A number of the report's findings, which are based on an independent global survey of participants in the financial reporting supply chain, have ramifications for audit independence.

The report is based on a global survey commissioned by IFAC to assess the impact of the significant efforts in recent years to change and improve financial reporting. The report identifies positive aspects of the financial reporting supply chain, areas of concern and recommended next steps. In relation to audit independence, the report finds that the strengthening of the independence rules for auditors in recent years has been a positive move that has yielded good results. To further strengthen external audit and to preserve public confidence, the report suggests that a continued focus on independence, objectivity and integrity is required as a priority.

The report identifies some form of audit rotation as a positive for maintaining audit independence, objectivity and integrity. However, it also noted that audit rotation has raised concerns about the loss of valuable knowledge and experience, long lead times to get up to speed and more expensive audits.

A further area of concern identified in the report with potential repercussions for audit independence, is the limited choice of audit firms. It can often be the case that for listed companies the choice may be made only between the Big Four firms. If one is the outgoing auditor and another is providing consultancy services, the choice is narrowed down to two firms. The report recommends the removal of unnecessary barriers that limit the choice of auditor. The level of liability of auditors is seen as one area acting as a barrier to increased supply of auditors and competition between firms.

Further audit independence related international developments included:

- The significant advancement of the independence project of the IESBA. During the year, the IESBA made progress in revising and updating the independence requirements in IFAC's Code of Ethics for Professional Accountants, addressing the meaning of 'public interest entities' and partner rotation issues and strengthening guidance on additional services provided by auditors. These changes were approved by the IESBA in January 2008.
- The release of two major pieces of guidance by the IAESB aimed at assisting professional accountancy organisations and educators in developing high quality ethics education. Specifically, the IAESB released International Education Practice Statement (IEPS) 1, Approaches to Developing and Maintaining Professional Values, Ethics, and Attitudes, and the Ethics Education Tool Kit, which features case studies and supporting notes, presentations, video clips, and other teaching materials. In addition, the IAESB released two IEPSs in 2007-08 addressing information technology and practical experience requirements.

The FRC did not become aware of any international developments during the year that suggest Australia's audit independence requirements are in need of revision or further enhancement. However, in light of recent financial market turmoil, the FRC considers that there may be merit in refreshing awareness of ethical standards and therefore proposes to continue to closely monitor international developments in 2008-09 in relation to the setting, teaching and enforcement of ethical standards as they relate to audit independence.

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 (subparagraph 225(2B)(a)(i));
 - 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 (subparagraph 225(2B)(a)(ii));
 - 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 (subparagraph 225(2B)(a)(iii));
 - 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 (subparagraph 225(2B)(a)(iv)); and
 - the investigation and disciplinary procedures of professional accounting bodies as those procedures apply to Australian auditors (subparagraph 225(2B)(a)(v));

- 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 (paragraph 225(2B)(b));
- giving the Minister reports and advice about the matters referred to in the above paragraphs (paragraph 225(2B)(c));
- 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 (paragraph 225(2B)(d));
- 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 (paragraph 225(2B)(e)); 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 (paragraph 225(2B)(f)).

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.

FRC'S PERFORMANCE OF ITS AUDITOR INDEPENDENCE FUNCTIONS

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

- established an Audit Independence Committee 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); and
- met with the MOU bodies and selected accounting firms.

Audit Independence Committee

The Audit Independence Committee held five meetings during 2007-08.

Members of the Committee during the year were:

- Ms Elizabeth Alexander AM (Chairman to 31 October 2007);
- Mr John Gethin Jones;
- Mr David Jackson (to 19 March 2008);
- Mr Jeffrey Lucy AM (from 11 December 2007);
- Mr Charles Macek (to 10 December 2007);
- Mr Jim Murphy (from 9 April 2008); and
- Ms Catherine Walter AM (Chairman from 7 December 2007).

The Committee's Charter provides that the Committee 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 needed to ensure the FRC meets the obligations imposed on it by subsection 225(2B) of the ASIC Act;
- 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 Australia, the ICAA and the 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 CALDB concerning the exchange of information.

Meetings with MOU bodies and audit firms

For the 2007-08 year, meetings were held with the APRA, ASIC, CPA Australia, the ICAA and the NIA. In addition, meetings were also held with the AQRB, CALDB, the Big Four audit firms and a number of firms in the group immediately below the Big Four.

Auditor independence consultant

In December 2004, Mr William J Bartlett was engaged to assist the FRC in the performance of its auditor independence functions. Mr Bartlett's contract concluded on 20 December 2007.

APPENDIX C

MATTERS ARISING FROM 2006-07 INDEPENDENCE REPORT

The following tabulation lists the matters arising from the 2006-07 independence report and the action that has been taken in respect of each matter.

Page	Issue	Action
4, 27	The FRC proposed to engage a consultant during 2007-08 to undertake a mapping of the reporting supply chain, identifying all participants, their role, inter-relationships and the reward-punishment incentives which shape their behaviour. In the second stage, to be undertaken in 2008-09, the FRC would compare the existing Australian and UK models against the conceptual framework to determine where there is a need to make recommendations to the Minister for refinements to the Australian model.	The evaluation of outstanding recommendations from previous consultations was completed and the FRC decided that, there was no requirement to engage consultants.
4	The FRC intends to consider whether there is a need for it to make any recommendations to the Minister and the professional accounting bodies about issues arising out of the consultants' reports.	The recommendations have been considered and actioned accordingly. Recommendations that have yet to be actioned have been incorporated into the 2008-09 work program.
5	The FRC will continue to review, and analyse, the level of compliance with audit-related disclosure requirements by considering the information provided by the bodies with which the FRC has signed a Memorandum of Understanding (MOU bodies).	Information has been provided by ASIC and the ASX to assist in this task.
5, 11, 34	The FRC plans to continue its research into the quantum of fees received by auditors of audited entities for audit and non-audit services provided to those entities. The FRC is of the view that the provision of audit services versus non-audit services needs to be considered further to ensure that there is no systemic problem. This exercise, whilst looking at the services in monetary terms, will focus on the nature of the work to ascertain whether it may impede auditor independence, and is on the FRC's work program for 2008-09.	The FRC continued to examine this issue and found no evidence of systemic issues and/or impediments to auditor independence in 2007-08.
18	The FRC believes that there would be merit in both ASIC and the professional accounting bodies having appropriate educative programs targeted at auditors.	The FRC continued to encourage ASIC and the professional accounting bodies to further improve and expand their educative programs.

Page	Issue	Action
25	The FRC intends to examine the findings and recommendations collectively made by the consultancies engaged by the FRC from 2005-07.	The FRC considered the recommendations and, where appropriate, has built them into the 2008-09 work program.
28	As part of the 2007-08 work program, the FRC may also consider whether there is a need for it to make any recommendations to the Minister and the professional accounting bodies about the quality review programs and disciplinary procedures of the bodies.	The FRC made informal recommendations to the professional accounting bodies about the quality review programs and disciplinary procedures of the bodies.
30	As part of its 2007-08 work program, the FRC intends considering the need to make recommendations to the Minister and the professional accounting bodies about the promotion and teaching of professional and business ethics by, or on behalf of, the bodies and related matters.	The FRC made informal recommendations to the professional accounting bodies and relevant stakeholders about the promotion and teaching of professional and business ethics through meetings.
32	The FRC will continue to review, and analyse, the level of compliance with audit-related disclosure requirements by considering the information provided by the MOU bodies.	MOU bodies provided relevant reports, and feedback at meetings. An analysis of this information is included in this report.

AUDITOR INDEPENDENCE FUNCTIONS: 2008-09 WORK PROGRAM

Function	Approved work program for 2008-09
<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 will continue to be provided by ASIC (under the terms of the MOU with the FRC).</p> <p>In addition, the FRC will monitor the AQRB's work in this area and consult, as necessary, accounting firms that conduct audits of listed entities.</p>
<p>Monitoring and assessing the nature and overall adequacy of:</p> <ul style="list-style-type: none"> (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. 	<p>In 2008 09, the FRC will continue to perform this function by reviewing information supplied to the FRC under the terms of its MOU with the professional accounting bodies, obtaining information at periodic meetings with and reviewing publicly available information issued by the professional accounting bodies.</p>
<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 continue to be met through the examination of material supplied to the FRC under the terms of the its MOU with the professional accounting bodies, obtaining information at periodic meetings with, and reviewing publicly available information issued by, the professional accounting bodies.</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. (These disclosure requirements are listed in Appendix G.)</p>	<p>As part of its 2008-09 work program, 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>

Function	Approved work program for 2008-09
<p>Giving the Minister reports and advice about the matters referred to above.</p>	<p>The FRC will continue to 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> <ul style="list-style-type: none"> (a) the Corporations Act; and (b) codes of professional conduct; and <p>in the light of those developments give the Minister and professional accounting bodies, reports and advice on any additional measures needed to enhance the independence of Australian auditors.</p>	<p>In 2008-09, the FRC will continue to perform this function by:</p> <ul style="list-style-type: none"> (a) monitoring media reports and information on relevant websites (this information is provided to all FRC members on a monthly basis); and (b) meeting with appropriate bodies in other jurisdictions as part of overseas visits by the FRC chairman and the Secretariat.
<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 reports of the consultants and the recommendations contained in those reports.</p> <p>Consultation with the professional accounting bodies, the APESB and relevant stakeholders will be made concerning the implementation of those recommendations accepted by the FRC.</p> <p>The FRC will seek participation from relevant stakeholders to jointly develop an 'ethics education campaign'.</p>
<p>Other matters.</p> <ul style="list-style-type: none"> (a) Issues associated with the provision of non-audit services. 	<p>The FRC Secretariat will undertake research on this issue during 2008-09. The FRC will continue to monitor trends in fees received by auditors of audited entities for audit and non-audit services.</p>

SHORT GUIDE TO THE AUDITOR INDEPENDENCE REQUIREMENTS IN THE CORPORATIONS ACT⁶

Audit of annual financial report

A company, registered scheme or disclosing entity must have the financial report for a financial year audited in accordance with Division 3 of Part 2M.3 of the *Corporations Act 2001* (the Corporations Act) and obtain an auditor's report (section 301).

A small proprietary company is not required to prepare a financial report unless it is directed to do so under section 293 (shareholder direction) or section 294 (ASIC direction).

Appointment of individual, firm or company as auditor

The Corporations Act allows a company or registered scheme to appoint an individual, or a firm, or a company, as its auditor (section 324AA).

The underlying policy rationale of the Corporations Act is to ensure that audit work for a company or registered scheme is carried out by or under the supervision of one or more registered auditors.

- It is an offence for an individual to consent to be appointed as an auditor, or to act as auditor, or to prepare an audit report, if the individual is not a registered company auditor (section 324BA).
- Where an audit firm is appointed as the auditor of a company or registered scheme:
 - all of the registered company auditors who are members of the firm are treated as auditors of the company (section 324AB(1)); and

⁶ This guide was prepared by the Treasury.

- at least one member of the firm must be a registered company auditor who is ordinarily resident in Australia (section 324BB(5)).
- The CLERP 9 Act permitted auditors to incorporate and to be registered as an authorised audit company:
 - a company appointed as auditor must be an authorised audit company (section 324BC); and
 - Part 9.2A, which establishes a system for the registration of authorised audit companies, requires that:
 - : each director of the company is a registered company auditor (section 1299B(a));
 - : the audit company be controlled and majority owned by registered company auditors (section 1299B(c)); and
 - : ASIC is satisfied that the company has adequate and appropriate professional indemnity insurance for claims that may be made against the company in relation to audits undertaken by the company under the Corporations Act.

A site map of the auditor independence provisions in the Corporations Act

Most of the auditor independence provisions are contained in Division 3 of Part 2M.4 of the Corporations Act. However, the requirements relating to the annual independence declaration and the disclosure requirements relating to non-audit services are contained in Divisions 1 and 3 of Part 2M.3 and the auditor rotation requirements are contained in Division 5 of Part 2M.4.

The general requirement for auditor independence

Australia has incorporated a general standard of independence as a cornerstone of its statutory requirements. The 'general requirement' for auditor independence is contained in Subdivision A of Division 3 of Part 2M.4 of the Corporations Act.

The general requirement obligations are framed around the question of whether a 'conflict of interest situation' has arisen (section 324CD). A 'conflict of interest situation' will arise where:

- an auditor is not capable of exercising objective and impartial judgment in relation to the conduct of an audit having regard to all relevant circumstances,

including all relationships between the auditor and the audit client (the subjective test – independence in mind); or

- a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment in relation to an audit, having regard to all relevant circumstance, including all relationships between the auditor and the audit client (the objective test – independence in appearance).

The inclusion of the general auditor independence requirement, in addition to recognising that an auditor must be independent in mind and appearance, also serves the purpose of ensuring that auditor independence is a comprehensive and continuing requirement in the sense that it applies to all circumstances relating to a particular audit, including all relationships between the auditor and the audit client.

Specific auditor independence requirements applying to employment and financial relationships

Subdivision B of Division 3 of Part 2M.4 of the Corporations Act contains the specific auditor independence requirements encompassing both employment and financial relationship restrictions for an individual auditor (section 324CE), an audit firm (section 324CF) and an authorised audit company (section 324CG).

The restrictions introduced by the CLERP 9 Act substantially implemented the relevant recommendations in the Independence of Australian Company Auditors Report (the Ramsay report) which described these ‘specific restrictions’ as ‘a list of what can be regarded as core circumstances which, if they exist, necessarily mean that the auditor is not independent’.

There are three important aspects to the specific auditor independence requirements which must be recognised in order to fully comprehend how the provisions operate:

- the criminal liability aspects of the requirements;
- the content and scope of the specific restrictions; and
- the notification procedures.

The criminal liability rules

The specific requirements for individual auditors, audit firms and authorised audit companies are dealt with under separate provisions in the Corporations Act because different liability rules apply to individual auditors, firms and authorised audit companies.

The operation of the liability rules can be explained by reference to the requirements applying to audit firms under section 324CF of the Corporations Act. A fundamental principle of the criminal law is that only a natural person, a body corporate or a body politic can be held criminally responsible. An audit firm, being an unincorporated body, is not a legal person and thus cannot be prosecuted and it has been necessary to impose vicarious liability on the partners of the audit firm.

- A partner of an audit firm is liable to be prosecuted under a fault based offence (section 324CF(1)). For purposes of establishing a contravention under section 324CF(1), the evidential burden is placed on the prosecution to prove beyond a reasonable doubt each of the following elements of the offence:
 - the audit firm was engaged in ‘audit activity’ at a particular time;
 - a prohibited employment or financial relationship exists at that time;
 - the defendant was a partner of the firm at that time;
 - the fact that liability will fall on any partner of the firm who has knowledge of the independence breach, and not just a partner who is directly involved in the audit, encourages a firm wide culture of compliance;
 - the defendant knows about the breach (is or becomes aware that the firm was engaged in audit activity at the same time that a prohibited relationship exists); and
 - the defendant has not, as soon as possible after becoming aware of those circumstances, taken all reasonable steps to ensure that the audit firm does not continue to engage in audit activity in those circumstances.
- A strict liability offence for an inadvertent breach that provides a statutory defence which would allow the partner to escape liability by pointing to evidence that shows that he or she had reasonable assurance that the firm had in place a quality control system that provided reasonable assurance that the firm and its employees were complying with the auditor independence requirements section 324CF(2), (3) and (4).

Content and scope of the specific restrictions

The CLERP 9 reforms applied these restrictions on an ‘all partner’ basis, rather than just focussing on those persons in the audit firm with a close connection to the audit who would be able to influence the outcome of an audit (that is the professional members of the audit team). Following public consultation on the discussion paper *Australian Auditor Independence Requirements: A Comparative Review* (the comparative review), the Government decided to limit the restrictions in relation to financial

investments to professional members of the audit team rather than all the partners in the firm. This 'covered person' approach to the financial investment restrictions was implemented under the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* (the SRS Act).

The notification procedures

The CLERP 9 Act introduced notification procedures to ensure that there was a staged process in place before an auditor's appointment was terminated on the grounds of the auditor's failure to address a breach of a specific auditor independence requirement. It is important to emphasise that the operation of the notification procedure is quite separate from the criminal offence provisions in section 324CF(1) and (2). The staged procedures involve the following steps:

- An audit firm is required to notify ASIC within seven days if it becomes aware that there has been a breach of the independence rules that has not been resolved (subsection 324CF(1A) of the Corporations Act). Similar requirements apply to an individual auditor under subsection 324CE(1A) and to an audit company under subsection 324CG(1A) of the Corporations Act. No notification is required if the breach is resolved before the end of the seven day period. ASIC is required to give a copy of the notice to the audit client so that the company is put on notice that its auditor has an independence issue that needs to be resolved.
- After the firm has notified ASIC, the firm has a further 21 days (the remedial period) to resolve the conflict of interest situation (subsection 327B(2B)). Similar requirements apply to an individual auditor under subsection 327B(2A) and to an audit company under subsection 327B(2C) of the Corporations Act.
- An audit firm thus has a maximum period of 28 days after it becomes aware of a conflict of interest situation to rectify the conflict (the initial seven day period plus the 21 day remedial period).
- If the conflict of interest situation is not resolved at the end of the 21 day remedial period, the audit firm's appointment as auditor of the particular audit client automatically terminates (subsection 327B(2B)). Similar requirements apply to an individual auditor under subsection 327B(2A) and an audit company under subsection 327B(2C) of the Corporations Act.
- ASIC has been given the power to extend the remedial period of 21 days referred to in section 327B of the Corporations Act, in appropriate circumstances.

Cooling off period for former audit team partners

To deal with the threat to independence when a retired audit partner joins the board of an audit client, the Ramsay report recommended that there be a mandatory period of

two years following resignation from the audit firm before a former audit partner could become a director of the client.

This recommendation was implemented by section 324CI of the Corporations Act which imposed a mandatory period of two years from the date of departure from the firm before a former partner of an audit firm, or a former director of an audit company, who was on the audit team can become an officer of the audit client. A similar restriction was imposed on the lead or review auditor of an authorised audit company under section 324CJ.

Following public consultation on the comparative review, the Government modified the way in which the two year separation period is calculated in the SRS Act by amending section 324CI(d) to ensure that the two year separation period commences from the date the auditor's report under section 308 (annual financial report) or section 309 (half year financial report) was made in respect of the latest audit in which the former partner or former director participated.

- For example, where a retiring partner had last worked on an audit of the audit client five years prior to the partner's departure from the firm, the partner would be able to become an officer of the audit client immediately after leaving the firm. Prior to the amendment made by the SRS Act, the retiring partner would have been required to wait for two years from the date of departure from the firm before joining the audit client.

A similar amendment was made in the SRS Act to section 324CJ(d) in relation to a former lead auditor or review auditor of an audit company.

Multiple former audit firm partner restriction

The HIIH report recommended that in implementing the proposed CLERP 9 Act, the proposals for restrictions on employment relationships between an auditor and the audit client should include 'a prohibition on any more than one former partner of an audit firm, at any time, being a director of or taking a senior management position with the client'.

The HIIH recommendation was implemented as part of the CLERP 9 Act reforms in section 324CK of the Corporations Act.

In its response to the Report of the Taskforce on Reducing Regulatory Burdens on Business, Rethinking Regulation, the Government announced that it would review the multiple audit firm partner restriction by the end of 2006. The Treasury progressed this review through its targeted consultation on the comparative review.

All the respondents agreed that the restriction in section 324CK serves a useful purpose, however there was also agreement that some changes should be made to

address the perceived over reach of the existing requirement. The stakeholders proposed that former partners of an audit firm and former directors of an authorised audit firm who had departed from the firm or audit company for five or more years should be excluded from the restriction.

A minimum five year separation period was considered appropriate because the longer former partners have been out of the firm, the less likely they will be in a position to influence the current professional members of the audit team or be so familiar with the audit approach and testing strategy that they are able to circumvent them. A time limit is also easy to apply and enforce.

The SRS Act amended section 324CK(c) to limit the application of the restriction in section 324CK to a former member of an audit firm or former director of an audit company who becomes an officer of the audited body within a period of five years after the person ceased to be a member of the audit firm or a director of the audit company (as the case may be).

Auditor rotation

The auditor rotation requirements are contained in Division 5 of Part 2M.4 of the Corporations Act and were introduced as part of the CLERP 9 Act auditor independence reforms.

The rotation requirements only apply to audits of listed companies and listed registered schemes.

There are two basic auditor rotation requirements:

- The 'time out' rule in section 324DA(1).
 - The time out rule provides that an individual who has played a significant role in the audit of a particular client for five successive financial years is not eligible to continue to play a significant role unless the individual has not played such a role for at least two successive financial years. This means that:
 - : where an individual auditor has been appointed as the auditor of the listed company or listed scheme, that individual and the review auditor (if any) must rotate; or
 - : where an audit firm or authorised audit company has been appointed as the auditor of the company or scheme, only the lead auditor and the review auditor (if any) must rotate.
- The '5/7 rule' in section 324DA(1).

- The 5/7 rule provides that an individual may not play a significant role in the audit of a particular audit client for more than five out of seven successive financial years. The 5/7 rule prevents an individual from avoiding the 'time out' rule, for example, in circumstances where an individual plays a significant role for four successive years, resigns from the audit for only one year and then resumes playing a significant role for another four successive years.

The rotation requirements do not require that the audit firm or the authorised audit company rotate.

ASIC has a limited power under section 342A of the Corporations Act to modify the rotation requirements. The relief power allows ASIC to:

- declare that the time out rule applies to an individual as if the references to five successive years were reference to six or seven successive years; or
- declare that the 5/7 rule applies to an individual as if the references to five out seven successive financial years were references to six out of seven successive financial years.

ASIC may only use its relief power if it is satisfied that, without modification, the rotation requirements would impose an unreasonable burden on:

- the individual registered company auditor (the lead auditor or review auditor in the case where an audit firm or audit company has been appointed the auditor of an audit client);
- the audit firm or audit company on whose behalf the lead auditor or review partner acts in relation to the audit; or
- the audit client.

Auditor's annual independence declaration

The CLERP 9 Act introduced a new requirement in section 307C of the Corporations Act that an auditor provide a declaration as to whether the auditor is aware of any contraventions of the auditor independence requirements of the Act or of any applicable codes of professional conduct. Where an audit firm or audit company has been appointed as the auditor of a company or registered scheme, the obligation to provide a declaration has been imposed on the lead auditor (section 307C(3)).

The SRS Act addressed a timing anomaly in the CLERP 9 requirements so that section 307C(5)(a) now provides that the declaration must either be given when the

audit report is given to the directors of the company, registered scheme or disclosing entity or must satisfy the conditions in section 307C(5A).

For the purposes of section 307C(5A) a declaration must satisfy the following conditions:

- the auditor's independence declaration is given to the directors and the directors sign the report within seven days after the declaration is given to the directors;
- the auditor's report on the financial report is made within seven days after the directors' report is signed; and
- the auditor's report includes a statement to the effect that either the declaration would be in the same terms if it had been given to the directors at the time the auditor's report was made, or circumstances have changed since the declaration was given to the directors, and setting out how the declaration would differ if it had been given to the directors at the time the auditor's report was made.

Non-audit services

Australia opted not to impose a legislative ban on non-audit services. The Ramsay report considered whether non-audit services should be dealt with exclusively in either the Corporations Act or the ethical rules or whether a co-regulatory model might be appropriate. The Ramsay report concluded that the arguments favoured retaining the professional ethical rules, updated to reflect the IFAC Code requirements, as the basic guidance on maintaining audit independence when providing non-audit services to audit clients. In particular, the Ramsay report said that it had not uncovered any evidence to suggest that there were systemic failures within the accounting profession in complying with the ethical rules for providing non-audit services to clients.

The Ramsay report also recommended enhanced disclosure in a company's financial statements in relation to non-audit services provided by the external auditor, either as part of the accounting standards or as an amendment to the Corporations Act.

The Government adopted the basic approach recommended by the Ramsay report. The regulatory regime in Australia in relation to non-audit services comprises a matrix of requirements in the Corporations Act, the Accounting Standards and the professional accounting bodies' ethical rules:

- section 300(11B) of the Corporations Act provides that the annual directors' report of a listed company must disclose the fees paid for non-audit services provided by the auditor during the financial year, as well as a description of each service. In addition, the board of directors (in accordance with advice of the audit committee where applicable) is required under subsection 300(11D) to make a

statement that they are satisfied that the provision of non-audit services is compatible with the general auditor independence requirement imposed by the Corporations Act and an explanation of why those non-audit services do not compromise auditor independence;

- the general auditor independence requirement imposed on auditors under the Corporations Act applies to any non-audit service arrangement between an audit firm and an audit client. This enables ASIC to challenge a particular non-audit service arrangement when it considers that the arrangement creates a subjective and/or objective threat to the auditor's independence;
- a non-audit service provider (defined in section 9) for an auditor conducting an audit is subject to a number of financial investment restrictions if the provider exceeds a maximum hours test relating to the provision of non-audit services (10 hours) either during the period to which the audit relates or during the 12 month period immediately before the audit commences (section 324CE(5), table item 5 (individual auditor); section 324CF(5), table item 6 and section 324CF(6) (audit firm) and section 324CG(9), table item 6 and section 324CG (audit company));
- the Accounting Standards (AASB 101: Presentation of Financial Statements: Aus 126.1 and Aus 126.2) also require disclosure by an entity and by a group of details of non-audit services provided to the entity and to the group; and
- the *Code of Ethics for Professional Accountants* (APES 110) implements the ethical rules adopted by the International Federation of Accountants (the IFAC Code) in relation to non-audit services.

APES 110 recognises that non-audit services may create threats to the audit firm's independence and requires auditors to evaluate the significance of any threat created by the provision of such services. APES 110 provides that in some cases it may be possible to eliminate or reduce the threat created by the application of safeguards. In other cases, no safeguards are available to reduce the threat to an acceptable level, and if this is the case, APES 110 requires either the audit services or the non-audit services to be refused (APES 110: paragraph 290.158).

INSTITUTIONAL ARRANGEMENTS FOR MONITORING COMPLIANCE WITH AUDIT-INDEPENDENCE REQUIREMENTS

Australian Securities and Investments Commission

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.

ASIC conducts inspections of audit firms to assess their compliance with the audit requirements of the Corporations Act and auditing standards, including audit independence provisions.

ASIC also conducts financial reporting and auditor surveillance activities in relation to compliance by auditors and companies with the independence disclosure requirements of the Act.

Australian Securities Exchange

The ASX is required under the Corporations Act to ensure that the listed company markets are fair, orderly and transparent. Since 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 professional accounting bodies (the ICAA, CPA Australia and the NIA) undertake regular mandatory quality reviews of members who have a Certificate of Public Practice or Public Practice Certificate. The reviews include ensuring their members are complying with the accounting, auditing and assurance standards and the code of ethics issued by the APESB. The reviews take place on a rolling three-year program for auditors of listed entities.

The AQRB monitors firms that audit publicly listed companies (currently its role is limited to the Big Four firms) to assess whether they comply with professional standards and the law.

Each of the professional accounting bodies has entered into a Memorandum of Understanding with the AQRB under which they share information where appropriate, consult regularly and promote discussion on issues such as quality control and independence in the auditing of publicly listed companies. Since June 2007, the AQRB has been represented on the ICAA's Quality Review Committee.

Accounting Professional and Ethical Standards Board

The APESB was established in February 2006 by the ICAA and CPA Australia as an independent body to set the code of ethics and the professional standards by which their members are required to abide. The NIA has subsequently become a member of the APESB.

Audit Quality Review Board

The AQRB is a not for profit company limited by guarantee that was established in December 2005 for an initial three year term at the initiative of, and with the commitment of, the four largest accounting firms, to act as an independent review body. The AQRB, which is chaired by Professor the Hon Andrew Rogers QC, has up to 10 members who have broad knowledge and experience in legal, regulatory, business and auditing affairs.

The Board has established a Constitution, Code of Conduct and Rules, which provide the framework for its operations.

The initial participants in the AQRB's review program were the Big Four accounting firms, which audit collectively 90 per cent by composition and 95 per cent by market capitalisation of the 300 largest listed entities on the ASX. Participation in the program is voluntary and available to all Australian audit firms which audit listed companies.

The AQRB's primary purpose is to monitor the processes by which participating audit 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. In its 2007 reviews the AQRB has expanded its scope to cover 'public listed entities', which it has defined as public listed entities, unlisted disclosing entities, APRA regulated bodies and large proprietary companies (as defined in the Corporations Act).

The AQRB has stated that it 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. The FRC understands that the future of the AQRB is currently being reviewed.

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 APRA against an auditor or liquidator. The 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; and suspend or cancel a person's registration. The CALDB does not have the power to initiate disciplinary actions on its own.

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.

AUDIT-RELATED DISCLOSURE REQUIREMENTS OF THE CORPORATIONS ACT AND ACCOUNTING STANDARDS

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

- subsection 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 342A⁷, 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 of 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;

⁷ 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.

- : 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
- 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).