

7. APPOINTMENT AND INDEPENDENCE OF AUDITORS

701. This chapter examines the issues associated with the appointment of a person (or firm) as auditor of a company and the subsequent independence of the auditor from the company and its management.

702. Independence for a professional is a state of mind. No specific restrictions or requirements can achieve independence. However, some specifications can contribute significantly towards the maintenance of independence of mind, as well as the appearance of independence. In practice, independence has three main elements:

- (a) adequacy of remuneration (to ensure that the professional is less likely to be placed under financial pressure);
- (b) adequacy or security of tenure (to ensure that the professional has some degree of protection in order to be able to form an independent opinion); and
- (c) freedom from undue influence in making decisions.

CURRENT SYSTEM

703. The initial appointment of an auditor of a company after its incorporation may be made by either the directors of the company or the company in general meeting. A person appointed in this way holds office until the next AGM of the company, at which time the company must appoint an auditor who will hold office until death, retirement or removal. Casual vacancies in the office of auditor are filled in a similar manner.

704. The Law also contains provisions that have the objective of ensuring that an auditor is independent of each company he or she audits. For example, section 324 provides that a registered company auditor shall not consent to be appointed as an auditor of a company or act as auditor of a company if:

- (a) the person (or, in the case of a firm, any member of the firm), or a body corporate in which the person is a substantial shareholder, owes more than \$5,000 to the company being audited, to a related body corporate or to an entity that the company controls (except in respect of loans in the ordinary course of its ordinary business by a bank or life assurance company, to natural persons to finance the purchase of that person's principal place of residence); or

- (b) except in the case of a proprietary company, the person is an officer of the company, is a partner, employer or employee of an officer of the company, or is a partner or employee of an employee of an officer of the company.

705. The ethical rules of the ICAA and ASCPA contain detailed requirements relative to independence, including independence as an auditor, as do auditing standards which are mandatory for members of these two bodies.

ISSUES

706. It would seem that in many cases the directors of a company have the ability to control or influence the majority of voting shares and thus can ensure that any resolution they might place before the AGM of the company is carried.

707. Many members of the accounting profession and the wider business community argue that although there have been a few instances where the independence of an auditor could be questioned, in the vast majority of cases the auditors have been, and continue to be, independent of the directors who nominated them for appointment. On the other hand, some accountants and representatives of smaller investors and shareholder groups believe that lack of independence is a significant problem and that the auditor is, in practice, responsible to management or the directors.

PROPOSALS

708. The Working Party has identified the procedures for appointment of auditors by companies and measures to enhance the independence of auditors as important issues that need to be addressed.

Appointment

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

- (a) retaining the existing requirements with or without the provision of a period of fixed tenure for the appointment;
- (b) restricting voting at AGMs on resolutions to appoint auditors to those shareholders:
 - (i) who are not directors; or

- (ii) who have not exercised a right (whether written or otherwise), based on the size of their share holdings, to have a nominee appointed to the board of directors;
- (c) having the auditor appointed according to existing requirements but on the recommendation of an audit committee or a committee of non-executive directors; and
- (d) having the auditor appointed by a completely independent body such as the ASC, the Court or an independently established tribunal.

710. Australia's regulations relating to audit appointment are broadly in line with those of other developed countries. There is no precedent for appointment by an independent body (option d) and, on the evidence before it at this time, the Working Party is of the view that a move in this direction would create more problems than it would solve. The Working Party believes options (b) and (c) have merit, particularly option (c) which would complement the increasing emphasis on external directors and audit committees in the overall context of corporate governance. It is also in line with the recent recommendations of the Auditing Practice Board in Great Britain.

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

712. To facilitate the implementation of this proposal, the Working Party considers that either the ASX listing rules or the Law should be amended to make it mandatory for listed companies to have an audit committee. Non-executive directors should, preferably, constitute the majority of members of such a committee.

713. The Working Party is also of the view that changes to the auditors of a disclosing entity should be made a continuous disclosure matter. This matter is considered further later in this chapter.

Recommendation 7.1

If the ASX listing rules do not so provide, the Law should be amended to require listed companies to have an audit committee. Non-executive directors should constitute the majority of members of such a committee.

Recommendation 7.2

Auditors of a listed company should be appointed and their remuneration determined on the recommendation of the company's audit committee or, where there is no audit committee, an appropriate committee of non-executive directors.

Recommendation 7.3

Auditors of an unlisted company should be appointed on the recommendation of the company's audit committee where such a committee exists.

Independence

714. A failure on the part of an auditor to maintain his or her independence can have significant consequences for the auditor, including:

- (a) being subject to a damages action by a party that claims to have suffered loss as a result of the auditor's lack of independence or by the ASC under section 50 of the ASC Act;
- (b) under section 52 of the Trade Practices Act (or under a Fair Trading Act) for 'conduct that is misleading or deceptive';
- (c) where the lack of independence arises through the auditor's breach of subsection 324(1), being prosecuted under section 1311 of the Law;
- (d) being subject to a hearing by the CALDB as to whether the auditor is a fit and proper person to remain registered as an auditor
 - (i) where the auditor is convicted of an offence under section 1311; or
 - (ii) when the ASC has formed the prima facie view that an auditor has failed to carry out or perform adequately and properly the duties of an auditor (section 1292);

- (e) being subject to disciplinary action by the auditor's accounting body (if he or she is a member of such a body); and
- (f) criminal action.

715. The need to ensure that significant arrangements are in place to maintain an auditor's independence raises a number of issues including:

- (a) whether the level of indebtedness (\$5,000) referred to in paragraphs 324(1)(e) and (2)(f) of the Law continues to be appropriate;
- (b) whether the requirements of section 327 dealing with the duration of an auditor's appointment are appropriate;
- (c) whether the external auditor of a company, or his or her firm, should be permitted to provide any other services to the company;
- (d) the impact that practices such as audit tendering are having on the quality and independence of auditors;
- (e) the relationship of the external auditor with independent directors and the audit committee;
- (f) the impact of opinion shopping on audit independence;
- (g) whether the current provisions relating to the removal and resignation of auditors are appropriate;
- (h) whether the auditor's role and privilege with respect to attendance and speaking at AGMs should be extended;
- (i) whether a limitation should be placed on the dependence of an auditor or his or her firm on fees derived from one particular client;
- (j) the extent to which independence issues should be laid down by regulation or alternatively delegated to professional bodies for incorporation into self regulated professional standards and ethical rulings; and
- (k) the place of the teaching of business ethics in tertiary institutions and by professional bodies.

Level of Indebtedness

716. Indebtedness has two aspects: the auditor being indebted to the audit client and the audit client being indebted to the auditor.

717. Indebtedness by an auditor to a client is addressed in section 324 of the Law. The limitation of \$5,000 for both individual auditors and firms has remained the same since 1982. If permitted indebtedness had been indexed in line with changes in the Consumer Price Index, the figure would now be \$10,000. No submissions have been made to the Working Party on this point. Although the Working Party is of the view that the level of indebtedness is not a critical issue providing it is not material, an increase to \$10,000 or such other amount as may be prescribed by regulation would appear to be appropriate.

718. As part of this question there is some concern about how widespread the indebtedness restriction should apply within an audit firm. One view is that indebtedness considerations should extend no further than those partners directly engaged on the audit. At present, indebtedness between any partner and the audit client is subject to this limitation.

719. A corollary of this question is whether particular types of indebtedness should be excluded from the calculation. Where, for example, the audit client is a bank or other financial institution, it has been proposed that borrowings of up to \$100,000 from the institution by partners not involved in the audit should be permitted. The one qualification on such relationships would be that the indebtedness only arose in the ordinary course of business and was written on normal commercial terms.

720. There has been no suggestion that the present exemption granted by subsection 324(3), in respect of home loans from banks and life assurance companies, be changed.

721. The prohibitions on indebtedness outlined above should also apply to relatives of an auditor. These relatives could be expected to include:

- (a) a spouse or de facto spouse of an auditor;
- (b) a parent, son or daughter of such an auditor, spouse or de facto spouse;
- (c) an entity over which a person of the kind referred to above has control, either individually or in association with another person (including another auditor or a relative of that other auditor).

722. The second aspect of indebtedness relates to amounts owed by the audit client to the auditor. Although AUP 32¹ raises the issue, there is no Australian prohibition on the owing of money by an audit client to the auditor. This is not the case in the USA. The Working Party considers that there is merit in prohibiting an auditor from accepting (or continuing) an audit engagement when the audit client is indebted to the auditor.

¹ It should be noted that, despite the codification of auditing standards whereby the new standards become operative from 1 July 1996, AUP 32 remains operative in its present form with interim endorsement.

Indebtedness in respect of outstanding professional fees, or deposits with a financial institution of up to \$100,000 by partners not involved in the audit, should be permitted.

Recommendation 7.4

The level of indebtedness by an auditor to a client (as referred to in paragraphs 324(1)(e) and (2)(f) of the Law) should be increased from \$5,000 to \$10,000 or such other amount as may be prescribed by regulation, subject to recommendation 7.6.

Recommendation 7.5

A prohibition should be placed on the indebtedness of a company to its auditor, with the exception of professional fees and amounts up to a maximum of \$100,000 deposited with a financial institution or life insurance company by a natural person on normal commercial terms and in the ordinary course of business of the financial institution or life insurance company, subject to recommendation 7.6.

Recommendation 7.6

The monetary indebtedness prohibitions should only apply to partners of a firm of auditors who are directly engaged on the audit assignment and relatives of such partners.

Term of Appointment

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

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

- (a) an auditor may be removed from office by resolution of the company at a general meeting of which special notice has been given; and
- (b) an auditor of a public company may resign if the ASC has consented to the resignation (the auditor of a proprietary company does not need the ASC's consent to resign).

725. Options available in respect of the tenure of auditors include:

- (a) retaining the existing requirements;

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

Audit Rotation

726. In some European countries, the audit appointment is limited to three years with the incumbent auditor eligible for reappointment. Only in Spain and Italy is there a requirement to rotate the audit after a specified period of time (nine years).

727. Submissions received by the Working Party showed little support for audit rotation. On the contrary, the anticipated cost, disruption and loss of experience to companies is considered unacceptably high, as is the unwarranted restriction on the freedom of companies to choose their own auditors.

728. Although the Working Party believes that a minimum fixed term of appointment (in the absence of a takeover) has merit, the Working Party is disinclined to the view that the term of appointment should be fixed or that audit rotation should be mandated.

Audit Partner Rotation

729. AUP 32 recommends consideration of periodic rotation of the audit partner and staff on an assignment after a suitable period of time. There is also international support for audit partner rotation.

730. Submissions generally supported rotation of the audit partner although rotation is not favoured by small practitioners who regard such a requirement as discriminatory. The Working Party sees merit in the audit partner rotation proposal but is concerned about the potential impact on small practitioners.

731. The Working Party concluded that there should be mandatory rotation of audit partners in accordance with the principles laid down in AUP 32 for all listed companies.

Recommendation 7.7

There should be mandatory rotation of the audit partners responsible for the audit of listed companies in accordance with the principles laid down in AUP 32.

Second (Review) Partner

732. A procedure currently employed in many firms is to have a second (review) partner who signs off on an audit opinion prior to its signature by the audit engagement partner. This process is followed as a quality control measure that complements the audit partner rotation concept.

733. The Working Party is interested in the possible formalisation of a second (review) partner concept but again is concerned about the possible impact on small practitioners. The Working Party is also concerned that introduction of a second partner from another firm may involve difficult professional indemnity issues.

734. Accordingly, the Working Party is not inclined to mandate a second (review) partner except as a possible alternative option for rotation of the audit partner.

Provision of Non-auditing Services by Auditor

735. An issue that is closely related to the independence of auditors is whether an accounting firm that has been appointed as the external auditor of a company should be permitted to provide 'other services' to that company. Other services range from performance of a formal internal audit function through provision of accounting-related services to matters such as executive search and management consultancy.

736. Since 1971, Schedule 5 to the Regulations and its predecessors (Schedule 7 to the Companies Regulations and the Ninth Schedule of the State/Territory Companies Acts/Ordinances) have required the financial statements of a company to disclose separately the amounts paid to the auditor of the company for 'auditing the accounts' and 'other services', thus clearly recognising the fact that auditors provide other services to the companies that they audit.²

737. One of the policy objectives underlying the requirement for separate disclosure of these amounts is to provide sufficient information to enable a reader of the financial

² In December 1996, the Australian Accounting Standards Board (AASB) issued accounting standard AASB 1034 'Information to be Disclosed in Financial Reports', which has replaced Schedule 5 to the Corporations Regulations in respect of financial years ending on or after 30 June 1997. The standard contains a requirement equivalent to the current disclosure requirement, which is in clause 27 of Schedule 5.

statements to make his or her own assessment of the auditor's dependence on income from other services. It can be argued that, as the income an auditor receives from other services increases, the greater will be the temptation for the auditor to do nothing that will affect the relationship with the client (such as a substantial qualification of the audit report).

738. Options available in respect of provision of 'other services' include:

- (a) maintaining the status quo (that is, no requirements other than those dealing with disclosure) with a possible additional requirement for the provision of information on nature of other services;
- (b) restricting the range of other services that the auditor of a company may provide to the company by prohibiting specified types of other services;
- (c) placing a total prohibition on the provision of other services to a company by the auditor of that company; and
- (d) requiring the directors of a company to obtain audit committee and/or shareholder approval (either generally or for specific services up to or in excess of a particular monetary amount) before engaging the auditor of the company to provide other services or in some way monitoring the other services provided.

739. In terms of developed countries, only Italy and France prohibit the delivery of management consulting type services by a firm to an audit client. In other countries there are selective prohibitions on specific services (such as executive recruitment and share registry services in the USA).

740. The ethical rulings and audit statements of the accounting bodies (in particular REC 4 ('Professional Independence')³ and AUP 32) provide extensive guidance to auditors performing other services, particularly in sensitive areas such as internal control, accounting services and internal control reviews (especially in the latter case in the context of systems involving advanced information technology). Among other things the statements provide that:

- (a) AUP 32 requires auditors to be 'free of any interest which might be regarded, what ever its actual effect, as being incompatible with integrity and objectivity'.
- (b) 'In each professional assignment he undertakes, a member in public practice shall both be and be seen to be free of any interest which is incompatible with objectivity. This is self evident in the exercise of the

³ This is the ICAA document. The equivalent ASCPA document is F.1 'Professional Independence'.

reporting function and also applies to all other professional work' (REC 4).

- (c) 'When providing management consulting services to an audit client, a practice or a person in the practice must not participate in the executive function of that client. Decision making is part of the duties of the board of directors and management of a company and not of its auditors' (REC 4).

- (d) '[a] A practice should not participate in the preparation of the books of a public company audit client save in exceptional circumstances.

'[b] In the case of a private company audit client it is recognised that it is frequently necessary to provide a much fuller service than would be appropriate in the case of a public company audit client and this may include participation in the preparation of books.

'[c] In all cases in which a practice is concerned in the preparation of the books of an audit client, particular care must be exercised to ensure professional independence and to ensure that the client accepts full responsibility for such books and that no person in the practice has taken part in the executive decision making functions of the client' (REC 4).

- (e) 'The concept of independence is fundamental to auditing, since the auditor's objective is to enhance, through the expression of an independent opinion, the credibility of the reported financial information of an entity' (AUP 32).

- (f) 'When the auditor is involved in providing "other services"...there are particular independence issues which must be resolved' (AUP 32).

- (g) 'In principle there is no objection to providing a client with services additional to audit services. However care should be taken to ensure that:

'[a] actual independence is not at risk by the auditor performing management functions or making management decisions; and

'[b] perceived independence is not at risk because of a perception that the auditor is too closely aligned with the entity's management' (AUP 32).

- (h) 'The provision of internal audit services by the external auditor of the same entity may...place at risk the perception of the independence of the external auditor from the perspective of the financial report users and other interested parties' (AUP 32). The statement goes on to detail the steps necessary in order for the external auditor performing internal audit work to demonstrate independence.

741. Submissions provided little support for a legislative prohibition on other services. One submission proposed that internal audit not be performed by the external auditor but the overwhelming view was that no restrictions should apply, save that in accepting an undertaking to provide other services, the auditor should comply with the ethical requirements and audit standards referred to in paragraph 740 above.

742. Submissions generally supported the right of a company to engage whoever they considered most appropriate for non-audit work and stressed that the auditor may well be the most appropriate person to do that work.

743. The Working Party is of the view that additional services provided by an external auditor in the areas of accounting services, internal audit and special-purpose reviews of internal control involve a higher degree of risk of impairment of the independence of the work of the external auditor. Even if there is no actual impairment, these services could well give rise to an appearance of impairment of independence. Therefore it seems appropriate that additional procedures apply to help to eliminate any difficulties in this area.

744. For accounting services, REC 4 already specifies precautionary procedures that should be followed and limits the extent of involvement of the external auditor. It is the view of the Working Party that where the principal role of the accounting firm is in the provision of external audit services, then another partner should take responsibility for any accounting services. The general rules applicable to acceptance of such additional work will of course remain in place.

745. Regarding internal audit services, these services are an extension of the role of the internal controls of the enterprise being audited, being quite separate in their nature from external audit work. Therefore, to help ensure that the different roles are not confused, it would seem essential that the partner handling the internal audit work be not the same as the partner handling the audit engagement.

746. Internal control reviews and assessments are a vital part of the work of the external auditor. As a by-product of the audit, the external auditor will bring to the attention of management and the directors issues of concern which have been noted.

747. Particular care needs to be taken where the external auditor has a formal responsibility to report to third parties on aspects of internal controls; sufficient work needs to be performed on the internal controls to be able to make the necessary report.

748. In this situation it would seem inappropriate for the auditor to undertake a specific and separate assignment to review internal controls, for the benefit of management and/or the directors.

Working Party's Position

749. Having regard to the significant legal and professional sanctions when there is a failure by an auditor to maintain his or her independence and the emphasis on disclosure referred to in the next paragraph, the Working Party is not inclined to the view that any specific restrictions should be placed on non-audit services being performed by the auditor or his or her firm.

750. However, the Working Party believes there are good reasons to require the current disclosure requirements relating to non-audit services to be extended to provide a broad breakdown of the nature of those services.

751. Non-audit services provided to a company by its auditor or his or her firm should be reviewed annually by the company's audit committee or, if there is no audit committee, by another committee of non-executive directors.

Recommendation 7.8

Providing there is a continuing mandatory requirement to adhere to the independence requirements of current ethical rulings and auditing standards, the Law should not place any restrictions on an auditor or his or her firm performing non-auditing services for an audit client. However in the current review of ethical requirements by the accounting bodies, it is recommended that attention be directed toward the provision of additional procedures (including allocation of responsibility for the additional services to a partner other than the external audit partner) for application in the more contentious areas of accounting services, internal audit and specific and separate internal control reviews to strengthen independence in these areas.

Recommendation 7.9

The current disclosure requirements relating to non-audit services should be expanded to require a breakdown of the nature of those services and to include services provided by entities whose beneficial ownership is substantially the same as that of the auditor's firm.

Recommendation 7.10

Non-audit services provided to a company by its auditor or his or her firm should be reviewed annually by the company's audit committee or, where there is no audit committee, by the full board to satisfy itself that the non-audit services provided are not of a nature that would compromise the independence of the external auditor from the perspective of the company.

Method of Selecting Auditor

752. There is a perception in some sections of the community that the practice of some companies' directors of seeking tenders for the auditing of their companies' financial statements has led to a decline in the quality of company audits. This could also lead to concerns regarding independence, as adequate remuneration is considered to be an ingredient of independence (see paragraph 702).

753. While there does not appear to be any empirical data that supports this perception, it would, nevertheless, seem to be fundamental that if the remuneration auditors are receiving for individual company audits is either declining or remaining static, in the long term costs associated with the audit must also be reduced or contained.

754. The point has been made to the Working Party that the cost to both tenderers and companies is very high in that many companies call for a substantial number of tenders all of which require a significant amount of preparation and presentation time. There is also concern that additional tenders are sometimes called to place fee pressure on a

preferred auditor in circumstances where there is no real prospect of the additional tenderers being appointed.

755. As tendering is a normal procedure for obtaining goods and services in both the public and private sectors, restricting or preventing its use as a means of selecting company auditors could involve some difficulty. Suggestions have been made to the Working Party, however, that tender procedures should be overseen by an independent tribunal and/or that tender proposals be made available to all tenderers; also that the number of detailed tender proposals called for be limited in some way such as by a preliminary filtering process to reduce costs.

756. The use of tendering for selecting company auditors would indicate the need for measures such as scrutiny via quality reviews and the establishment of audit committees and the further strengthening of the profession's ethical guidelines in this area.

757. The Working Party appreciates the need for freedom for companies to negotiate the audit fee. Having said this the Working Party sees audit services as 'special' services provided for the protection of shareholders (see paragraph 128) and therefore somewhat different in nature to the provision of other products or services where tendering has long been an established practice. The Working Party also believes there is a need to strengthen the role of the auditor in audit tender situations to safeguard the maintenance of high quality audit services. As a consequence, the Working Party generally supports suggestions contained in AUP 32 that the audit fees should be commensurate with the service provided and that recovery of the cost of an audit in any one period should not depend upon an expectation of recovery from the fees of future audits and/or other services to be provided to the client. The Working Party also sees merit in the specific targeting of audits recently won by tender in the quality control review processes of the ICAA and ASCPA.

Working Party's Position

758. The Working Party does not believe it is appropriate to remove tendering as one of the possible methods for selecting auditors. As previously indicated, however, the Working Party is of the view that auditors of listed corporations should be appointed on the recommendation of an audit committee. This view carries with it the expectation that audit committees will be closely involved in the calling and evaluation of tenders where this method of selection is employed.

759. The Working Party also considers that the provisions of AUP 32 on audit tenders should be embodied in the mandatory audit or ethical standards of the accounting bodies.

760. The Working Party also believes that steps need to be taken to limit the number of auditors invited to submit detailed proposals to firms identified (if necessary, by a

brief preliminary process such as inviting expressions of interest) as meeting a company's major criteria and therefore having a realistic opportunity for appointment.

Recommendation 7.11

The Law should not place any restrictions on the use of tendering as a means of selecting a company's auditors but companies should be encouraged to reduce the number of formal tenders required.

Relationship of the External Auditor with the Audit Committee or Non-Executive Directors

761. The Working Party notes the growing debate on corporate governance issues and in particular the trend toward the introduction of audit committees and the strengthening of the role of non executive directors. The Working Party is supportive of these trends which it believes can significantly strengthen the role of the auditor.

762. The Working Party also sees a need to increase the level of communication between auditors and the board of directors, for example by attending board meetings. In this respect it is significant to note that auditors do not have the right to attend board meetings.

763. Valuable insight and discussion on the role of the audit committee was contained in the Kirk Report,⁴ issued in September 1994 in the United States. The Report considered the relationship of the auditor with the board of directors and the audit committee:

Today, in most companies, the auditor's interaction with the board of directors is through the board's audit committee. The audit committee assists the board in fulfilling its oversight responsibilities in the areas of financial reporting, internal controls, financial policies, and the independent and internal audit processes. While it is certainly appropriate and effective for the board to delegate those responsibilities to the audit committee, the Panel believes that the auditors can add to the effectiveness of the board in monitoring corporate performance on behalf of the shareholders without detracting from the important role of audit committees by direct involvement with the full board and particularly its independent directors.

⁴ Advisory Panel on Auditor Independence, 'Strengthening the professionalism of the independent auditor — Report to the Public Oversight Board of the SEC Practice Section, AICPA', Public Oversight Board, Stamford, 1994.

The Panel believes it essential that the full board and particularly the independent directors have more exposure to the outside auditor to assist the board in meeting its responsibilities to shareholders. The independent auditor can provide the board a wide and objective perspective of the company's operations as well as its financial reporting policies and practices.

As the shareholders' representative, the board is accountable to them for monitoring the company's performance in achieving its goals and plans. That accountability is discharged, in part, by ensuring that shareholders receive relevant and reliable financial information about the company performance and financial position. The board should expect the auditor to assist it in discharging that responsibility to the shareholders, and the auditor should assume the obligation to do so. Therefore, the full board needs to have direct exposure to the auditors at least once a year prior to reappointment of the auditor.

The involvement of the auditor with the full board of directors is not intended in any way to bypass the audit committee or to replicate the committee's work at the full board level. The committee would continue to review with the auditors the details of the company's financial statements, management's discussion and analysis [MD&A], other financial data and systems, and audit findings and judgements related thereto. It is the intention of the Panel's suggestions that audit committees would report the auditor's views at meetings of the full board and would ask the auditor to be present at such meetings as frequently as necessary, but at least once a year.

764. The Working Party also believes that the Law should be amended to allow an auditor by prior notification, to attend any meeting of the board of directors to discuss issues which have relevance to the audit.

765. Finally, the Working Party favours a requirement for auditors to meet with the full board at least annually to discuss financial statements tabled for adoption by the board and to meet with the audit committee where such a committee exists.

Recommendation 7.12

The Law should be amended to provide that where a company's audit committee or the company's board is to discuss issues which have relevance to the audit, the company's auditor should be given notice of the meeting and be invited to attend the meeting or relevant part thereof. The Law should also be amended to permit an auditor (by prior notice) to attend an audit committee meeting or board meeting to raise and discuss issues which have relevance to the audit.

Compliance with Accounting Standards

766. The Working Party has noted the potential for opinion shopping to erode the independence of the auditor. Although the ICAA and ASCPA have introduced ethical rulings with respect to opinion shopping, the Working Party is inclined to the view that more needs to be done in this area.

767. The Working Party believes that one means of achieving this may be to revisit the proposal of the ASCPA and the ICAA to establish a FRRB to:

- (a) provide specific guidance to individual companies and their auditors on contentious accounting issues and interpretations of accounting standards; and
- (b) investigate suspected breaches of accounting standards and where appropriate to refer matters for disciplinary action against directors and/or auditors.

768. The establishment of the Urgent Issues Group (UIG) has provided a mechanism for dealing with issues surrounding the application of accounting standards which are of concern to members of the accounting profession and the wider business community. As a consequence, the UIG has reduced the need for the interpretative role that had been proposed for the FRRB. However, there would still appear to be a role for it in investigating suspected departures from accounting standards or other reporting anomalies. Under this proposal, the FRRB would investigate and, where it found that there had been a prima facie breach of an accounting standard or other reporting anomalies, it would seek appropriate remedies. If it is unsuccessful, the matter would be referred to either the accounting bodies or the CALDB for further action.

Recommendation 7.13

The Working Party encourages the establishment of a Financial Reporting Review Board (FRRB) or similar group to inquire into apparent departures from accounting standards or other reporting requirements. Where it was found that departures had occurred, it would seek appropriate remedies. If it is unsuccessful, the matter should be referred to either the accounting bodies or the CALDB or both for appropriate disciplinary action.

Removal and Resignation of Auditors

769. The Working Party has received submissions suggesting that consideration should be given to circumstances when it may be appropriate for a change of auditors to take place other than at an AGM or without the requirement to obtain ASC approval. The Working Party is concerned at the potential in these circumstances for the independence of the auditor to be compromised.

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

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

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

Recommendation 7.14

The Law should be amended to provide that a proposed change to the auditor of a disclosing entity is a continuous disclosure matter.

Recommendation 7.15

The Law should provide that any proposal for appointment of auditors of a disclosing entity must contain information on the proposed fees.

Attendance at AGM

773. Subsection 332(8) of the Law currently provides that an auditor of a company or an agent of the auditor is entitled to attend any general meeting of the company and to be heard on any part of the business of the meeting that concerns the auditor in the capacity of auditor.

774. The Working Party received submissions suggesting the role of the external auditor at a company's AGM should be strengthened as this is the only forum where the auditor and the persons to whom he or she is accountable can meet on a face to face basis. The Working Party is supportive of the underlying principles involved.

775. The Working Party believes that there should be a requirement for an auditor to attend the AGM at which his or her audit report is tabled, either in person or by nominee, except in exceptional circumstances. This would appropriately complement the draft provision in the Second Corporate Law Simplification Bill which provides that if a company's auditor or his or her representative is at the AGM, the chairperson of the AGM must allow a reasonable opportunity for members at the meeting to ask questions of the auditor relevant to the conduct of the audit and the preparation of the auditor's report.

776. The Working Party notes that subsection 1289(1)(a) provides that an auditor has qualified privilege in respect of any statement that he or she makes, orally or in writing, in the course of his or her duties as auditor.

Recommendation 7.16

The Law should be amended to require an auditor, or a representative of the auditor, to attend the AGM at which the auditor's report is tabled unless reasonable circumstances preclude his or her attendance.

Restriction on Fee Levels for a Particular Client

777. AUP 32 recommends that, in order to strengthen independence, fees from one audit client or a group of audit clients not exceed an appropriate limit of the gross fees of the practice, set according to individual circumstances. AUP 32 states that the auditor should consider and document the effect on independence when the total fees in the financial reporting period paid by the audit client or group of clients exceeds 15 per cent of the gross fees of the practice.

778. Small practitioners are opposed to such a recommendation becoming mandatory on the grounds of discrimination. They point out that independence is a state of mind and in view of the stringent ethical rulings of the ICAA and ASCPA relative to independence, there is no need or benefit to be obtained from greater restrictions.

779. The Working Party is of the view that the principles outlined in AUP 32 provide sound guidance. AUP 32 is not mandatory, however, and the Working Party believes that where total fees in the financial reporting period paid by the audit client or group of clients exceeds 15 per cent of the gross fees of a practice, there should be detailed consideration and documentation on the relevant audit file of the implications for independence and this document should be available for review in the normal quality review process.

Recommendation 7.17

An appropriate mandatory standard of the accounting bodies should require that where the total fees in respect of all services in a financial reporting period paid by an audit client or group of clients exceeds 15 per cent of the gross fees of the practice, there must be detailed consideration and documentation on the relevant audit file of the implications for independence and that the document is to be available for review in the normal quality review process.

Regulation or Self-regulation

780. The Working Party has received submissions which on the one hand favour the introduction of additional regulation into the Law and similar legislation to deal with proposals of the type considered by the Working Party. On the other hand there is a strong view that proposals to be adopted should, in the main, be introduced by way of ethical and technical standards of the accounting bodies.

781. The Working Party has noted the strong self-regulatory standards of the ICAA and the ASCPA and the willingness of these bodies to introduce new and strengthened regulations where appropriate. Current self-regulatory controls include:

- (a) high education entry requirements;
- (b) rigorous induction programs;
- (c) careful character checks before entry;
- (d) compulsory public practice induction program;
- (e) compulsory continuing professional development;
- (f) extensive ethical rulings and codes of ethics;
- (g) separate public practice registration;
- (h) compulsory quality review program;
- (i) compulsory professional indemnity insurance; and
- (j) detailed mandatory auditing standards and auditing pronouncements.

782. The Working Party considers that whilst it will be necessary to retain direct legislative control over certain requirements, it would be preferable to embody as much of the detail of the regulatory requirements as possible in the profession's mandatory standards and pronouncements and self regulatory framework.

Recommendation 7.18

Regulatory requirements for auditors should, to the maximum extent practicable, be embodied in the mandatory standards and pronouncements and self regulatory framework of the authorised accounting bodies.

Teaching of Professional and Business Ethics

783. The Working Party is aware that the ICAA and ASCPA have incorporated a substantial segment on professional ethics into their induction programs. It is of the view, however, that there should be greater encouragement for the inclusion of business ethics in approved tertiary courses so as to inculcate ethical principles in undergraduate education.

784. The Working Party believes that endeavours should be made through the appropriate educational channels to introduce and strengthen the teaching of ethical principles in primary and secondary schools.

785. The Working Party also believes that the accounting bodies should specifically require an adequate level of teaching of professional and business ethics as a pre-requisite to granting course accreditation to tertiary institutions for graduates entering the induction programs of the accounting bodies.

Recommendation 7.19

Endeavours should be made through the appropriate educational channels to introduce and strengthen the teaching of ethical principles in primary and secondary schools.

Recommendation 7.20

The accounting bodies should require an adequate level of teaching of professional and business ethics as a pre-requisite to granting course accreditation to tertiary institutions for graduates entering the induction programs of the accounting bodies.

