

## CHAPTER 1: AUDIT REFORM

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25. Schedule 1 of the Bill contains the amendments for the reform of the audit provisions in the *Australian Securities and Investments Commission Act 2001* (ASIC Act) and the *Corporations Act 2001*. Within the Schedule the amendments are grouped as follows:

- Part 1        Auditing standards
- Part 2        Qualifications of auditors
- Part 3        Auditor appointment, independence and rotation requirements
- Part 4        Registration of authorised audit companies
- Part 5        Auditors and AGMs
- Part 6        Qualified privilege
- Part 7        Expansion of auditors' duties
- Part 8        Companies Auditors and Liquidators Disciplinary Board

## PART 1: AUDITING STANDARDS

### Overview

26. The text in this Part of the Commentary is divided into the following topics:

- new and amended definitions;
- changes to objects of Part 12;
- changes to FRC's functions and powers;
- AUASB's establishment, functions, powers, procedures, membership and other administrative matters;
- auditing standards; and
- liability for damages.

27. The Bill expands the responsibilities of the Financial Reporting Council (FRC), which currently oversees the accounting standard setting process, to oversee auditor independence requirements in Australia and the auditing standard setting arrangements. To this end, the existing Auditing and Assurance Standards Board (AuASB)<sup>1</sup> will be reconstituted with a Government appointed Chairman under the auspices of the FRC, similar to the Australian Accounting Standards Board (AASB). Auditing standards will have the force of law on the same basis as AASB standards.

28. These arrangements will bring together, under a single oversight body, policy advising, monitoring and technical oversight functions for the key elements of the financial reporting framework. Having broad policy direction coming from a single overarching body will ensure coherent and effective oversight while at the same time protecting the independence of the two technical boards within the structure.

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<sup>1</sup> The AuASB currently exists as a board of the Australian Accounting Research Foundation, an unincorporated body jointly controlled and funded by The Institute of Chartered Accountants in Australia and CPA Australia.

29. Part 1 of Schedule 1 of the Bill amends both the ASIC Act and the Corporations Act to implement the oversight arrangements. In particular, this Part:

- sets out new functions for the FRC in relation to auditor independence and oversight of the audit standard setting process;
- establishes the Auditing and Assurance Standards Board (AUASB) as a statutory body corporate and sets out its functions, powers, membership structure and administrative arrangements;
- gives the AUASB power to make auditing standards for the purpose of the Corporations Act; and
- requires auditors to comply with standards made by the AUASB when conducting Corporations Act audits and provide for the imposition of penalties where auditors fail to comply with such standards.

## Definitions

30. The Bill contains a number of new and amended definitions which are inserted into subsection 5(1) of the ASIC Act (see Items 2 to 6) and section 9 of the Corporations Act (see Items 33, 34 and 35). Particular definitions to note are:

- 'AUASB' is an abbreviation for the Auditing and Assurance Standards Board that is used in both the ASIC and Corporations Acts (items 2 and 33);
- 'auditing standard' is defined to mean either a standard in force under proposed section 336 or a provision (paragraph) of such a standard (item 34);
- 'Australian auditor', which is defined to mean an individual auditor, an audit firm or an audit company that is conducting, or has conducted, Corporations Act audits, has been included in the legislation to facilitate the drafting of proposed amendments to Part 12 of the ASIC Act (item 3);
- 'international auditing standards', means standards made by the International Auditing and Assurance Standards Board (IAASB) (a body established by the International Federation of Accountants) (paragraph (a) of the definition) or another body specified in the regulations (paragraph (b) of the definition). Paragraph (b) has been included principally to provide flexibility in the event that another overseas body/standard setter takes over the role of the IAASB in developing a set of internationally accepted

auditing standards (cf. definition of 'international accounting standards') (item 4);

- 'member' means, in relation to the AUASB, a member of that body (item 5);
- 'professional accounting body' means a body prescribed by the regulations for the purposes of the definition. It is envisaged that Australia's three main accounting bodies will be prescribed: CPA Australia, The Institute of Chartered Accountants in Australia and the National Institute of Accountants (items 6 and 35).

### **Changes to objects of Part 12 of ASIC Act**

31. Items 8 and 9 amend section 224 (Main objects of this part) to reflect the CLERP 9 decision to reconstitute the AUASB as a statutory body and to give auditing standards the force of law.

32. Item 8 inserts proposed paragraph 224(aa), which provides that one of the objects of Part 12 is to facilitate the development of auditing standards that:

- provide auditors with relevant and comprehensive guidance in forming an opinion about, and reporting on, financial reports; and
- require the preparation of auditors' reports that provide beneficial information to the users of the financial reports to which they relate.

#### **Issue 1.1**

Does proposed paragraph 224(aa) adequately express the role auditing standards should be playing in Australia's financial reporting system?

### **Changes to FRC's functions and powers**

#### **Oversight of AUASB**

33. Items 11, 12 and 13 of the Bill amend section 225 of the ASIC Act (Functions and powers of the Financial Reporting Council) to reflect that the FRC will be responsible for overseeing both the AASB and the AUASB.

34. Provisions relating to the FRC's oversight of the AUASB are modelled on the current AASB/FRC arrangements (see proposed subsection 225(2A)).

35. One area in which the FRC's oversight functions for the AUASB differs slightly in terms of wording, but significantly in terms of outcome, from its existing functions in respect of the AASB concerns promoting the adoption of international best practice standards in Australia. As the AUASB already has a policy of adopting international best practice auditing standards, the FRC's function refers to 'promoting the continued adoption' of such standards (see proposed paragraph 225(2A)(g)) to reflect the current state of affairs. As the AASB is now also in the process of adopting international best practice accounting standards, an equivalent amendment is being made to the FRC's functions in respect of that body — proposed paragraph 225(2)(g) refers.

### Monitoring auditor independence

36. Item 11 of the Bill also amends section 225 of the ASIC Act to specify the FRC's functions in relation to auditor independence.

37. Proposed subsection 225(2B) provides that the FRC's auditor independence functions include:

- monitoring and assessing the nature and overall adequacy of:
  - the systems and processes used by:
    - : Australian auditors to ensure compliance with auditor independence requirements; and
    - : professional accounting bodies for planning and performing quality assurance reviews of audit work; and
  - the investigation and disciplinary procedures of the professional accounting bodies;
- monitoring the overall compliance by companies and other entities with audit-related disclosure requirements;
- giving the Minister and professional accounting bodies reports and advice about the above matters;
- monitoring international developments in auditor independence, assessing the adequacy of Australian requirements in light of those developments and giving the Minister and professional accounting bodies reports and advice on any additional measures needed to enhance Australian requirements; and
- promoting the teaching of professional and business ethics by the professional accounting bodies, universities and other tertiary institutions.

38. It is important to note that, notwithstanding the FRC's extensive functions on auditor independence, its role is purely one of monitoring activities and/or developments and providing appropriate advice to Ministers or the accounting bodies. Enforcement of auditor independence requirements is the responsibility of either ASIC or the accounting bodies, depending on whether the independence requirement is contained in the Corporations Act or a code of professional conduct of one of the bodies.

39. The FRC is currently considering how to operationalise its role within this overarching framework.

### Information gathering powers

40. To assist the FRC in the performance of its auditor independence functions, proposed section 225A (item 14) gives the FRC power to obtain from each professional accounting body: information about, or documents relating to:

- its code or proposed code of professional conduct and proposed amendments to that code;
- its planning and performance of quality assurance reviews, to the extent that those reviews apply to audit work undertaken by Australian auditors; and
- its investigation and disciplinary procedures, to the extent that those procedures apply to Australian auditors.

41. It should be noted that the FRC may not seek information from an accounting body about the review of a particular audit or an investigation of, or disciplinary action taken against, a particular person (proposed paragraph 225A(2)(b)).

42. The FRC may also give written notice to an Australian auditor for the purpose of obtaining information about, or documents (including audit working papers) relating to, one or more audits conducted by the auditor and the measures adopted, or the procedures put in place, to ensure the auditor was, and continues to be, independent of the audited body (proposed subsection 225A(3)). An auditor must comply with a notice to provide such information, even it results in a breach of any obligation of confidentiality between the auditor and the audited body (proposed subsection 225A(4)). The purpose of these subsections is to enable the FRC to obtain information about the systems and processes that have been put in place by auditors and to assess, by reference to material about individual audits, whether those systems and processes are being followed by the auditor when it conducts an audit.

## Audit papers

43. As a means of assisting the FRC monitor auditor independence, and as a mechanism to facilitate ASIC's enforcement role, item 36 amends the Corporations Act by inserting proposed section 307B which requires auditors to retain all documents (including audit working papers) for a period of seven years after the date of the audit report.

44. The legislation will allow ASIC to approve the destruction of the working papers before the end of the seven year period where an individual auditor dies or resigns their registration, an audit firm is dissolved or an authorised audit company is wound up or ceases to be authorised to conduct audits. However, before approving the destruction of any papers ASIC is required to consider whether:

- it is investigating any matters concerning the auditor or audited body to which the papers relate;
- a professional accounting body has an investigation or disciplinary action pending in relation to the auditor;
- there are civil or criminal proceedings in relation to the audit or the contents of the financial report to which the papers relate have commenced or are about to commence.

## *Transitional arrangements*

45. Proposed section 1450 of the Corporations Act (inserted by item 1 of Schedule 12) provides that proposed section 307B applies in respect of a financial year that begins on or after the day on which the Bill commences.

## Reporting to Ministers

46. Item 22 inserts section 235BA, which requires the FRC to report annually to the Minister on its audit independence functions, including the findings and conclusions that it reached in performing those functions and the actions that it took in relation to those findings and conclusions.

47. The report, which may be included in the FRC's annual report under section 235B or prepared separately, must be tabled in Parliament.

## **AUASB's establishment, functions, powers, procedures, membership and other administrative matters**

48. Amendments to the ASIC Act to establish the AUASB, set out its functions and powers, require it to have regard to the views of the FRC, specify its meeting procedures and provide for its membership arrangements are contained in items 15, 19 and 25 to 30.

49. Except where noted, these provisions mirror the equivalent AASB provisions.

### **Establishment, functions and powers**

50. Item 15 of the Bill amends the ASIC Act to establish the AUASB (proposed section 227A) and set out its functions and powers (proposed section 227B).

51. Section 227A establishes the AUASB as a body corporate thereby allowing it to employ staff and acquire property in its own right. This means the AUASB will be a Commonwealth authority for the purposes of the *Commonwealth Authorities and Companies Act 1997* (CAC Act). This Act sets out the reporting, financial and other requirements with which Commonwealth authorities must comply.

52. As with the AASB, it is envisaged that the AUASB's reporting obligations under the CAC Act will be covered by the report that the FRC prepares in accordance with section 235B and the AUASB will not be required to prepare a separate report specifically for the purposes of the CAC Act. To this end, the Bill amends section 235B of the ASIC Act (see items 20 and 21) to require the FRC's annual report to contain:

- disclosures about the operations of the AUASB and its committees, advisory panels and consultative groups (proposed subparagraph 235B(1)(a)(iii)); and
- details of any change to the AUASB's priorities or business plan that was made as a result of action taken by the FRC (proposed subsection 235B(2A)).

53. Under proposed section 227B, the significant functions of the AUASB will be to:

- make auditing standards for the purposes of the Corporations Act;
- formulate auditing standards for purposes other than those of the Corporations Act (for example, non-financial audits such as performance or efficiency audits); and

- participate in the formulation of international auditing standards so as to influence their content towards the achievement of the objectives set out in section 224.

### **Issue 1.2**

Proposed section 227B is silent about the ability of the AUASB to formulate standards to be used for assurance engagements and to develop guidance material for auditors performing audit and assurance engagements. Comments are sought on whether the AUASB needs to be given such functions.

54. For the purpose of performing these functions, the AUASB will have power to engage staff and consultants, establish committees, advisory panels and consultative groups, and receive money contributed towards its operating costs.

55. The AUASB will be empowered to make an Australian auditing standard by issuing the text of an international standard with any minimum modification to ensure that the standard operates effectively having regard to the existing Australian legislative framework and institutional regulatory arrangements. The AUASB may make such a standard regardless of the fact that the international standard does not reflect the views of the AUASB when it provided comments on the exposure draft of the standard or when the AUASB participated in any deliberations during the standard's development. The rationale for this is that it may be considered in Australia's best interests to adopt an international standard with minimum modification because it represents the results of many deliberations and compromises necessary to achieve international acceptance.

56. The provisions dealing with auditing standards refer to the AUASB 'making' and 'formulating' auditing standards. The word 'making' is used when the AUASB issues a standard for the purposes of the Corporations Act while the word 'formulated' is used when the standard is for other purposes (for example, non-financial audits).

### **Issue 1.3**

Proposed subsection 227B(1) does not confer on the AUASB the function of developing a conceptual framework for the purpose of evaluating proposed Australian and international auditing standards. Comments are sought on whether the AUASB needs to be given such a function.

## AUASB to have regard to FRC views

57. Item 19 inserts proposed section 234C which provides that, when it is performing its functions, the AUASB must have regard to the FRC's views concerning the broad strategic direction of the standard setter, follow the general policy directions given to the standard setter by the FRC and take into account the advice and feedback provided by the FRC on matters of general policy.

58. The FRC does not have a power to direct the AUASB in relation to the development, or making, of a particular standard (see proposed subsection 225(7)).

## AUASB — general provisions

59. Item 25, which inserts 'Subdivision BA — The Auditing and Assurance Standards Board' into Part 12 of the ASIC Act, contain provisions which set out the procedural requirements for the conduct of AUASB meetings and provisions concerning AUASB membership.

### *Meeting procedures*

60. Proposed section 236E (Procedures) contains a number of procedural requirements relating to the conduct of AUASB meetings. As with the AASB, a meeting, or part of a meeting, concerned with the content of an auditing standard must be held in public.

### *Appointment, resignation and termination of members of the AUASB*

61. Proposed section 236F (Appointment of members of the AUASB) sets out the procedures for appointing the Chair and other members of the AUASB. These requirements mirror requirements currently applying to the AASB.

62. Proposed section 236G (Resignation and termination of appointment) deals with the manner in which the Chair or another member of the AUASB may either resign or have their appointment terminated. The independence of the AUASB is preserved by strictly limiting the grounds upon which an appointment can be terminated.

63. In the case of resignation, the Chair is required to provide a written resignation to the Minister, while other members are required to provide a written resignation to the Chair of the FRC (proposed subsection 236G(1)).

64. The Minister may terminate the appointment of the Chair for misbehaviour or physical or mental incapacity. The Minister must terminate the appointment of the Chair if the Chair:

- becomes bankrupt;
- applies to take the benefit of any law for the relief of bankrupt or insolvent debtors;
- compounds with their creditors;
- makes an assignment of his or her remuneration for the benefit of their creditors; or
- contravenes section 237 (proposed subsections 236G(3) and (4)).

65. Proposed subsections 236G(6) and (7) deal with the circumstances in which the FRC may or must terminate the appointment of a member of the AUASB (other than the Chair). These subsections are expressed in terms similar to proposed subsections 236G(3) and (4) and give the FRC the same powers in respect of AUASB members as the Minister has in respect of the AUASB's Chair.

66. Under proposed section 236H (Acting appointments), the Minister will be able to appoint a person to act as Chair of the AUASB during any vacancy in the office of Chair or at any time when the Chair is absent from duty (proposed subsection 236H(1)). Similarly, the members of the AUASB will also have the ability to appoint one of their number to act as Deputy Chair during any vacancy in the office of Deputy Chair or at any time when the Deputy Chair is absent from duty (proposed subsection 236H(2)). The FRC will also be able to appoint a person to act as a member of the AUASB (other than Chair) during any vacancy in the office of member or at any time when a member is absent from duty (proposed subsection 236H(3)).

67. Subsection 236H(1) is primarily intended to ensure that any delegations, functions or powers that can only be exercised by the Chair of the AUASB can continue to be dealt with during any period in which there is either no Chair (for example, because of death, resignation or expiration of appointment) or the Chair is absent (for example, because of overseas representational requirements, recreation leave or illness). The other provisions are intended to ensure that the AASB retains the structure and the number of members needed to operate effectively and efficiently.

### Confidentiality requirements

68. Items 26 to 28 amend section 237 of the ASIC Act (Confidentiality) to make the AUASB subject to the same confidentiality requirements that are currently applicable to the FRC and AASB.

69. The practical effects of these amendments are that the AUASB:

- will be required to protect from unauthorised use or disclosure information that is given to it in confidence;
- may disclose information where such disclosure is allowed by a law of the Commonwealth, is made to enable an authority or a person in a jurisdiction outside Australia to perform or exercise a function or power that corresponds to any of the functions or powers of the AUASB, or is made to a body that sets international auditing standards; and
- may disclose information to ASIC to facilitate ASIC's performance of its functions under the corporations legislation (other than the excluded provisions<sup>2</sup>).

### Moneys of AASB and AUASB

70. Items 29 and 30 amend section 238 (Application of money) to include provisions concerning the moneys of the AUASB. The moneys of the AUASB may only be applied:

- in payment or discharge of the costs, expenses and other obligations incurred by the AUASB in the performance of its functions or the exercise of its powers;
- in paying or discharging, or reimbursing someone for, the costs, expenses and other obligations incurred in connection with the performance by the FRC of its functions and the exercise of its powers;
- in meeting the administrative expenses of the committees and advisory groups the FRC establishes;
- in payment of any remuneration and allowances payable to any person appointed to the FRC or the AUASB; and
- in making payments to the AASB (proposed subsection 238(2)).

71. Equivalent amendments are proposed to the provision dealing with the moneys of the AASB (currently section 238).

72. The provisions have been structured so that either the AASB or AUASB may:

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<sup>2</sup> The excluded provisions are section 12A (other functions and powers) and Division 2 of Part 2 (unconscionable conduct and consumer protection in relation to financial services) of the ASIC Act.

- pay or discharge the costs, expenses and other obligations incurred by the FRC; and
- pay the remuneration and allowances payable to any person appointed to the FRC.

73. The objective of these provisions is to enable the expenses of the FRC to be shared by the AASB and AUASB in accordance with decisions made by the FRC. The ability of the AASB and AUASB to make payments to each other is also intended to:

- facilitate payment of FRC expenses where one body makes the payments and the other body reimburses the first body (for example, the AASB pays all of the FRC's expenses and is reimbursed by the AUASB); and
- allow the sharing of contributions made by government, the accounting profession and business towards the cost of the standard setting arrangements where the payment is made to one body but is intended to be for the three bodies.

## **Auditing standards**

### **Procedural matters**

74. Item 19, which inserts Division 2A into Part 12 of the ASIC Act, contains provisions dealing with:

- the interpretation of auditing standards;
- some of the powers of the AUASB to make standards;
- requirements with which the AUASB must comply when making standards; and
- the ability of the FRC and the Minister to give directions to the AUASB.

75. The provisions of this Division are based on the equivalent accounting standards requirements in Division 2 of Part 12. The principal difference is the omission of requirements equivalent to:

- section 230, which provides that accounting standards for the preparation of financial reports for a period may require the inclusion of comparative amounts for earlier periods; and

- section 231, which requires the AASB to carry out a cost/benefit analysis of the impact of a proposed Australian or international accounting standard.

76. Notwithstanding the omission of a provision equivalent to section 231, the AUASB will still be obliged to prepare a cost/benefit analysis of a proposed Australian auditing standard, or a significant amendment to such as standard. The Government's requirements for the preparation of Regulation Impact Statements (RIS), which are applicable to the AUASB, includes a requirement for an analysis of costs and benefits.

77. Major features of Division 2A are:

- Proposed section 234A provides that auditing standards are to be interpreted in a manner that promotes the objects of Part 12 of the ASIC Act. In addition, the proposed section provides that each auditing standard made by the AUASB is to be interpreted in a manner that promotes the purpose or objective of that auditing standard, provided that that purpose or objective is not contrary to the purpose or objective of Part 12 of the ASIC Act.
- Proposed section 234B provides that auditing standards may be of general application (that is, apply to all audits) or limited application (that is, apply to different types of audit and specified industries or entities).
- Proposed section 234D provides that the Minister may give the AUASB a direction about the role of international auditing standards in the Australian auditing standard setting system. However, prior to giving a direction to the FRC, the Minister must obtain and consider a report from the FRC about the desirability of giving the direction.
  - This provision is intended to provide a mechanism for the Minister, upon the advice of the FRC, to require the AUASB to move towards greater adoption of international standards if it is considered appropriate and the AUASB has not moved in that direction of its own accord.
  - In practice, this provision is likely to have little effect as the AUASB is already working towards convergence of Australian auditing standards with international standards. In addition, the AUASB is currently considering the appropriateness of adoption of international auditing standards as Australian standards.
- Should the AUASB, through error or oversight, fail to follow all the procedures associated with the making of auditing standards when it makes or formulates a particular standard (for example, fails to have regard to the views of the FRC), the error or oversight will not affect the validity of the

standard made as a result of those defective procedures (proposed section 234E).

### **Making auditing standards**

78. Proposed section 336 of the Corporations Act, which is inserted by item 40, provides that the AUASB may make auditing standards for the purposes of that Act. A standard, which must be in writing and must not be inconsistent with either the Corporations Act or the Corporations Regulations, is a disallowable instrument for the purposes of section 46A of the *Acts Interpretation Act 1901*. This means each standard made by the AUASB has to be tabled in each House of the Australian Parliament within 15 sitting days after the day on which the standard is made (proposed subsections 336(1) and (2)).

79. Auditing standards made by the AUASB are expressed to apply to financial reports in respect of particular financial periods. The Bill provides that, in the absence of a specific commencement date in a standard, the standard applies to each financial period ending after the commencement of the standard. The AUASB may, however, specify a later commencement date and provide that the standard is to apply to all financial periods either ending or starting on or after that date (proposed subsection 336(3)).

80. Proposed subsection 336(4) allows auditors to adopt an auditing standard before the commencement date specified in the standard, provided the standard does not expressly preclude early adoption. Where an auditor adopts a standard prior to its commencement date, the auditor's decision must be recorded in the audit report.

### *Transitional arrangements*

81. Proposed section 1451 of the Corporations Act, which is inserted by item 1 of Schedule 12, is designed to give interim legal backing to some or all of the auditing standards made by the AUASB, as currently constituted, and issued by the Australian Accounting Research Foundation (AARF) on behalf of The Institute of Chartered Accountants in Australia and CPA Australia. The primary objective of the transitional provision is to ensure there is, and continues to be, a comprehensive body of standards available to provide guidance to auditors who are appointed to conduct audits under the Corporations Act.

82. The auditing standards to be given interim legal backing will be listed in regulations made for the purpose of proposed subsection 1451(1) and will have effect as if they were made by the AUASB under proposed section 336 on the day specified in the regulations. Table 1 lists existing auditing standards. All

standards that are relevant to Corporations Act audits are expected to be prescribed in the regulations.

83. Auditing standards that are given interim legal backing are to be subject to a two-year sunset period, although provision is made for the regulations to extend the period. During the two-year period (or such longer period as may be allowed by the regulations) it is proposed that the AUASB should review the standards and remake them in accordance with proposed section 336.

**Table 1: Australian Auditing Standards as at 1 October 2003**

Reference	Title	Date issued or revised
AUS 102	Foreword to Australian Auditing and Assurance Standards and Guidance Statements	January 2002
AUS 104	Glossary of Terms	July 2002
AUS 106	Explanatory Framework for Standards on Audit and Audit Related Services	November 2001
AUS 108	Assurance Engagements	October 2001
AUS 202	Objective and General Principles Governing an Audit of a Financial Report	July 2002
AUS 204	Terms of Audit Engagements	June 2000
AUS 206	Quality Control for Audit Work	July 2002
AUS 208	Documentation	July 2002
AUS 210	The Auditor's Responsibility to Consider Fraud and Error in an Audit of a Financial Report	January 2002
AUS 212	Other Information in Documents Containing Audited Financial Reports	October 1995
AUS 214	Auditing in a CIS Environment	October 1995
AUS 218	Consideration of Laws and Regulations in an Audit of a Financial Report	January 2002
AUS 302	Planning	October 1995
AUS 304	Knowledge of the Business	July 2002
AUS 306	Materiality and Audit Adjustments	May 2001
AUS 402	Risk Assessments and Internal Controls	July 2002
AUS 404	Audit Implications Relating to Entities Using a Service Entity	July 2002
AUS 502	Audit Evidence	October 1995
AUS 504	External Confirmations	July 2002
AUS 506	Existence and Valuation of Inventory	July 2002
AUS 508	Inquiry Regarding Litigation and Claims	July 2002
AUS 510	Initial Engagements — Opening Balances	July 2002
AUS 512	Analytical Procedures	October 1995
AUS 514	Audit Sampling and Other Selective Testing Procedures	April 1998
AUS 516	Auditing of Accounting Estimates	October 1995
AUS 518	Related Parties	July 2002
AUS 520	Management Representations	July 2002

Reference	Title	Date issued or revised
AUS 522	Audit Evidence Implications of Externally Managed Assets of Superannuation, Provident or Similar Funds	October 1995
AUS 524	The Auditor's Use of the Work of the Actuary and the Actuary's Use of the Work of the Auditor in Connection with the Preparation and Audit of a Financial Report	July 2002
AUS 526	Auditing Fair Value Measurements and Disclosures	September 2002
AUS 602	Using the Work of Another Auditor	July 2002
AUS 604	Considering the Work of Internal Auditing	October 1995
AUS 606	Using the Work of an Expert	July 2002
AUS 702	The Audit Report on a General Purpose Financial Report	March 2002
AUS 704	Comparatives	July 2002
AUS 706	Subsequent Events	October 1995
AUS 708	Going Concern	July 2002
AUS 710	Communications with Management on Matters Arising from an Audit	May 1999
AUS 802	The Audit Report on Financial Information Other than a General Purpose Financial Report	May 2002
AUS 804	The Audit of Prospective Financial Information	July 2002
AUS 806	Performance Auditing	July 2002
AUS 808	Planning Performance Audits	October 1995
AUS 810	Special Purpose Reports on the Effectiveness of Control Procedures	July 2002
AUS 902	Review of Financial Reports	July 2002
AUS 904	Engagements to Perform Agreed-upon Procedures	July 2002

### The use of auditing standards

84. Proposed section 307A of the Corporations Act, which is inserted by item 36, requires audits of a financial report for a financial year and audits or reviews of a financial report for a half-year to be conducted in accordance with auditing standards.

85. Items 37 and 38 amend sections 308 (Auditor's report on annual financial report) and 309 (Auditor's report on half-year financial report) by inserting proposed subsections 308(3A) and 309(5A). The proposed subsections require an auditor to include in their report any statements or disclosures required by the auditing standards.

86. Item 41 inserts a requirement dealing with the audit of financial statements of financial services licensees (see proposed section 989CA).

*Transitional arrangements*

87. Proposed section 1450 of the Corporations Act (inserted by item 1 of Schedule 12) provides that proposed sections 307A and 989CA apply in respect of a financial year that begins on or after the day on which the Bill commences.

**Liability for damages**

88. Items 31 and 32 amend section 246 of the ASIC Act, which lists the people who are not liable to an action or other proceeding for damages in relation to an act done in good faith in performance of any function conferred by the corporations legislation.

89. The Bill extends the protection to the following:

- members of staff, or consultants, of the AASB and AUASB (proposed paragraphs 246 (i) and (j)); and
- officers or employees of an Agency (within the meaning of the *Public Service Act 1999*) or an authority of the Commonwealth whose services are made available to the FRC or Companies Auditors and Liquidators Disciplinary Board (CALDB) (proposed paragraph 246(k)).

90. In addition, the Bill provides that the following are taken to be appointments for the purposes of the ASIC Act:

- members of the CALDB;
- members of the FRC or committees or advisory groups established by the FRC;
- members of the AASB and AUASB or committees, advisory panels or consultative groups established by those bodies (proposed subsection 246(2)).

91. Proposed subsection 246(3) provides that a member of the FRC has qualified privilege in relation to a report or advice given to the Minister or a professional accounting body in the performance of the FRC's functions.

## PART 2: QUALIFICATIONS OF AUDITORS

### Overview

92. The Bill will update and enhance the qualification requirements applying to accountants who seek registration as company auditors.

93. The amendments to the Corporations Act contained in Part 2 of Schedule 1 of the Bill:

- provide that the practical experience requirements for registration may be satisfied by completion of all the components of a competency standard in auditing;
- revise the education requirements for registration to include completion of a specialist course in auditing;
- make an auditor's continued registration subject to compliance with any conditions that may be imposed by ASIC in accordance with the regulations;
- replace the requirement for auditors to lodge a triennial statement with a new requirement to lodge an annual statement;
- revise the matters that may be referred to the CALDB; and
- permit Commonwealth, State and Territory Auditors-General to delegate to senior members of their staff responsibility for Corporations Act audits.

### Registration of auditors

#### Practical experience

94. Items 43 to 45 amend section 1280 (Registration of auditors), which sets out the educational and practical experience requirements for registration as a company auditor.

95. Proposed paragraph 1280(2)(b) provides two ways in which the requirements can be met:

- by satisfying all the components of an auditing competency standard that has been approved by ASIC under section 1280A (for further details, see the comments on proposed section 1280A below); or

- by having the practical experience in auditing that is prescribed in the regulations. Regulation 9.2.04 (Practical experience in auditing) provides that the prescribed practical experience in auditing is work in auditing under the direction of a registered company auditor for a period of not less than three years and at least one continuous year during the five years immediately before the date of the application spent supervising audits of companies. The Audit Review Working Party's 1997 Report<sup>3</sup> proposed that the regulations be amended to require:
  - at least 2,000 hours work in auditing over five years under the supervision of a registered company auditor; and
  - a minimum of 500 hours of this time being spent on work that involves a senior level of responsibility for audits.

#### **Issue 1.4**

Comments are sought on whether the Working Party's hours-based proposal should be adopted or whether the more general years-based requirement currently set out in the regulations should be retained.

### **Education requirements**

96. In addition to the practical experience requirements, persons seeking registration as a company auditor will be required to meet certain educational requirements and have completed a specialist course in auditing.

97. Proposed subsection 1280(2A), which is based on existing subparagraph 1280(2)(a)(ii), continues to require applicants for registration to have a degree, diploma or certificate from a university or another institution. As at present, the course must include study in accountancy (including auditing) of not less than three years' duration and commercial law (including company law) of not less than two years' duration. The universities and other institutions at which the degree, diploma or certificate may be obtained, and the courses in auditing which may be undertaken, are to be prescribed in the regulations.

- The universities and other institutions to be prescribed are expected to be based on those prescribed for the purposes of the existing subparagraph

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3 The Audit Review Working Party (ARWP) was established by the Ministerial Council for Corporations to examine (among other things) the system of registration, appointment and supervision of auditors under the Corporations legislation and to consider whether the system is adequate or needs to be revised or replaced.

1280(2)(a)(ii) (see regulations 9.2.02 and 9.2.03), subject to amendments to reflect changes in the names and/or status of any of the bodies.

98. In addition, applicants will be required to have completed a specialist course in auditing.

- These courses will be prescribed in the regulations and are expected to be those courses that are conducted by, or on behalf of, the professional accounting bodies.

99. Existing subparagraph 1280(2)(a)(i), which provides that membership of The Institute of Chartered Accountants in Australia (ICAA), CPA Australia (CPAA) or any other accounting body prescribed in the regulations satisfies the educational pre-requisites for registration, will be omitted. The original reason for having this provision was to deal with the situation in which a member of the ICAA or CPAA obtained his or her qualifications through the satisfactory completion of the body's own examinations. As a university degree or equivalent has been a pre-requisite for membership of both the ICAA and the CPAA for more than 20 years, few, if any, applications for registration are now received from individuals who are not graduates.

100. Proposed subsection 1280(2B) provides that an applicant satisfies the educational requirements where, in ASIC's opinion, they have qualifications or experience equivalent to that specified in subsection 1280(2A). This provision, which is equivalent to the existing subparagraph 1280(2)(a)(iii), would, for example, enable ASIC to process applications from persons who are members of an overseas accounting body or who have a degree from an overseas university. In either case, it would be necessary for ASIC to consider whether the course of study undertaken by the person to obtain the membership or their degree is equivalent to the requirements set out in subsection 1280(2A).

#### Approval of auditing competency standard

101. Item 46 inserts proposed section 1280A, which sets out the method of approving a competency standard to be used for the purposes of proposed paragraph 1280(2)(b), the manner in which the standard may be amended and the circumstances in which the approval may be revoked. The proposed section also sets out the basic content requirements for a competency standard.

102. Any person may make application for the approval of a competency standard (proposed subsection 1280A(1)). However, an application for either the variation of a competency standard or the revocation of an approval may only be made by the person who sought the original approval for the standard (proposed subsections 1280A(2) and (4)). All approvals of new standards,

approvals of variations or revocations of approvals made by ASIC must be in writing.

103. While it is envisaged that the three main professional accounting bodies will be the groups most likely to seek approval of a competency standard, the provisions have been framed to allow other professional associations, individual accounting firms or groups of accounting firms to seek approval of their own competency standards. However, whether such associations or firms seek such an approval will be a matter for each association or firm to decide, as a competency standard approved on the application of another body will be available for use by any person seeking registration as a company auditor (see the note to proposed subsection 1280A(1)).

104. Proposed subsection 1280A(3) provides that ASIC must not approve a competency standard, or a variation to a standard, unless it is satisfied that the standard:

- requires a person's performance against each component of the standard to be verified by a person who is a registered company auditor and who has sufficient knowledge of the person's work to be able to give that verification;
- is not inconsistent with the Corporations Act or any other Commonwealth law under which ASIC has regulatory responsibilities;
- adequately addresses the level of practical experience needed for registration as a company auditor; and
- is harmonised as much as possible with other approved competency standards.

105. Proposed subsection 1280A(4) provides, in part, that ASIC may revoke the approval of a competency standard where it is no longer satisfied that the standard complies with the requirements of subsection 1280A(3).

106. An example of the matters that might be included in a competency standard may be viewed on the ICAA's website ([www.icaa.org.au](http://www.icaa.org.au) under technical resources/auditing/draft audit competency guidelines).

#### **Transitional arrangements: registration using auditing competency standard**

107. Proposed section 1452 of the Corporations Act (inserted by item 1 of Schedule 12) provides that applications for registration as a company auditor that are made prior to the new requirement coming into operation will be

processed in accordance with the requirements in force at the time the application was lodged.

108. It should be noted that, while the legislation is silent about whether a competency standard may have regard to audit work and other experience gained prior to the commencement of the new requirements, any application made shortly after the commencement of the new requirements and based on such prior experience would need to be extensively documented to allay any concerns the regulator might have about the authenticity of the claims made in support of the application.

### **Conditions on registration of auditors**

109. Item 51 inserts new Division 2A of Part 9.2, which gives ASIC the ability to impose conditions on the registration of an auditor (see proposed section 1289A). The purpose of this amendment is two-fold:

- to provide ASIC with greater flexibility when considering applications from persons seeking registration as a company auditor (for example, it is envisaged that, where circumstances warrant, it would be possible for ASIC to register a person subject to a restriction on the types of entities the person may audit); and
- to provide ASIC with enhanced post-registration supervision of registered auditors (for example, where a person is not a member of a professional accounting body it might impose conditions such as a requirement to undertake continuing professional development and to participate in a quality assurance program).

110. Key features of ASIC's power to impose conditions on registration include:

- the conditions may only be of a kind specified in the regulations (it is envisaged that the kinds of conditions to be specified might include matters such as those mentioned in the previous paragraph); and
- where it is proposed that a condition be imposed by ASIC after a person has been registered, the condition must not be imposed unless ASIC has first given the person the opportunity to appear before, or be represented at, a private hearing held by ASIC and to make submissions in relation to the matter (however, it should be noted that the requirement for a hearing does not apply where the condition is being imposed at the request of the registered auditor). A decision by ASIC concerning the imposition of a condition may be the subject of an appeal to the Administrative Appeals Tribunal in accordance with Part 9.4A of the Corporations Act.

## Transitional arrangements

111. Proposed section 1454 of the Corporations Act (inserted by item 1 of Schedule 12) makes it clear that ASIC may impose a condition on a person's registration as an auditor, even if the registration took place prior to the day on which the Bill commences. However, where ASIC seeks to impose a condition in such circumstances, the auditor is entitled to a hearing in accordance with proposed subsection 1289A(4).

## Annual statements by auditors

112. Although the triennial statement that each registered company auditor has to lodge with ASIC under section 1288 of the Corporations Act is intended to allow ASIC to monitor the registered company auditor's audit activities, the Audit Review Working Party noted that there are widely held views that the statement fails to achieve this objective. Perceived deficiencies of the statement include that it does not provide up to date information for surveillance purposes, that it requires the disclosure of information that has already been provided to ASIC, and that the particulars of audits conducted during the period give no indication of the size or complexity of those audits. The Working Party concluded that many of these concerns could be overcome by the adoption of an annual reporting requirement and the provision of revised information to ASIC. The Ramsay report endorsed the move to an annual statement.

113. Item 48 inserts proposed section 1287A, which replaces the existing requirement for auditors to lodge a triennial statement with a new requirement for the lodgment of an annual statement. Under the proposed amendment, every person who is a registered company auditor at the end of a calendar year is required to lodge a statement by 31 January in the following calendar year (proposed subsection 1287A(1)), although an application may be made to ASIC for an extension of the period in which the statement has to be lodged (proposed subsection 1287A(2)).

114. The content of the annual statement will be prescribed in the regulations. It is envisaged that the information to be prescribed will include:

- the auditor's personal particulars (serving the purpose of confirming or updating ASIC's records);
- details of the nature and complexity of major audit work undertaken by the auditor; and
- details concerning compliance with any conditions that may be imposed on the auditor's registration.

115. Items 42, 49, 50 and 56 contain technical amendments to sections 1274 (Registers), 1288 (Triennial statements by registered auditors and liquidators) and 1298 (Effect of suspension) associated with the introduction of a requirement for auditors to lodge an annual statement. The items amend:

- subparagraph 1274(2)(a)(ii) to include an annual statement lodged by an auditor in the list of documents that may be searched by the public;
- subsections 1288(3) and (4) to omit references to registered company auditor (when amended, section 1288 will require only liquidators to lodge a triennial statement); and
- section 1298 to provide that, where a person's registration as an auditor is suspended, the person is still required to lodge an annual statement.

### Transitional arrangements

116. Proposed section 1453 of the Corporations Act (inserted by item 1 of Schedule 12) provides that the annual statement requirements for auditors will apply from the first calendar year ending after the day on which section 1287A comes into operation. As it is envisaged that the legislation will commence on 1 July 2004, all registered company auditors will be required to lodge an annual statement for 2004 by no later than 31 January 2005.

117. The information to be included in the first annual statement will cover the period from either the end of the period covered by the last triennial statement or the date of the person's registration, whichever is the later.

### Powers of CALDB in relation to auditors

118. Items 52 to 55 amend subsection 1292(1), which sets out the matters in respect of which the Companies Auditors and Liquidators Disciplinary Board (CALDB) may cancel or suspend a person's registration as an auditor. As a result of the amendments made elsewhere in this Part of the Bill, the matters that may be referred to the CALDB have been revised to include:

- failing to lodge an annual statement in accordance with proposed section 1287A (this replaces the existing matter concerning the failure by an auditor to lodge a triennial statement);
- failing to comply with a condition of the person's registration; and
- ceasing to have the practical experience necessary for carrying out audits, as demonstrated by a failure to perform any audit work, or any significant audit work, during a continuous period of five years.

119. For the purpose of deciding whether the audit work performed by a person is significant, proposed subsection 1292(1A) provides that regard is to be had to the following matters:

- the nature of the audit;
- the extent to which the person was involved in
- the audit; and
- the level of responsibility the person assumed in relation to the audit.

### **Delegations by Auditors-General**

120. Item 47 will amend section 1281 (Auditor-General taken to be registered as auditor) to provide that where an auditor-general delegates to a person the function of conducting an audit, or the power to conduct an audit, that person is also taken to be a registered company auditor under Part 9.2. With the increasing number of government business enterprises being formed or reconstituted as Corporations Act companies, Auditors-General are experiencing a significant increase in the number of audit reports they have to sign. By allowing Auditors-General to delegate responsibility for signing Corporations Act audits to senior staff, the amendment will facilitate Auditors-General in the performance of their functions.

## PART 3: AUDITOR APPOINTMENT, INDEPENDENCE AND ROTATION REQUIREMENTS

### Overview

121. The text in this part of the Commentary is divided into the following key topics:

- independence requirements for auditors;
- rotation of auditors; and
- non-audit services.

122. Current section 324 of the Corporations Act contains provisions relating to:

- the appointment of individuals and firms as an auditor of a company;
- the effect of appointing a firm as auditor including the reconstitution of a firm;
- the registration requirements for appointment of an individual and a firm as auditor; and
- auditor independence requirements in relation to an individual auditor and an audit firm.

123. In light of the CLERP 9 proposals which significantly expand the auditor independence requirements and the need to include authorised audit companies in the legislative framework, the matters dealt with in section 324 are contained in three separate Divisions of Schedule 1, Part 3:

- Division 1 — Entities that may be appointed as an auditor for a company or registered scheme.
  - Division 1 broadly replicates the effect of existing provisions in section 324 which recognise the status of an individual and a firm for appointment as an auditor of a company as well as provisions relating to the effect of the appointment of a firm as an auditor, including the reconstitution of an audit firm. Division 1 now also extends those provisions to authorised audit companies.
- Division 2 — Registration requirements

- Division 2 replicates the effect of the provisions in section 324 relating to registration requirements for appointment of an individual and a firm as auditor of a company. Division 2 extends these requirements to an authorised audit company. Division 2 also replicates the effect of the current exception in section 324 from the registration requirement for a proprietary company which applies in certain circumstances.
- Division 3 — Auditor independence
  - These provisions are considered in detail below (as well as the auditor's independence declaration which is contained in proposed section 307C).

124. Current sections 327 and 328, which deal with the appointment and nomination of auditors, have been broadly replicated in Division 6, Subdivision A. Current sections dealing with the appointment of registered scheme auditors (section 331AA and 331AB) are broadly replicated in Division 7.

## Definitions

125. Items 57 — 78 of the Bill amend section 9 of the Corporations Act by inserting a range of definitions relevant to the independence requirements. In particular, the following definitions should be noted:

- associated entity (see also item 79):
  - This definition is drawn from the definition of *related entity* in Professional Statement F.1;
- audit company;
- audit-critical employee;
- engage in audit activity;
- investment in a company;
- investment in a registered scheme;
- lead and review auditors;
- professional employee;
- professional members of the audit team (see also proposed section 324AE):

- The definition has drawn on the definition of the *audit engagement team* in the Ramsay report, which in turn is based on the relevant definitions in Professional Statement F.1. The definition is also similar to the definition of *audit engagement team* in the SEC's rule on auditor independence in the US. Like the SEC's definition, the approach in the draft Bill is designed to cover the people in an audit firm or audit company who are most directly in a position to influence the audit.
- senior manager.

## **Auditor independence**

126. Auditor independence is fundamental to the credibility and reliability of auditors' reports. Division 3 implements the Ramsay report as discussed and refined in CLERP 9, and the relevant recommendations contained in the HIH Royal Commission Report (the HIHRC report).

127. The Ramsay report recognises the following four functions of an independent audit in relation to capital market efficiency:

- adding value to financial statements by improving their reliability;
- adding value to capital markets by enhancing the credibility of financial statements;
- enhancing the effectiveness of capital markets in allocating valuable resources by improving the decisions of users of financial statements; and
- assisting to lower the cost of capital to those using audited financial statements by reducing information risk.

128. The HIHRC report noted that an independent audit also contributes to capital market efficiency by enhancing the consistency and comparability of reported financial information in Australia.

## **Auditor independence rules and the liability of auditors**

129. The Bill applies the new auditor independence requirements to individual auditors (sole practitioners), audit firms and audit companies.

130. The general liability framework that has been adopted in the Bill is as follows:

- When an individual auditor contravenes an independence requirement, the individual auditor commits an offence.

- When an audit firm contravenes an independence requirement, each member (partner) of the firm contravenes the relevant provision, but the firm itself does not commit an offence.
  - As an audit firm is an unincorporated body (and thus not a legal person), the firm itself cannot be prosecuted.
- When an audit company contravenes an independence requirement, the general rule is that the company and each of the directors of the company commit an offence.

131. There has been widespread concern about the efficacy of the audit function arising out of recent major corporate collapses in Australia and overseas, including that of HHH.

132. To this end, the Bill, through the liability framework, encourages a 'culture of compliance' by the whole firm or audit company. This is achieved by placing liability on all firm members and directors of audit companies rather than just focussing on the lead auditor responsible for a particular audit. To this end, individual auditors and each firm and audit company will need to put in place adequate internal systems to prevent a contravention of the independence requirements arising before the individual auditor, audit firm or audit company consents to act as an auditor and during the conduct of the audit. By sheeting home liability to each of the partners of an audit firm and the directors of the audit company, the Bill will ensure that each partner and director has an interest in adequate internal control systems being established.

133. Specific defences have been developed in the Bill in light of the vicarious nature of the liability in relation to members of an audit firm and the directors of an audit company. Proposed subsections 324CJ(2) and (4) provide respectively that a member of an audit firm or a director of an audit company do not commit an offence at a particular time because of a contravention of a provision of Subdivision A (the general requirement for auditor independence) or Subdivision B (specific auditor independence requirements) if:

- the member or director either:
  - does not know at that time of the circumstances that constitute the contravention; or
  - knows of those circumstances at that time but takes all reasonable steps to correct the contravention as soon as possible after the member or director becomes aware of those circumstances.; and
- the member or the director has reasonable grounds to believe that the audit firm or company has in place a quality control system that provides

reasonable assurance that the firm or company and their employees comply with the independence requirements.

### General requirement for auditor independence

134. Proposed section 324CA establishes a general requirement for auditor independence in the Corporations Act. CLERP 9 proposed a general statement of principle requiring the independence of auditors which was based on the relevant recommendation in the Ramsay report. The general requirement for auditor independence contained in proposed section 324CA is based on the CLERP 9 proposal together with a number of important refinements recommended by the HIHRC.

135. Proposed subsection 324CA(1) prohibits an individual auditor, an audit firm or an audit company from engaging in audit activity (defined in section 9) in relation to an audited body at a particular time if:

- a conflict of interest situation exists in relation to the audited body at that time;
- the individual auditor, the audit firm or the audit company are aware that the conflict of interest situation exists; and
- the individual auditor, the audit firm or the audit company does not take all reasonable steps to ensure that the conflict of interest situation ceases to exist, as soon as possible after the relevant person referred to in proposed paragraph 324CA(1)(b) becomes aware that the conflict of interest situation exists.

136. Proposed subsection 324CA(2) deals with circumstances where a conflict of interest situation exists in relation to the audited body but the individual auditor, the members of the audit firm or the audit company are *not* aware that the conflict of interest exists. The provision prohibits an individual auditor, an audit firm or an audit company from engaging in audit activity in relation to an audited body at a particular time if the individual auditor, audit firm or audit company would have been aware of the existence of the conflict of interest situation if they had in place a quality control system reasonably capable of making them aware of the existence of such a conflict of interest. Compare proposed section 324CJ covering inadvertent breaches where having a quality control system in place is an essential element in terms of the protection provided in that section against an offence being committed because of a contravention of the auditor independence requirements contained in the Division.

137. Proposed subsections 324CA(3) and 324CA(4) explain the consequences when an audit firm and an audit company contravene subsections (1) and (2), including the criminal liability of members of the firm and the directors of the audit company.

138. Proposed subsection 324CA(5) makes it clear that the obligations imposed under the general requirement for auditor independence are in addition to, and do not derogate from, any obligation imposed by another provision of the Corporations Act or a code of professional conduct

139. Proposed subsection 324CB(1) provides that a conflict of interest situation exists in relation to an audited body at a particular time, if circumstances exist at that time that:

- impair, or might impair, the ability of the auditor, or a professional member of the audit team, to exercise objective and impartial judgment in relation to the conduct of an audit of the audited body (proposed paragraph 324CB(1)(a)); or
- would give a person, with full knowledge of the facts and circumstances, reasonable grounds for concern that the ability of the auditor, or a professional member of the audit team, to exercise objective and impartial judgment in relation to the conduct of an audit of the audited body is, or might be impaired (proposed paragraph 324CB(1)(b)).

140. In considering an appropriate standard of audit independence, the HIIHRC noted that rarely would there be unequivocal evidence that conclusively establishes, for example, a connection between influence exerted by management upon the auditor and the provision by the auditor of an unqualified audit opinion. The HIIHRC observed that the existence of such a connection from a range of surrounding circumstances can usually only be inferred and that the difficulties associated with identifying a compromise of audit independence are inherent in the nature of the audit process.

141. In light of these considerations, the HIIHRC concluded that it is critical that the auditor should be seen to be exercising impartial and objective judgment in addition to the actual exercise of that impartial and objective judgment. The HIIHRC considered that the difficulties in discerning any actual lack of independence, coupled with a reluctance on the part of auditors to confront their own lack of independence, supported the proposal in CLERP 9 for the introduction of an objective standard of independence.

142. These policy considerations have been taken into account in framing the requirements relating to a conflict of interest situation in proposed subsection 324CB(1).

143. CLERP 9 proposed a high standard of certainty in relation to a lack of independence by requiring that a reasonable person *would* conclude that the auditor is not independent. The HIHRC examined a number of situations where the law imposes obligations upon people who face conflicts between their interests and their duties. The HIHRC concluded that a general standard of independence for auditors should be adapted from the test laid down by the High Court to determine whether a judge is disqualified by reason of the appearance of bias. This test is whether a fair-minded lay observer *might* reasonably apprehend that the judge might not bring an impartial and unprejudiced mind to the resolution of the question the judge is required to decide.

144. In recommending that the auditor independence test should be stated in terms of *might* rather than *would*, the HIHRC stated that the CLERP 9 proposals do not pay sufficient regard to the importance of auditors being seen to be exercising impartial and objective judgment. Proposed paragraphs 324CB(1)(a) and (b) have adopted the HIHRC recommendation by expressing the test in the conflict of interest situation in terms of *might*.

145. For purposes of determining whether a conflict of interest situation exists, proposed subsection 324CB(2) requires that regard be had to circumstances arising from any relationship between:

- the individual auditor; or
- the audit firm or any current or former member of the firm; or
- the audit company, any current or former director of the audit company or any person currently or formerly involved in the management of the audit company;

and:

- a company; or
- a disclosing entity; or
- a registered scheme.

### Employment and financial relationships

146. Current section 324 of the Corporations Act contains a number of specific restrictions relating to auditor independence. CLERP 9 proposed that the current restrictions in relation to employment and financial relationships be significantly expanded in line with the recommendations in the Ramsay report, in addition to the introduction of the proposed general standard of

auditor independence. The new independence requirements have also been applied to authorised audit companies and registered schemes.

147. The specific independence requirements are contained in:

- proposed section 324CC: an individual auditor.
- proposed section 324CD: an audit firm.
- proposed section 324CE: an audit company.

148. Each of these sections contain a table for the purpose of identifying the specific auditor independence requirements applying to each of the persons or entities listed in the table. The impermissible relationships are determined by applying a list of relevant relationships (set out in proposed subsection 324CF(1)) to the persons or entities listed in each of the tables in sections 324CC, 324CD and 324CE.

#### Specific requirements for individual auditor

149. Proposed subsection 324CC(1) provides that an individual auditor must not engage in audit activity at a particular time if a relevant relationship outlined in proposed subsection 324CF(1) applies at that time to a person or entity specified in the table in subsection 324CC(1). For example, an individual auditor (subsection 324CC(1) — table item 1) cannot engage in 'audit activity' (see definition in section 9) if the individual is an officer of the audited body (subsection 324CF(1) — table item 1).

150. The following information about the particular items in the table in proposed subsection 324CC(1) should be noted:

- Item 1A: a service company or trust or other entity acting for, or on behalf of, the individual auditor.
  - The purpose of this item is to subject a service company or trust arrangement to the independence requirements to prevent these structures being used to avoid the provisions.
- Item 5: a person who is a non-audit services provider and who does not satisfy the maximum hours test in proposed subsection 324CC(2).
  - This requirement implements a CLERP 9 proposal based on a recommendation in the Ramsay report that such a person should not have certain investments in the audited body because of the threat posed to the independence of the auditor. The purpose of the maximum hours test in proposed subsection 324CC(2) is to exclude such a person from

the restriction where the number of hours for which non-audit services are provided during the relevant period does not exceed 10 hours. The period of 10 hours has been adopted from the corresponding restriction in the US SEC auditor independence rules. A similar restriction applies to an immediate family member of a non-audit services provider under item 6 of the table.

- Item 9: a person who is a former professional employee of the auditor and who does not satisfy the independence test in proposed subsection 324CC(3).
  - This item is based on a recommendation in the Ramsay report to address the threat to auditor independence when a former professional employee of an auditor becomes an officer or audit critical employee of an audited body. The independence test in proposed subsection 324CB(3) will exclude former professional employees from the restriction where they no longer influence the operations and financial policies of the audit practice and have no residual financial links or stake in the practice other than certain regular payments which are not dependent on the revenue, profits or earnings of the auditor.
- Item 10 is similar to item 9 but applies the requirement to an individual who is a former owner of the individual auditor's practice.

#### Specific requirements for audit firms and authorised audit companies

151. Similar processes and requirements apply to audit firms (see proposed sections 324CD and 324CF) and authorised audit companies (see proposed sections 324CE and 324CF).

#### Relevant relationships

152. Proposed subsection 324CF(1) contains a table which lists the impermissible relationships that are relevant for the purposes of the specific employment and financial independence requirements contained in proposed sections 324CC, 324CD and 324CE.

153. The relationships listed in the table are based on the proposals in CLERP 9 and the Ramsay report.

154. Items 1 to 9 relate to the employment relationships identified in the Ramsay report which threaten an auditor's independence. Items 10 to 19 list the financial relationships which the Ramsay report recommended should be dealt with in the Corporations Act.

155. The Ramsay report recommendations in relation to employment and financial relationships drew on the current requirements in the Corporations Act, the auditor independence rules formulated by the International Federation of Accountants (IFAC) and some of the relevant SEC auditor independence rules in the US. The IFAC rules have been adopted in Australia by the Institute of Chartered Accountants in Australia and CPA Australia and are contained in Professional Statement F.1.

156. The following background commentary on each of the items is noted:

- Items 1 to 6:
  - These items are based on the Ramsay report recommendation relating to the restrictions on the employment by the audited body of a current auditor or employee of the auditor. The restriction is based on existing subsections 324(1) and (2) of the Corporations Act. Drawing on corresponding requirements in the IFAC and SEC rules, the Ramsay report recommended that the existing requirements should be extended beyond current partners of an audit firm to cover the professional employees of the audit firm and should also extend to an immediate family member of the audit engagement team.
  - The recommendations in the Ramsay report have been implemented and expanded (as a result of the application of the requirements in sections 324CC, 324CD and 324CE to the table of relationships in section 324CF):
    - : The requirements have been applied to an individual auditor, an audit firm and an audit company.
    - : In this context, a professional employee of the auditor referred to in the Ramsay report is applied to a *professional member of an audit team* (this definition should not be confused with another new definition in section 9 of *professional employee* which is used in the case of a former professional employee of an auditor joining an audited body).
    - : The service company or trust arrangement has been expressly covered.
    - : In addition to the existing case of *an officer of the audited body*, items 2, 3, 4, 5, and 6 also refer to *an audit critical employee* (which is defined in section 9 of the Corporations Act). The objective is to cover employees who are in a position to affect the efficacy of the audit but who would not be caught by the definition of *officer* in section 9.
- Item 7 is based on the existing paragraph 324(2)(h) of the Corporations Act with the following changes:

- The relationship is applied to an individual auditor and to an audit company, in addition to an audit firm as reflected in the current provision.
- In line with the CLERP 9 proposal, the restriction applies to any consultancy and is not limited, as in the current provision, to a consultancy on accounting or auditing matters.
- Consistent with the approach adopted in items 2 to 6, the scope of the restriction has been extended beyond *an officer of the audited body* to also cover *an audit-critical employee of an audited body*.
- Item 9 implements the recommendation in the Ramsay report in relation to employment by an audit firm (now also applying to an individual auditor and to an audit company) of a former employee of an audited body. The restriction will apply, in addition to the period to which the audit relates, to:
  - the 12 months immediately preceding the beginning of the period to which the audit relates; and
  - the period during which the audit is being conducted or the audit report is being prepared.
- Items 10 to 14 implement the recommendations in the Ramsay report relating to investments in audited bodies. These financial relationships are prohibited under the IFAC and SEC rules.
- Item 15 is based on the current paragraphs 324(1)(e) and 324(2)(f) of the Corporations Act. In accordance with the Ramsay report recommendation the current prohibition has been extended to include an entity that the client controls. The prohibition does not apply to:
  - a debt owed under a housing loan (see proposed subsection 324CF(5)); or
  - a loan which would be prohibited under item 18 but for the exception in proposed subsection 324CE(6) (which relates to loans made in the ordinary course of business etc).
- Items 17 to 19 implement the recommendations in the Ramsay report relating to :
  - loans to and from audited bodies; and
  - loan guarantees involving the auditor and audited body.

- : Proposed subsections 324CF(6) and (7) provide for exceptions in relation to loans and guarantees made in the ordinary course of business etc. under items 18 and 19 respectively.

157. CLERP 9 endorsed the Ramsay report recommendation that the restrictions on employment relationships should not apply to small proprietary companies as defined in section 45A. This has been implemented in relation to each of the employment relationships contained in items 1 to 9 of the table.

#### **Retiring partners of audit firms and retiring directors of authorised audit companies**

158. Proposed section 324CG implements the relevant recommendation of the HIHRC relating to mandatory waiting periods for members of an audit firm and directors of an audit company becoming an officer of an audited body.

159. Where a member of an audit firm or a director of an audit company was a professional member of the audit team in relation to the audit of the audited body, the waiting period is four years before that person can join the audited body as an officer. Where the member of the firm or the director of the audit company was not a member of the audit team, the waiting period is two years from the departure time.

160. It is proposed that section 324CG will operate prospectively and will apply in relation to a member of an audit firm or a director of an audited body who retires or resigns from the audit firm or the audit company at some time after the commencement of the legislation.

161. Proposed paragraph 324CG(1)(d) contains a small proprietary company carve out.

162. It is noted that proposed paragraph 300(1)(ca) (item 81) provides that the director's report must include details of:

- the name of each officer who becomes an officer of the company, registered scheme or disclosing entity at any time during the year;
- who was a partner in an audit firm or a director of an audit company that is an auditor for the company, disclosing entity or registered scheme for the year; and
- was such a partner or director at a time when the audit firm or audit company undertook an audit of the company, disclosing entity or registered scheme.

163. The HIIHRC recommendations extend the original CLERP 9 proposal which applied a two year waiting period to partners in an audit firm who were directly involved in the audit of the audited body. The HIIHRC recommended the extension of the two year waiting period to four years because it considered that the two year period 'might not be sufficient to arrest a reasonable apprehension that former partners retain an influence over members of the audit team.' The HIIHRC also recommended that former partners of an audit firm who had not been directly involved in the audit of the audited body should be subject to a two year waiting period.

164. This is the first time that the public will have had an opportunity to comment on the HIIHRC recommendations, and in particular their practical implementation. The Government will carefully consider submissions to ensure that an appropriate balance is struck between the need to put in place mechanisms to ensure auditor independence and the objective of not unduly impeding auditing professionals from joining companies and bringing accounting and financial expertise with them to those companies.

165. It is noted that the concept of a mandatory waiting period has been adopted in a number of overseas jurisdictions:

- The European Commission issued a Recommendation to member companies on Auditor Independence in mid-2002, which endorsed a mandatory waiting period of two years.
- The Institute of Chartered Accountants in England and Wales has decided to adopt a two-year waiting period in its professional rules.
- Section 206 of the Sarbanes–Oxley Act in the US has introduced a one year cooling off period before a member of the audit engagement team may accept employment in certain designated positions with the audited client.

#### Retiring professional member of audit team

166. Proposed section 324CH extends the waiting period restriction to a former professional member of the audit team in relation to the audited body, in line with the HIIHRC recommendation. A former professional member of the audit team is subject to a four year waiting period.

167. The effect of the provision is that the waiting period for a professional member of the audit team is four years from the departure time. It is proposed that section 324CH will operate prospectively and will apply in relation to a professional member of the audit team who retires or resigns from the audit firm or the audit company at some time after the commencement of the legislation.

168. Proposed paragraph 324CH(1)(e) contains a small proprietary company carve out.

169. As indicated above, the Government will give careful consideration to submissions regarding the practical implementation of this HIHRC recommendation.

#### Multiple former audit firm partners or audit company directors

170. Proposed section 324CI implements a recommendation of the HIHRC that the Corporations Act contain 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 audited body.

171. Proposed section 324CH also extends the prohibition to a director of an audit company.

172. The prohibition operates in relation to the current audit of an audited body for a financial year. The offence is committed by the former partner of the firm or former director of the audit company who joins the audited body at a time when other former partners of the firm or former directors of the audit company are officers of the audited body

173. It is proposed that the prohibition will operate prospectively and will apply in relation to a partner of an audit firm or a director of an audit company who resigns or retires from the firm or audit company after the commencement of the legislation. The prohibition does not apply to a former partner of the audit firm or former director of the audit company who is already an officer of the audited body at the commencement of the legislation.

174. Proposed paragraph 324CI(e) contains a small proprietary company carve out.

175. The HIHRC explained the underlying rationale for this recommendation by reference to the fact that three former partners of Andersen were directors of HIH and that these circumstances resulted in the perception that Andersen was not independent of HIH.

176. The Government will carefully consider public submissions regarding the practical implementation of this recommendation and whether it strikes an appropriate balance between the need to safeguard auditor independence and the policy objective of not unduly impeding senior auditing professionals from joining companies and bringing accounting and financial expertise with them to those companies.

### Inadvertent breaches

177. Proposed subsection 324CJ(1) provides that an individual auditor who is the auditor of a company or registered scheme does not commit an offence at a particular time because of a contravention of Subdivision B (specific auditor independence requirements) if:

- the auditor either:
  - did not know of the circumstances that constitute the contravention; or
  - knows of those circumstances at that time but takes all reasonable steps to correct the contravention as soon as possible after the auditor becomes aware of those circumstances; and
- the auditor has in place a quality control system that provides reasonable assurance (taking into account the size and nature of the person's audit practice) that the auditor and the auditor's employees comply with the requirements of Division 3.

178. Proposed subsection 324CJ(2) provides a member of an audit firm and proposed subsection 324CJ(4) provides a director of an audit company with a similar defence in relation to a contravention of Subdivision A or Subdivision B (the general and specific auditor independence requirements).

179. Proposed subsection 324CJ(3) provides an audit company with a similar defence in relation to a contravention of Subdivision B.

### Auditor's independence declaration

180. Proposed subsection 307C(1) (item 85) requires an auditor to give the directors of a company, registered scheme or disclosing entity a written declaration that the auditor has complied with the auditor independence requirements of the Corporations Act and the Corporations Regulations and of any applicable codes of professional conduct. The requirement applies to an auditor who conducts an audit of the financial report for the financial year or an audit or review of the financial report for a half-year.

181. Proposed subsection 307C requires the declaration to be given when the audit report is given to the directors of the company, registered scheme or disclosing entity.

182. Proposed subsection 307C requires the declaration to be made and signed by:

- the registered company auditor if the auditor is an individual auditor; or

- the lead auditor on behalf of the auditor if the auditor is an audit firm or audit company.

183. Proposed paragraph 298(1)(c) (item 80) provides that the annual directors' report must include a copy of the auditor's independence declaration made under proposed section 307C. Proposed subsection 306(2) (item 84) contains similar provisions in relation to the directors' half-year report.

#### **Transitional arrangements for auditor independence amendments**

184. Proposed section 1456 (item 1, Schedule 12) outlines the transitional arrangements for the auditor independence requirements in Division 3 of Part 2M.4.

#### **People who are regarded as officers of a company for the purposes of this Division**

185. Proposed section 324CK is based on current subsections 324(4), (5) and (6).

#### **Deliberately disqualifying auditor**

186. Proposed subsections 324CL(1) and (2) replicate the effect of the current subsection 324(16) in relation to an individual auditor and an audit firm.

187. A similar requirement is imposed on a director of an authorised audit company under proposed subsection 324CL (3).

#### **Rotation requirements for auditors**

188. Division 5 sets out the framework for auditor rotation in circumstances where either an individual auditor, an audit firm or authorised audit company has been appointed as auditor of a listed company or registered scheme. The provisions in this Division implement recommendations of both CLERP 9 and the Ramsay report.

189. The provisions rely on the concept of an auditor having 'played a significant role' in the audit which will be defined in section 9 of the Corporations Act (see item 74 of Schedule 1, Part 3). Generally the persons to whom the rotation obligations apply are the lead and review auditors. Where an individual plays a significant role in the audit of a listed company for five successive financial years, the individual cannot play a significant role in the audit of that company for at least another two successive financial years (see proposed section 324DA).

190. Proposed subsection 324DA(2) further provides that a person may not play a significant role as auditor for more than five out of any seven successive financial years. This approach recognises that auditors may not necessarily audit a body in consecutive years however the relationship between the auditor and the audited body can still give rise to a threat to independence. In these circumstances rotation should still be required. In addition this approach prevents an auditor from avoiding the rotation obligation specified in proposed section 324DA, for example, in circumstances where an auditor plays a significant role for four successive years, resigns from the audit for only one year and then resumes a significant role for another four successive years.

191. ASIC will be able to provide relief from the rotation requirements in certain circumstances (see below).

#### Individual auditor's rotation obligation

192. Proposed section 324DB provides that an individual who does not comply with the rotation requirements of the Act has contravened the Act.

#### Audit firm's rotation obligation

193. Proposed section 324DC operates in circumstances where an audit firm is appointed as a listed company's or listed scheme's auditor. The section recognises that individuals will act on behalf of the firm and therefore places the rotation obligation on both the lead and review auditors (see proposed section 324AF for the definition of the lead and review auditors).

194. Liability for a breach of the rotation obligations is directed at both the firm and the individual auditor. Where an individual plays a significant role in an audit of a listed company or scheme, and is not eligible to do so due to the rotation requirements, liability to the firm will arise where another member of the firm becomes aware of this breach. In this case the audit firm must remove the individual from playing a significant role in the audit, or resign from the audit. If neither of these occurs, then the firm has contravened the Act and each member of the firm is deemed guilty of the breach. However the firm itself is deemed not to have committed an offence. The requirement for another member of the firm to be aware of the breach is to ensure that firm liability will only arise where there is some collective awareness of a breach of the provisions. Members of the audit firm who were unaware of the breach or who took steps to rectify the breach will be deemed not to have committed an offence (see proposed subsection 324DC(3)). This approach is consistent with the approach taken to firm liability in relation to the auditor independence requirements more generally. It is intended to place responsibility on members of the firm as a whole to ensure that collectively the members promote a culture of compliance. Whether or not the firm is guilty of an offence under

proposed section 324DC, the individual auditor who breaches the rotation provisions will still have committed an offence under proposed section 324DB.

#### Authorised audit company's rotation obligation

195. Proposed section 324DD provides that an authorised audit company that does not comply with the rotation requirements of the Act has contravened the Act. This provision effectively mirrors proposed section 324DC, other than that the company itself can be deemed to have committed an offence. Again, the approach taken to the liability of the company is consistent with that taken in relation to auditor independence more generally.

#### ASIC's power to modify the rotation requirements

196. The Bill recognises that in some circumstances, the rotation obligations could place a burden on particular audit firms or listed companies. To this end, the Bill provides ASIC with a power to provide relief from the rotation requirements.

197. Proposed section 342A gives ASIC the power to extend the period before rotation of an auditor is required. Where an auditor has performed an audit for five successive years, paragraph 342A(1)(a) allows the period before rotation will be required to be extended to six or seven years. After this time, the auditor must not undertake the audit of that listed company for the next two years.

198. Paragraph 342A(1)(b) provides for ASIC relief in cases where an audit has not been undertaken in consecutive years. In these circumstances, ASIC can extend the period before rotation will be required from any five out of seven successive years to any six out of seven successive years. These provisions would apply for example, where an auditor conducts four successive audits, resigns from the audit for one year and returns to the audit in year six and further seeks to perform the audit in year seven. Under subsection 324DA(2), the auditor would not be able to perform the audit in year seven unless relief had been provided under paragraph 342A(1)(b).

199. ASIC will only be able to extend the period in response to a written application by the individual auditor or the audit firm or authorised audit company for whom the auditor works. Proposed subsection 342A(6) requires ASIC to be satisfied that to refuse the extension would cause an unreasonable burden on the auditor, the audit firm or authorised audit company, or the listed company subject to the audit. Proposed subsection 342A(7) requires ASIC, when considering whether an unreasonable burden would be placed on any of these parties, to take into account the nature of the listed company being

audited and the degree of specialist knowledge an auditor might need to undertake an effective audit. ASIC will also be able to take into account the availability of alternative auditors capable of providing a satisfactory level of audit services to the relevant companies. This might for example be an issue in the case of auditors operating in rural or remote areas.

200. ASIC's use of the relief power will be monitored to ensure it is achieving its intended objectives.

#### **Auditor to notify company or registered scheme of ASIC relief**

201. Proposed section 342B requires an auditor who remains significantly involved in the preparation of an audit pursuant to an ASIC order under proposed section 342A to give the listed company, or the responsible entity of the listed scheme, written notice that the ASIC order has been provided. This notice should be provided to the company as soon as practicable, if the company's auditor for the relevant financial year has already been appointed. If the auditor has not been appointed, the notice must be forwarded before the appointment is made. Where an auditor remains significantly involved in the audit pursuant to an ASIC order under proposed section 342A, the company should advise shareholders of the details in its annual financial or directors' report.

#### **Transitional arrangements**

202. Schedule 12 of the Bill contains the transitional arrangements applying to the rotation obligations.

203. Proposed section 1457 provides that the auditor rotation provisions are to apply from two years following the date that the legislation comes into effect. This will give publicly listed companies and audit firms sufficient time to implement the rotation requirements under the Act.

204. Where a person has already conducted three or more successive annual audits for a listed company or scheme at the time that the legislation takes effect, they, their audit firm and the client company or scheme will need to be aware that the auditor must be replaced for the audit following the date at which the rotation provisions take effect (that is, two years following commencement of the Act).

205. It should be noted that rotation will remain a requirement under Professional Standard F.1 with which auditors, not just those of listed companies, should comply.

## **Non-audit services**

### **Disclosure of non-audit services**

206. The Bill implements the recommendations of the HIIHRC and requires the board of directors of a listed company to provide a statement in the annual report that identifies all non-audit services provided by the audit firm and the fees applicable to each item of non-audit service (see item 83, subsection 300(11B)). In addition, the report must include a statement by the directors that they are satisfied that the provision of non-audit services is compatible with the general standard of independence and an explanation of why those non-audit services do not compromise audit independence (see item 83, subsection 300(11B)). Where a company has an audit committee, this statement must be made in accordance with advice provided by that committee (see item 83, subsection 300(11D)).

207. The Bill does not contain a definition of non-audit services. Consistent with the terms of the Ramsay report, it is intended that non-audit services will encompass any services provided by the auditor which are not included in the terms of the audit engagement.

208. CLERP 9 initially proposed that the fees paid for nine identified categories of non-audit services be disclosed in the annual directors' report together with a statement by the company's audit committee as to whether it is satisfied that the provision of non-audit services is compatible with auditor independence. Where a company does not have an audit committee, the Board of Directors were to make the declaration.

209. The HIIHRC considered that the provision of non-audit services to audited bodies raises two threats to audit independence:

- Self-review threats. These situations arise where the auditor may need to review work performed either by the auditor or the auditor's firm.
- The sacrifice of audit integrity in order to procure more lucrative non-audit work. The CLERP 9 paper also raised this issue in terms of audit as a 'loss-leader'.

210. The HIIHRC recommended the CLERP 9 proposals be revised on the basis that disclosure of the categories of non-audit services may not allow users of annual reports to ascertain the extent of the independence threat posed by the provision of non-audit services. As an example, the HIIHRC cited that disclosure of fees paid for 'taxation services' would not allow a reader to determine whether those services relate to strategic tax advice or tax

compliance work, even though the former poses a more significant independence threat than the latter.

211. The HIHRC also considered that it was an obligation on all directors to understand the nature and extent of all services provided by the auditor and to assess the impact of those services on audit independence. Hence all directors, rather than the audit committee should make a statement whether non-audit services threatens independence.

#### **Transitional provisions**

212. Companies must comply with these requirements for directors' reports that relate to financial years beginning on or after the commencement of the legislation (see Schedule 12, proposed section 1455).

#### **Accounting standards**

213. Currently Australian accounting standards require disclosure of the aggregate amount of fees paid to the auditor for the audit and related services and for non-audit services. This requirement applies to all entities required to prepare financial reports in accordance with accounting standards. The Bill does not relieve entities from the requirements of the accounting standards.

## **PART 4: AUTHORISED AUDIT COMPANIES**

214. The Corporations Act currently does not allow a company to be registered as a company auditor. Schedule 1, Part 4 of the Bill establishes a framework for incorporation of audit firms.

215. Allowing auditors to incorporate will address some of the concerns relating to the professional liability of auditors. Incorporation will also provide accounting firms with an additional option in terms of how they structure their operations.

### **Application for registration as authorised audit company**

216. Proposed section 1299A provides that a company may apply to ASIC for registration as an authorised audit company. An application must be in writing as prescribed and must contain such information as is prescribed.

### **Eligibility for registration as an authorised audit company**

217. Proposed section 1299B provides that a company is only eligible to be registered as an authorised audit company if:

- each of the directors of the company is a registered company auditor and is not disqualified from managing a corporation under Part 2D.6; and
- each share in the company is held and beneficially owned by a person who is an individual or the legal representative of an individual; and
- a majority of the votes that may be cast at a general meeting of the company attach to shares in the company that are held and beneficially owned by individuals who are registered company auditors; and
- ASIC is satisfied that the company has adequate and appropriate professional indemnity insurance; and
- the company is not an externally-administered body corporate.

### **Registration as authorised audit company**

218. Proposed section 1299C sets out the requirements relating to ASIC's granting or refusal of the application and the requirements in relation to the registration of the company as an authorised audit company.

### **Registration may be subject to conditions**

219. Proposed section 1299D provides that the company's registration as an authorised audit company is subject to the provisions of Part 9.2A, any conditions or restrictions specified in the regulations and any other conditions or restrictions determined by ASIC.

### **Register of authorised audit companies**

220. Proposed section 1299E requires ASIC to keep a Register of Authorised Audit Companies and sets out the matters that ASIC must enter in the Register in relation to each authorised audit company.

### **Notification of certain matters**

221. Proposed subsection 1299F(1) provides that an authorised audit company must notify ASIC if a condition or restriction to which the company's registration is subject is contravened.

222. An authorised audit company is also required under proposed subsection 1299F(3) to notify ASIC if a change occurs in the details of a matter that is required to be entered in the Register of Authorised Audit Companies.

### **Annual statements by authorised audit companies**

223. Proposed section 1299G requires an authorised audit company to lodge at the end of a calendar year, on or before the next 31 January, an annual statement with ASIC.

### **Cancellation or suspension of registration**

224. Proposed section 1299H provides that ASIC may cancel a company's registration as an authorised audit company if the company requests ASIC to cancel the registration. ASIC's decision to cancel the company's registration comes into effect as soon as practicable on the making of the decision.

225. Proposed section 1299I provides that ASIC may cancel or suspend a company's registration as an authorised audit company if the company ceases to be eligible to be registered as an authorised audit company or the company fails to meet conditions or observe restrictions imposed on the company's registration as an authorised audit company.

226. Proposed section 1299J requires ASIC to give a company a written notice setting out ASIC's decision to cancel or suspend the company's

registration within 14 days after the decision. ASIC is also required to publish written notice of the decision in the Gazette.

227. Proposed subsection 1299K(1) provides that subject to subsection (2) and to sections 41 and 44A of the *Administrative Appeals Tribunal Act 1975* a decision by ASIC to cancel or suspend a company's registration as an authorised audit company comes into effect at the end of the day on which the company is given notice of the decision under paragraph 1299J(1)(a).

228. Proposed subsection 1299K(2) provides that ASIC may, in order to enable an application to be made to the Tribunal for review of the decision to cancel or suspend the registration, determine that the decision is not to come into effect until a specified time or the happening of a specified event.

### Effect of suspension

229. Proposed section 1299L provides that a company whose registration is suspended is, except for the purposes of subsection 1299E(4), sections 1299F and 1299G and Division 2, taken not to be registered as an authorised audit company so long as the registration is suspended.

### Effect of cancellation

230. Proposed section 1299M provides that if a company's registration as an authorised audit company is cancelled, each appointment of the company as auditor for a company or registered scheme that is in force on the day on which the cancellation takes effect is terminated at the end of that day.

### Authority to sign on behalf of authorised audit company

231. Proposed section 324AD provides that a report or notice that purports to be made or given by an audit company appointed as auditor of a company or registered scheme must be signed by a director of the audit company or the lead auditor or review auditor for the audit both in the company's name and in his or her own name. Proposed section 324AD recognises that under a corporate structure it may not be practicable or desirable for all the former partners of a large accounting firm to be appointed as directors of the audit company.

## PART 5: AUDITORS AND AGMS

### Overview

232. The amendments contained in this Part of the Bill are designed to facilitate shareholder participation at Annual General Meetings (AGMs) and improve auditor accountability by:

- allowing shareholders to ask questions of the company auditor, in writing before the AGM as well as orally at the AGM; and
- requiring company auditors to attend the AGM.

233. Since the *Company Law Review Act 1998* came into effect, members of a company have been entitled to ask questions of the auditor concerning the conduct of the audit and the contents of the audit report. This however only applies in relation to shareholders who attend the AGM and in circumstances where the auditor is in attendance at the meeting.

234. The Bill extends these provisions by requiring the auditor of a listed company (or their representative) to attend the AGM, and by providing an alternative mechanism by which all members — not just those in attendance — can ask questions of the auditor. For unlisted companies, there is no change to auditor attendance requirements brought about by this Bill. Auditors of unlisted companies will not be compelled to attend the AGM, but if they do attend, members of the company will be entitled to ask them questions.

235. CLERP 9 recommended that shareholders be able to submit questions by e-mail and that questions be posted on the company web site. The provisions in the Bill are medium neutral and will allow questions to be submitted by members in writing in all forms. Companies will be required to make the questions available to members attending the AGM. Companies may choose to post the questions on their website, however this will not be a requirement of the legislation.

236. By facilitating shareholder participation in this way, these provisions will strengthen the accountability of auditors to shareholders. The direct questioning of auditors will improve the ability of shareholders to assess both the quality of the audit, and the performance of the company management.

## **Questions submitted by members of listed company before AGM**

237. Item 102 in Schedule 1 of the Bill inserts proposed section 250PA which allows a member of a listed company to submit questions to the auditor about the contents of the audit report or the conduct of the audit.

238. Proposed subsection 250PA(2) requires that questions be submitted no later than the closing time for the receipt of voting proxies for the AGM. Proposed subsection 250PA(4) requires the company to forward all questions it has received to the auditor as soon as practicable, so as to give the auditor maximum time to consider the issues raised.

239. The auditor is required to prepare a list of questions submitted and, following any filtering, provide that list to the company far enough in advance of the AGM so as to allow the company to make it available to members attending the AGM (see proposed subsection 250PA(5)).

240. Proposed subsection 250PA(5) allows the auditor to filter questions on the basis of relevance to the audit report or conduct of the audit. It is considered appropriate that the auditor determine relevance rather than the company. The company could however, express an opinion to the auditor regarding the relevance of individual questions. The auditor may also exclude questions that are the same in substance as other questions, and questions that were not passed to the auditor in reasonable time for the auditor to assess their suitability for inclusion in the list. (see proposed subsection 250PA(6)).

241. Proposed subsection 250PA(7) requires the company to make the list of questions provided by the auditor reasonably available to members attending the AGM. This may not necessarily require that printed copies be distributed to each attending member, although this would satisfy the requirement in most cases. The list could be made available by other means.

242. The main purpose of making the list available at the AGM is to highlight to shareholders where there may be areas of concern with the conduct of the audit and the audit report, and to prompt members attending the AGM of possible issues that could be raised with the auditor.

243. Item 104 in Schedule 1 of the Bill extends subsection 250T(1) to give the auditor or their representative a reasonable opportunity to answer written questions submitted under proposed section 250PA (see proposed paragraph 250T(1)(b)). Members already have a reasonable opportunity to ask the auditor questions at the AGM relevant to the conduct of the audit or the audit report under existing section 250T.

## **Answering questions**

244. There is no requirement in the Bill for the auditors to provide answers to written questions either at the AGM or following the meeting. Such a requirement would raise the issue as to whether the extra burden on auditors would lead to more useful information being disclosed. In addition, to require written questions to be answered would effectively elevate their status above questions asked orally at the AGM. As noted above, however, auditors will be given a reasonable opportunity to answer written questions at the AGM if they choose to do so.

## **Auditor's attendance at the AGM**

245. Item 103 in Schedule 1 of the draft Bill inserts proposed section 250RA which requires the auditor of a listed company to attend the AGM of that company where the audit report is to be considered. Where the auditor is an individual auditor, and that person is unable to attend the AGM, the auditor is allowed to arrange to be represented by a member of the audit team who is suitably qualified, and is in a position to answer questions about the audit (see paragraph 250RA(1)(b)). Where an auditor is an audit firm or company, the lead auditor would normally be expected to attend the AGM. However, the draft Bill is not prescriptive on this matter and any suitable member of the audit team may attend (see proposed subsection 250RA(2)).

246. The provision recognises that circumstances may arise where neither the auditor nor a representative would be able to attend the AGM, for example, where personal circumstances prevent attendance at the last minute and no replacement can be found in time (see proposed subsection 250RA(3)). Nevertheless, it is expected that auditors and audit firms will make every effort to ensure that the auditor or an appropriate representative is in attendance.

247. Proposed subsections 250RA(4), (5) and (6) outline liability in relation to audit firms and companies.

## **Qualified privilege**

248. Both auditors and their representatives will have qualified privilege in relation to answering questions at the AGM (see Schedule 1, item 107, proposed subsections 1289(3) and (4)). This is explained further under Part 6 below.

## PART 6: QUALIFIED PRIVILEGE

249. Proposed section 990L (item 106) will replace the existing section 990L in relation to qualified privilege of auditors of financial services licensees. The proposed section extends the qualified privilege provisions from individual auditors to registered company auditors acting on behalf of audit companies.

250. Proposed section 1289 (item 107) will replace the existing section 1289 in relation to qualified privilege of auditors. The proposed section extends the qualified privilege provisions from individual auditors to registered company auditors acting on behalf of audit companies.

251. As the auditors of listed companies will be required to attend company AGMs under proposed section 250RA, proposed subsection 1289(3) makes it clear that qualified privilege is extended to apply to answers to questions asked before (as provided by proposed section 250PA) or during a company AGM. Proposed subsection 1289(4) will also extend qualified privilege to a person representing the auditor at the AGM in cases where the auditor is not present.

## PART 7: EXPANSION OF AUDITORS' DUTIES

### Overview

252. Under current subsection 311(1) of the Corporations Act, a registered company auditor conducting an audit must notify ASIC in writing as soon as possible if the auditor has reasonable grounds to suspect that a contravention of the Act has occurred, and believes that the contravention has not been or will not be adequately dealt with by comment in the auditor's report or by bringing it to the attention of company directors.

253. To assist the auditor in performing their duties, section 1289 of the Corporations Act provides that an auditor has qualified privilege in respect of any statement made in the course of performing his/her duties as an auditor.

254. Experience indicates that section 311 has been used infrequently and limited reports are made to ASIC under the section. As a means of enhancing the use and effectiveness of the provision, CLERP 9 proposed that section 311 be amended to provide that an auditor must also report to ASIC if any officer or director of a company attempts to influence, coerce, manipulate or mislead the auditor.

255. In addition, amendments have been made to the provision to strengthen the reporting requirements and also to align similar obligations in the Corporations Act. The amendments recognise that auditors, as the external and independent parties who review financial statements are in a position to determine whether there is a contravention of the law. Consequently, auditors should be required to report any breach of the law on a timely basis.

256. Subsection 601HG(4) imposes a similar reporting obligation to that contained in section 311 on auditors of registered managed investment schemes while subsection 990K(2) contains the equivalent requirement for auditors of financial services licensees. Qualified privilege provisions which mirror those in section 1289 are contained in subsections 601HG(8) and 990L(1) respectively. In order to maintain consistency between similar legislative requirements, amendments based on those to be made to section 311 will also be made to existing sections 601HG and 990K.

### Reporting contraventions to ASIC

257. Item 108 replaces the existing section 311. Under the proposed amendment, an individual auditor who conducts an audit (which is defined for the purposes of the Corporations Act to include a review of a half-year

financial report) must notify ASIC in writing within seven days after they become aware of any circumstances that:

- they have reasonable grounds to suspect amount to a contravention of the Corporations Act;
- amount to an attempt, in relation to the audit, by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit; or
- amount to an attempt, by any person, to otherwise interfere with the proper conduct of the audit (proposed subsection 311(1)).

258. The main changes to note in section 311 are:

- the introduction of a requirement to notify ASIC of any attempts by a person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit;
- the introduction of a time limit within which breaches must be reported to ASIC. In addition, current paragraph 311(1)(b) has been removed.

259. These changes will significantly strengthen the reporting obligations of auditors where they have reasonable grounds to suspect a contravention of the law. Where such a suspicion exists, the auditor should be required to report to ASIC, regardless of whether the matter can be dealt with in the audit report or by bringing the matter to the attention of the directors as is currently the case. Reporting suspected breaches to ASIC should be on a timely basis. The Bill therefore provides that the auditor should notify ASIC as soon as practicable and in any case within seven days of becoming aware of the breach.

260. Proposed subsection 311(7) defines 'a person involved in the conduct of the audit' to mean the auditor, the lead auditor for the audit, the review auditor for the audit, a professional member of the audit team for the audit or any other person involved in the conduct of the audit.

261. Where an audit firm or audit company is conducting an audit, proposed subsection 311(2) imposes an obligation equivalent to that in proposed subsection 311(1) on the lead auditor. If there is a failure to comply with proposed subsection 311(2), the lead auditor of either the firm or the company will have contravened the section (proposed paragraph 311(3)(a) and proposed subsection 311(4)). Liability is also placed on the audit company under proposed subsection 311(2). However, an audit firm will not have contravened the provisions (proposed paragraph 311(3)(b)).

262. Proposed subsection 311(5) requires a review auditor and a professional member of the audit team to notify the auditor or lead auditor (in the case of an audit firm or audit company) of a suspected contravention of the law or of an attempt to unduly influence etc. Where the auditor or lead auditor is notified of such circumstances, they would, in turn, be required to inform ASIC in accordance with proposed subsections 311(1) or (2).

263. Item 109 amends current section 601HG along the lines of the amendments to section 311. Item 112 amends existing subsection 990K(2) by adding a requirement that an auditor must give a report to ASIC in relation to any matter that, in the opinion of the auditor, constitutes an attempt to unduly influence, coerce, manipulate or mislead the auditor in the conduct of the audit (proposed paragraph 990K(2)(c)).

## PART 8: COMPANIES AUDITORS AND LIQUIDATORS DISCIPLINARY BOARD

### Overview

264. The Companies Auditors and Liquidators Disciplinary Board (CALDB) is a disciplinary body which receives and reviews applications made to it by ASIC in respect of the conduct of either registered company auditors or liquidators. Under the existing structure of the CALDB, there are concerns about its operational capacity and its perceived independence from the accounting profession. Schedule 1, Part 8 of the Bill amends the current provisions governing the CALDB (see Part 11 of the ASIC Act) to address these concerns. In addition, the amendments facilitate the exchange of information between the CALDB and the professional accounting bodies for the purpose of assisting in their performance of their disciplinary functions.

265. The amendments will result in a change to the existing structure of the Board. The CALDB is currently comprised of three members, including the Chairperson, a member selected by the Minister from a Panel of five nominees put forward by the ICAA and a member selected by the Minister from a Panel of five nominees put forward by the CPAA. It is the Board itself that currently hears matters coming before the CALDB.

266. As a result of the amendments contained in the Bill, the new Board of the CALDB will consist of twelve people instead of three. The overall Board may meet to determine procedural issues and to conduct the business of the Board. However, the Board itself will no longer conduct hearings. Instead, up to two Panels will sit under the Board and will be constituted to hear matters. Members of each Panel will be chosen from the overall membership of the Board.

267. Currently, accountants form the majority of the Board of the CALDB. The importance of retaining accounting expertise on the Board to assist in the determination of particular disciplinary matters is recognised. At the same time, to enhance the perceived independence of the Board, its composition will be changed to allow for a majority of non-accountants to hear matters coming before each Panel.

268. This expanded membership will allow two Panels of the Board to sit at any given time and thereby hear and determine matters more expeditiously.

269. A Panel will normally consist of five persons including: the Chairperson or Deputy Chairperson (who must have legal qualifications), one member from each of the prescribed professional accounting bodies (the CPAA

and ICAA), and two members from the business community. On certain occasions (such as in the case of purely administrative matters) the Chairperson may consider it more cost efficient and appropriate to constitute a Panel with three members. A three person Panel would consist of the Chairperson or Deputy Chairperson, one accounting member and one business member.

## **Changes to membership of the Board of the CALDB**

270. Currently, the practical effect of section 203 of the ASIC Act is that the majority of the Board are accountants. Items 118 to 120 amend section 203 to provide for a reconstitution of the membership of the CALDB. These amendments provide for additional members to be appointed to the Board who are not members of the professional accounting bodies.

271. The Minister will be responsible for appointing four representatives from the business community who must have qualifications, knowledge or experience in business or commerce, the administration of companies, financial markets, financial products and services, economics or law.

272. The number of accountants appointed to the Board will also be increased. Three members must be chosen from seven nominees put forward by the ICAA, along with three members chosen from seven nominees put forward by CPAA. The business and accounting appointees must be resident in Australia.

273. The overall Board membership will also consist of a Chairperson, and a new position will be created for a Deputy Chairperson. The appointment of a Deputy Chairperson will allow the CALDB to hold more than one hearing simultaneously. The Deputy Chairperson must be a legal practitioner enrolled to practice in a Supreme Court of a State or Territory, or a court of higher jurisdiction, for not less than five years.

274. Due to the revised constitution of the CALDB and the appointment of additional members, it will no longer be necessary to appoint deputy members generally. Therefore, item 128 repeals section 209 and item 136 repeals subsection 212(1).

## **Terms and conditions of appointment**

275. Items 121 to 126 provide for the terms of appointment of the Chairperson, Deputy Chairperson and members, including the basis on which: they are appointed, they may resign, or their appointment may be terminated.

## Provisions for Acting Chairperson and Acting Deputy Chairperson

276. Item 127 replaces existing section 208 of the ASIC Act with proposed sections 208 and 208A. These sections provide for acting arrangements where there is a vacancy in the position of the Chairperson or Deputy Chairperson.

277. Proposed section 208 provides that during either the Chairperson's absence or a vacancy in the office of Chairperson or when for any reason the Chairperson cannot perform their functions, the Deputy Chairperson would normally fill the Chairperson's position. If the Deputy Chairperson is unavailable when a replacement is required, the Minister may appoint another eligible person to act as Chairperson.

278. Proposed section 208A provides that the Minister may appoint a person who is eligible for appointment as Deputy Chairperson to act in that position:

- during the absence of the Deputy Chairperson;
- during a vacancy in the office; or
- when the Deputy Chairperson is acting as Chairperson under proposed subsection 208(1).

## Meetings of the Board of the CALDB

279. Items 129 and 130 amend existing section 210 to provide for the conduct of meetings involving the overall Board of the CALDB. Item 129 inserts subsection 210(1A) which precludes any of the rules in section 210 from applying to a meeting of a constituted Panel. Item 130 amends subsection 210(3) to provide that at a meeting of the Board, the Chairperson plus five other members will comprise a quorum.

## The Constitution of a Panel and Panel Meetings

280. Item 131 inserts into the ASIC Act proposed section 210A, which sets out how a Panel is to be constituted to deal with an application to the CALDB under section 1292 or 1295 of the Corporations Act.

281. Proposed subsection 210A(2) provides that the Chairperson is to determine in writing which members are to form a particular Panel. The provision gives the Chairperson flexibility as to the convening of a Panel. In some circumstances the Chairperson may wish to convene the Panel relatively quickly, such as in routine matters. In other circumstances, the Chairperson may wish to give further consideration to a Panel's composition to ensure that

any conflicts of interest are avoided. It is also recognised that to ensure the availability of the part-time members, it may be necessary to constitute a Panel as close as possible to the date of the hearing.

282. While the Chairperson has discretion as to how they constitute a panel, wherever possible, the Chairperson should constitute a five member panel comprised of:

- the Chairperson or Deputy Chairperson;
- one member of the ICAA;
- one member of the CPAA; and
- two members of the business community.

283. Constituting a five person Panel may not be practicable or appropriate in certain circumstances, particularly in the case of more routine matters such as where a respondent has failed to lodge an annual statement, or in the case of similar matters of an administrative nature. In such circumstances, the Chairperson may choose to constitute a three person panel comprised of:

- the Chairperson or Deputy Chairperson;
- one member of the ICAA or CPAA; and
- one member of the business community.

284. Where, after a hearing has commenced, a member of the Panel becomes permanently unavailable, the matter must be reheard by a new Panel determined by the Chairperson (proposed subsection 210A(6)). It is expected that the reconstituted Panel will consist of the original members of the Panel, plus a replacement member. To avoid duplication of proceedings, the reconstituted panel may have regard to any record of the previous Panel's proceedings.

285. Since the members will be part-time, it is recognised that on occasions a Panel member may be temporarily unavailable to attend a meeting of a Panel. To provide for a Panel meeting to proceed where these circumstances arise, proposed section 210B provides for a quorum of the Panel.

286. The quorum for a five person Panel is three persons, comprising the Chairperson or Deputy Chairperson, one member from either the ICAA or CPAA, and one member from the business community. The quorum for a three person panel is two persons, comprising the Chairperson or Deputy Chairperson and the accounting member. The quorum provisions are not

intended to be used to allow a panel to continue operating where a panel member becomes permanently unavailable. In these circumstances, the Panel should be reconstituted pursuant to proposed subsection 210A(6).

### **Disclosure of interests**

287. Items 132 to 135 amend existing section 211 to require the Chairperson, Deputy Chairperson and other members to disclose any interest in a matter that is to be considered by the Board of the CALDB or by a Panel of the CALDB. The disclosure shall be recorded in the minutes and the relevant member may not normally be present during deliberation of the matter, or take part in any decision by the CALDB or by a Panel on the matter.

### **Sharing of information**

288. Items 137 and 138 amend current section 213 to provide that information given to a Panel is to be treated with the same confidentiality as if it were provided to the CALDB. However, to aid the ICAA, CPAA, and NIA in the course of exercising their disciplinary functions, disclosure of relevant information will be authorised where it is to assist a professional accounting body or other prescribed professional body to perform its disciplinary function. This will also allow scope for the CALDB to share information with other disciplinary bodies (for instance, a legal professional body or an insolvency body) as appropriate.

### **Panel powers and responsibilities**

289. Items 140 to 146 amend existing section 216. The changes reflect the distinction made in the Bill between the Board itself and the Panels convened to hear particular matters.

#### **Issue 1.5**

Where the Board decides to take disciplinary action against an individual, under subsection 1296(1) of the Corporations Act, a notice setting out the decision must be lodged with ASIC and also published in the Gazette. Further, pursuant to section 1274, a document lodged under subsection 1296(1) may be inspected. Comments are sought on whether, in addition to the information disclosed under section 1296, the notice should disclose details of the firm, where the individual subject to disciplinary proceedings is the member of a firm?

### **Changes to certain references**

290. Items 147 to 158 make technical amendments to existing sections 217 to 221 and 223 so as to refer to the Panel Chairperson or Panel where appropriate (rather than to the Chairperson or Disciplinary Board).

